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(202) 755-4846

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INVESTMENT ADVISER REGULATION: A SUBJECT TOO LONG NEGLECTED

Address by

Hugh F. Owens
Commissioner
Securities and Exchange Commission
Washington, D. C.

Money Management Institute
Long Island University
Brookville, New York
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The Federal securities laws comprise a many-faceted regulatory pattern and result in the Securities and Exchange Commission having wide-ranging responsibilities to public investors in the nation's securities markets. Perhaps most visible are the Commission's functions in obtaining disclosures for investors in public offerings of securities and its regulation of broker-dealers, securities exchanges and investment companies. One area of the Commission's concern, namely the regulation of persons engaged in the investment advisory business, appears, however, to have remained somewhat of a stepchild. While the focus of attention over past years has been on the more visible areas I have mentioned, the fundamental Federal statute regulating investment advisers, the Investment Advisers Act of 1940, has remained virtually unaltered since its enactment, with the exception of two significant changes I shall discuss later. It appears to me that the time is long overdue for us to take a hard look at the investment advisory industry with a view to strengthening the Federal regulatory framework in which that industry operates. My opinion in this regard is not determinative, of course, since I speak here for myself alone; the other Commissioners and the Commission's staff may or may not choose to agree with me.

It would seem that a good place to begin our examination of investment advisory regulation would be to assess the importance of the industry to this country's investors. In 1940, there were approximately 700 registered advisers with about $4 billion under advisement. The Institutional Investor Study submitted by the Commission to Congress in 1971 indicates that as of December 1970 the industry has expanded dramatically to about 3,500 investment advisory firms, excluding those firms whose sole business is issuing written advisory reports. As of June 30, 1969, assets under advisement totalled $130 billion. Advisory clients accounted for in these statistics included registered and unregistered investment companies, individual and personal accounts and employee benefit plans, including state and local retirement systems. Assets of investment companies under management constituted the largest category of advisory assets at $54.7 billion or 42 percent of the total $130 billion. Personal and individual trust account assets were about 20 percent of the total, followed by employee benefit plans at 15 percent. A recent survey of investment advisers was performed by our staff to obtain updated information. The last compilation, on the basis of the 59 percent return to date, indicates that assets under management by those registered investment advisers responding totalled above $116 billion, of which approximately $52 billion or 45 percent is investment company money. The next largest categories were pension and profit sharing plans at $22 billion (19 percent) and individual accounts at $19 billion (16 percent). The staff is continuing the survey in order to obtain a 100 percent return. It is obvious from these figures that we are talking about an industry which has the responsibility of advising the direction of investment of a major portion of the public's savings.

In contrast to the substantial amounts of money for which advisers are responsible, we have a rather "bare-bones" Federal regulatory structure. The Advisers Act sets forth a requirement that persons proposing to engage in the

advisory business must first register under the Act and provide certain minimal disclosures concerning their organization, personnel and various other aspects of their business, such as the basis of compensation from clients, and an indication whether or not the adviser or any person associated with it is subject to any disqualification which would be a basis for denial, suspension or revocation of registration as an investment adviser. Certain record-keeping requirements are also imposed similar to those promulgated under the Investment Company Act. The Advisers Act also prohibits fraudulent, deceptive and manipulative acts, practices and courses of business in a provision virtually identical to Section 10(b) of the Securities Exchange Act of 1934. Rules under this provision prescribe advertising practices of advisers and the safekeeping by the advisers of clients' funds and securities. Other provisions prescribe the kinds of fees that may be charged advisory clients and delineate certain acts which may form the basis for censure of the adviser or denial, suspension or revocation of his registration.

Most notable, however, is the absence of any requirement that advisers file financial statements with the Commission and the lack of any requirement for the filing of periodic or other reports. Thus, a person proposing to engage in the advisory business may commence advising other people how to invest their funds without the Commission even knowing whether or not the organization is solvent, without any prior experience in the field and without reporting further any information concerning his business to the Commission. While, of course, some investment advisers are broker-dealers and are required to comply with Federal regulations concerning that industry, the focus of the securities laws in that area is necessarily on the brokerage function where the policy considerations differ from those in the advisory area. Similarly, advisers to investment companies registered under the Investment Company Act come under regulation in connection with certain transactions they may enter into with an investment company; but the thrust of this regulation is to assure that the investment company is not treated disadvantageously in its relationship with the adviser, rather than to assure that the investment adviser's operation itself is sound from the viewpoint of giving reliable, quality service to clients. In any event, most advisers to investment companies also have other kinds of accounts under management which are not protected by the Investment Company Act.

While most advisers who advise large, sophisticated accounts undoubtedly have personnel qualified to carry on an advisory business, many operators have scant experience in this field. I recall that when I was Securities Administrator in the State of Oklahoma individuals with absolutely no experience sometimes attempted to register under our Securities Act as investment advisers. It was clear to me that such persons were totally unqualified to tell others what to do with their money, and I refused to permit them to give investment advice to residents of the State. Pursuant to powers set forth in the Uniform Securities Act adopted by the State Legislature, our Oklahoma Securities Commission promulgated a rule which requires investment advisers to take and pass the examination administered to persons seeking to register as broker-dealers in the State. In

addition, we enacted rules which require advisers to maintain a surety bond of at least $10,000 and, by statute, required a balance sheet and other financial information concerning the adviser to be filed upon registration.

In my view, the Oklahoma regulations I have just cited are minimal requirements; yet, even these types of standards are not enacted in many states. It appears to me, therefore, that the Commission has the responsibility to the public to consider what further must be done at the Federal level to provide adequate protection for investors served by the investment advisory industry. The reforms which I envision as necessary would take place in four main areas: qualification; financial responsibility; conflicts of interest; and bonding.

In the area of qualifications, the Advisers Act now merely calls for disclosure of the background and history of certain persons associated with the adviser. There are no requirements at the present time that persons proposing to engage in the advisory business demonstrate any proficiency whatsoever regarding the advisory business or the regulations which govern advisers. This is in marked contrast to the situation in the broker-dealer industry where each person proposing to act as a principal or non-clerical employee of a broker-dealer must pass an examination administered by either the National Association of Securities Dealers or the Commission. The securities exchanges impose additional qualifications requirements upon their member broker-dealers. The New York Stock Exchange, for example, requires a six-month training program and an examination of prospective registered representatives.

This variation in regulation presents an anomalous situation. An individual in an investment adviser's research department charged with the responsibility of selecting the securities for his firm to recommend to its clients is not required to meet any qualification standards. The salesman of a broker-dealer, on the other hand, whose role may be limited to transmitting these same research recommendations to the firm's customers, must pass examinations which test, among other things, his ability to analyze securities. Furthermore, except in a few states, the proprietors of registered investment advisers who confine their activities to the giving of investment advice need not pass any examination at all though they may be responsible for supervising research activities and passing on investment advice which will go to numerous individual clients or subscribers to their publications.

It seems clear to me that the clients of investment advisers rely as heavily, or even more heavily, on the professional competence of their advisers as do the clients of broker-dealers, and that the absence of qualifications requirements for investment advisers and persons associated with them constitutes an undesirable gap in the pattern of Federal securities regulation. I believe, therefore, that the Commission should act to assure that minimal standards of competence or experience should be applied to persons responsible for developing or supervising the development of investment recommendations or transmitting these recommendations to advisory clients. It is my hope that the Commission

will act to institute an examination system for investment advisers as soon as practicable which tests knowledge of the Federal securities laws, in particular the Investment Advisers Act and rules, regulations and forms thereunder, the workings of the securities market and methods of securities evaluation analyses. It also may be desirable to require that persons seeking to engage in the investment advisory business have a certain minimum training period, such as the six-month training for registered representatives required by the New York Stock Exchange, before being qualified to engage in the advisory business. Other requirements might be a minimum number of years experience in a position related to securities or financial analysis, or perhaps a degree in a field related to the securities or financial industries. The latter requirements would go farther than the Commission has gone in the broker-dealer industry and, therefore, would require a good deal of thought by the Commission and its staff, as well as consideration of the reactions to this idea of affected persons and the public at large. We might also consider the formulation of a "prospectus type" document to be given prospective advisory clients informing them of the qualifications of personnel in the advisory firm and the financial condition of the firm. The goals that I envision being achieved by instituting an examination and other minimal qualifications standards would be a general improvement in the quality of advisory services and, flowing from this in turn, more informed investment decisions in the allocation of public capital. Information transmitted to potential clients about the advisory firm and its personnel would provide them with valuable assistance in determining which adviser to select to manage their assets.

Another problem too long neglected in connection with investment advisers concerns the financial responsibility of these firms. At present, there are no minimum initial capital requirements for advisory firms, no provisions requiring continuing financial responsibility and no requirements for reporting financial information to the Commission. The absence of any controls in this area is very disturbing to me.

Over the past few years, the Commission has become acutely aware of the severe adverse consequences for clients of investment advisers who encounter financial difficulties. Our exposure to these problems comes primarily in the area of investment company relationships with their advisers. As you know, many states require that investment advisers reimburse investment company clients if the investment company's expenses exceed specified percentages of net assets. In addition, pursuant to performance fee provisions in advisory contracts, many advisers have promised to repay portions of the advisory fee paid by the investment company clients if the fund's performance did not exceed certain designated levels. In processing various materials filed with the Commission by investment companies, our staff began to discover that the obligations owed by a number of advisers to their investment company clients were not being paid because these advisory organizations were in precarious financial condition. In certain situations where the advisory organization was affiliated with a broker-dealer, usually as a wholly-owned subsidiary of the broker, the adverse conditions prevailing in the brokerage business had direct impacts on the advisory subsidiary's ability to perform. Where these broker-dealers were forced into

liquidation to protect the assets of brokerage customers with the firm, the investment adviser subsidiary was dragged down with the broker, leaving the investment company and other advisory clients with claims in liquidation against the broker-dealer for securities and funds owed and without investment counsel.

Aside from the failure of advisers to repay their contractual financial obligations to advisory clients, it is clear to me that the sudden interruption of an advisory service is in and of itself a traumatic event, possibly having adverse consequences for all the accounts under their advisement. While in some cases investment companies which have suddenly lost their adviser have been able to secure new management or to "internalize" the management function, this is normally done with great difficulty and ofttimes has exposed the fund's portfolio to inexperienced management. Moreover, whereas investment companies and institutional advisory clients have had the protection of directors or trustees whose fiduciary obligations required them to assure the continuance of advisory services for a fund's portfolio, individual clients frequently have not had the capability to cope with the abrupt interruption of advisory services.

The Commission and the Congress have already accomplished some improvement in at least one of these areas. As part of the Investment Company Amendments Act of 1970, many advisers to registered investment companies which were not previously required to register are now required to register under the Investment Advisers Act. One result of requiring advisers to registered investment companies to register under the Advisers Act is that performance fee contracts between registered advisers and registered investment companies must meet the revised standards governing such contracts under that Act. Performance fee arrangements must be tied to an appropriate index of securities prices and must reflect proportionate fee arrangements; that is to say, the fees must go down for adverse performance as much as they go up for favorable performance. More relevant to my discussion here, however, is that the Commission has interpreted the statute to require that interim payments of the performance fee may not be made since this may result in payment of a disproportionate fee. The effect of this interpretation is that an advisory client pays only the minimum fee under the performance fee contract during the computation period in order to eliminate the possibility of the adviser owing a refund on previously collected fees to the advisory client at the end of the period because of adverse performance. Although this approach eliminates one possible obligation the adviser may incur to its client, it appears to me that additional reforms are necessary to solve the more basic problem of assuring that investment advisers have sufficient financial capability to maintain properly the advisory function once they have assumed that responsibility.

I believe that we should explore the development of financial responsibility rules for investment advisers. One measure of the adviser's ability to meet current obligations is the working capital ratio; that is,

current assets divided by current liabilities. It seems to me that a rule which would require them to retain current assets at a minimum specified ratio above current liabilities would go a long way toward assuring their sound current financial condition without being an overwhelming restriction on the use of assets. Current assets could include cash, cash items, the value of securities for which there is a current public market and receivables from customers which are collected on a timely basis. Current liabilities could be defined as those obligations expected to be liquidated within one year.

In addition to a specified working capital ratio, I believe we should consider a minimum net capital requirement for advisers analogous to the net capital restrictions presently applicable to members of the brokerage industry. Such a rule could require a minimum dollar amount of capital and could also require that the amount of net capital increase from this point in accordance with a ratio tied to the amount of net assets under advisement.

Of course, the effectiveness of any financial responsibility rules is heavily dependent upon an independent monitoring system to assure compliance. To fulfill this requirement we could require financial statements of each adviser managing accounts to be filed upon registration and then to be updated periodically. Further, advisers could be required to report to the Commission on a timely basis any material change in their financial condition or any event which might have a significant impact on their financial condition. Although such reforms may sound far-reaching, I believe that they merely embody the kinds of requirements which advisers should routinely observe as a simple matter of good business policy.

A further concern I have relates to the potential conflicts of interest which would appear to be inherent in the operation of investment advisers. There are three specific areas where such conflicts can occur: (1) the allocation of securities and investment opportunities between various accounts under management; (2) the placing of transactions in advisory accounts with persons affiliated with the adviser; and (3) trading by the adviser and affiliated persons for their own accounts. Although the Institutional Investor Study examined some of these areas, it is evident that the Commission has very scant data concerning them.

In examining the manner in which securities are allocated among various accounts, for example, the Study found that some advisers had no allocation policy, some allocated economically attractive securities proportionately among accounts, others rotated such opportunities among accounts or divided them equally, and still others developed preferential policies. It appears that we need additional disclosures from advisers here to determine whether all accounts under management are fairly treated by an adviser relative to each other and also as compared with the adviser's own account.

In addition, I think we need more information from advisers in connection with the placement of portfolio transactions with broker-dealers affiliated with investment advisers. It is clear that these transactions provide the broker-dealer with a significant source of brokerage revenue, and the potential exists that transactions may be placed with the affiliated broker for his benefit rather than solely for the benefit of the advisory clients. The potential for possible churning of the client's account, of course, is always present where an affiliated broker-dealer is in the picture, especially when that broker may be having financial difficulties. Fuller disclosure of the brokerage transactions between advisory clients' accounts and affiliated broker-dealers is essential to the Commission's role of assuring a fair and honest market place for the investing public. This area of concern is of special current interest in view of its interrelationship with the advent of negotiated rates on institutional size trades and the Commission's instructions to the exchanges regarding the necessity for members to do a predominantly public business instead of simply existing to serve their institutional affiliates.

A third example of potential conflicts of interest, where we have insufficient information, concerns transactions where the adviser or persons associated with him may have an interest in securities as to which investment recommendations are made to advisory clients. A rule presently exists under the Advisers Act which requires the adviser to keep a record of any transaction in which the adviser or an advisory representative has or obtains a beneficial interest. Transactions where the adviser acts as principal in purchasing securities from or selling them to an advisory client other than an investment company are not required to be reported, however, although the adviser is obligated to inform the client that he is acting as principal in the transaction and obtain his consent. In view of the potential for abuse in these kinds of transactions, it appears that the Commission should be informed periodically about them in order to assure that the advisory client has been treated fairly in the deal. Where an adviser wishes to engage in such a transaction with a registered investment company which it advises, a far more stringent standard applies even now. Under Sections 17(a) and (b) of the Investment Company Act of 1940, no purchase or sale of this type is permitted until the Commission has determined that its terms are fair and reasonable and do not involve overreaching, and that it is consistent with the policy of the investment company covered and the purposes of the Act. Furthermore, the 1970 Amendments added new Section 17(j) to the Investment Company Act, dealing with trading by affiliated persons of an investment company in securities which the investment company holds or contemplates purchasing. That new section gives the Commission power to adopt rules to prohibit certain types of insider trading by these affiliates which the Commission defines and prescribes as fraudulent, deceptive and manipulative. In addition, the Commission is empowered to develop and require adoption of codes of ethics in this area applicable to affiliated persons of investment companies. Our staff is presently in the process of formulating the rules and regulations necessary to implement this much needed additional protection for shareholders of registered investment companies.

Another potential area for reform involves the bonding of investment advisers. Although some states presently require a bond to protect advisory clients from loss as a result of defalcation or misplacement of their assets held by the adviser, there are no such requirements under Federal law. While the Federal securities laws do require that clients' funds be held in separate bank accounts and clients' securities in segregation, the problems which recently plagued the brokerage industry in connection with unsafe handling of customers' funds and securities provide extensive recent evidence that these protections are not enough. Even in the presence of segregation and other safekeeping requirements, mistakes and unsafe procedures still occur which may be to the detriment of the public investor unless bonding is required.

In my view, the time has long since passed when we can ignore the growth and importance of the investment advisory industry. Indeed, the recent reorganization of the Commission's staff reflects recognition of the importance and historical relative inattention to this industry. Specifically, along the lines recommended by the Wells' Committee Report, the Commission has consolidated the regulation and inspection of investment advisers and investment companies in the new Division of Investment Company Regulation. The focus of that Division's attention will be on the problems raised in the business of money management, viewing the investment company as only one type of advisory client of the investment adviser. Thus, regulatory emphasis will be placed on the advisory function and the business operation of the investment adviser, while at the same time retaining the Commission's traditional concern and vigorous administration of the regulatory program regarding registered investment companies. As part of its responsibilities, the new Division will direct and coordinate an expanded inspection program for investment advisers and registered investment companies in order to quickly discern immediate and potential regulatory problems and formulate the necessary regulatory responses to such problems. Hopefully, this expanded and integrated effort in regulating the investment adviser and investment company industries will result in the Commission being in an anticipatory rather than reactionary posture in dealing with developing regulatory problems.

As the public increasingly turns to investment advisers to manage their savings, it becomes more critical that the quality, stability and fairness of that management service meet the needs of the public interest. Although the implementation of some of the specific changes set forth in my discussion today may require additional legislation, I believe that each of these suggestions falls within the general framework, philosophy and goals which Congress established in the Federal securities statutes. It is, therefore, my firm view that the Commission has the responsibility now to examine closely the existing pattern of Federal regulation over the investment advisory industry and institute the required reforms where it has the power to do so and seek legislative action where it does not.