

MEMO# 3741

May 1, 1992

STAFF DISCUSSION DRAFT OF HOUSE BILL ON INVESTMENT ADVISER REGULATION

- 1 - May 1, 1992 TO: INVESTMENT ADVISERS COMMITTEE NO. 19-92 RE: STAFF DISCUSSION
DRAFT OF HOUSE BILL ON INVESTMENT ADVISER REGULATION

Attached is a copy of a staff discussion draft of the House bill on investment adviser regulation and a section-by-section analysis. Set forth below is a brief description of the significant provisions of the draft.

Annual Fees The draft bill adds a new provision to the Advisers Act to require annual fees based on assets under management determined pursuant to a schedule ranging from \$300 to \$7,000. These fees will be used to cover the costs of increased inspections of registered investment advisers and investigations of persons required to register under the Act.

Inspections and Investigations The draft bill requires the SEC to inspect newly registered advisers within one year of becoming registered with the SEC. In addition, the SEC is required to establish a schedule for the regular inspection of advisers. This schedule would have to be revised periodically to take into account changes of factors that increase the need for inspections, such as custody of funds and authority to exercise investment discretion. The bill also directs the SEC to survey, at least once every 3 years, the extent of, and reasons for, the failure of persons to register under the Act.

Coverage of Statute The draft bill requires the SEC to develop rules to interpret the exclusions available for certain professionals and broker-dealers from the definition of "investment adviser" whose advisory services are rendered solely incidental to the conduct - 2 - of his or her business. The SEC is required to consult with state securities commissions in developing these rules. In addition, the SEC is required to establish standards for applying certain factors in reaching a determination as to whether such a professional is, in fact, eligible for the exclusion. Those factors include: whether the person holds himself out as an "investment adviser", "financial planner", or similar term; whether the person receives compensation for providing advisory services on a basis different than the person is compensated for other professional services; and whether the advisory services are related to the person's other professional activities.

Suitability and Other Obligations The draft bill includes a suitability requirement under which an adviser must obtain from the client information concerning the client's financial situation, investment experience, and investment objectives before determining whether the advice to be provided is suitable for the client. The draft bill also includes a recordkeeping requirement in connection with the records obtained from the client under this provision. The draft bill prohibits an adviser from: (1) providing a report or analyses to a client that is purported to be prepared individually for that client but that is prepared by someone other than the adviser, or person associated with the adviser, without disclosing that fact; and (2) guaranteeing that a specific result will be achieved as a result of the

investment advisory services. In addition, an adviser would be required to disclose to a client at the time the client enters into a contract for services that the client has the right to obtain an estimate of the prospective client's cost for such services. The SEC will, by rulemaking, specify how such estimate should be arrived at and presented. Additional Disclosure Requirements The SEC is directed to adopt rules requiring written disclosure to clients or prospective clients about certain specified items such as, but not limited to: (1) the background and qualifications of the investment adviser or any employee of the investment adviser who provides or is expected to provide services to the client; (2) the nature of the services being offered; and (3) the fees to be charged for such services, and any commissions to be earned in connection with purchases and sales recommended by the adviser. Rules are also required relating to written disclosure that must be provided before the client enters into a contract for advisory services of any material conflict of interest including - 3 - certain specified compensation arrangements and relationships that the adviser may have with the issuer of a security that is being recommended. In addition, the SEC's rules must require an adviser to provide certain written disclosure at the time advice is rendered of specific compensation amounts, including gifts and other noncash incentives, to be earned by the registered person or any of its employees or affiliates. Private Remedies The draft bill would establish an express private right of action against advisers who engage in certain fraudulent conduct. This section of the draft bill also provides for joint and several liability for controlling persons of persons liable under this new section, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action. The statute of limitations for purposes of this section would be 5 years after the violation on which the action is based, or 3 years after discovery of the facts constituting the violation or cause of action. Bond Requirement The draft bill authorizes the SEC to require certain investment advisers, such as advisers with custody of client funds or securities or that have discretionary authority to direct client investments, to obtain a fidelity bond. Confidentiality The Advisers Act would be amended to make it unlawful for any investment adviser to disclose the identity, financial affairs, or investments of any client unless the adviser is required to do so by law or unless the client consents to such disclosure. Federal-State Coordination The draft bill establishes the policy objective of greater federal and state coordination in the regulation of investment advisers in order to achieve the greatest effectiveness of regulation, inspection, and enforcement, and the greatest uniformity in federal and state regulatory standards. * * * - 4 - We have been asked by Congressman Edward J. Markey, Chairman of the House Telecommunications and Finance Subcommittee, and Congressman Rick Boucher to provide their staff with comments on the draft bill by May 13. Therefore, please provide me with your views on the discussion draft by Thursday, May 7, at the latest. I am particularly interested in your views on the proposed private right of action. My direct number is 202/955-3523. Amy B.R. Lancellotta Associate General Counsel Attachment