DRAFT 09/12/94 8:22am

ACTION MEMORANDUM

September , 1994

TO:	The Commission.
FROM:	Division of Investment Management.
SUBJECT:	Investment Adviser Conflicts of Interest.
RECOMMENDATION:	That the Commission issue a concept release attached as Exhibit A requesting comment on alternative approaches to addressing conflicts of interest faced by advisers who receive transaction-based compensation.
ACTION REQUESTED BY:	Routine Calendar Consideration.
TENTATIVE SUNSHINE ACT STATUS:	Open Meeting.
OTHER DIVISIONS AND OFFICES CONSULTED:	Division Of Market Regulation ( ) Office of General Counsel ( ) Office of Legislative Affairs ( ) Office of the Chief Economist ( )
REGULATORY FLEXIBILITY ACT STATUS:	Not Applicable.
PAPERWORK REDUCTION ACT STATUS:	Not Applicable.
PRIOR COMMISSION ACTION:	None.
PERSONS TO CONTACT:	Robert E. Plaze 942-0721 Kenneth J. Berman 942-0721 Karen J. Garnett 942-0728

I. Executive Summary

Over half of the 21,800 investment advisers registered with the Commission are financial planners.[1] Financial planners typically do not manage money, but rather prepare financial strategies for their clients which may include advice about securities, insurance, real estate, estate planning, and other personal financial matters. A financial planner may or may not assist in the implementation of the financial plan. Some financial planners receive

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[1] Of the 21,848 advisers currently registered with the Commission, 11,648 report in their Form ADV that they offer financial planning services.

compensation only in the form of fees charged to clients for preparation of financial plans. Most financial planners, however, are compensated at least to some extent on the basis of commissions or other payments received from selling products to clients in the implementation phase of financial planning.

Financial planners who receive commissions on securities sold to clients often face serious conflicts of interest in dealing with those clients. These planners have an incentive to recommend products based on the commissions they will receive rather than the needs of their clients. This bias can have significant consequences to clients who depend upon financial planners for unbiased advice for retirement and other types of financial planning. The Division recommends the Commission issue a concept release requesting comment on approaches to addressing these conflicts of interest.

II. Background

Both Houses of Congress have approved legislation that would amend the Investment Advisers Act of 1940 ("Act") to require registered investment advisers to pay annual fees, the proceeds of which would fund an enhanced investment adviser inspection program.[2] The House bill, however, contains a number of provisions not in the Senate bill. We understand that many of the additional provisions in the House bill are unacceptable to the Senate and could lead to an impasse between the two houses.[3]

On January 24, 1994, Chairman Levitt sent members of the House Energy and Commerce Committee and the Senate Banking Committee a letter in which he stated that the Commission would develop rules to address four matters in the House bill.[4] The Commission addressed two of these matters in March when it proposed two new rules that would prohibit advisers from providing unsuitable investment advice and would prohibit certain custody practices.[5] A third matter concerns amendments to Form ADV to improve the brochure advisers are required to provide clients. The Division has been working for some time with the North American Securities Administrators Association ("NASAA") to improve the quality of adviser brochures. The substantial revisions to Form ADV that are contemplated by the Division and NASAA would require the more than 21,000 investment advisers now registered with the Commission under the Advisers Act to file new registration

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[2] On May 4, 1993, the House of Representatives passed H.R. 578, the Investment Adviser Regulatory Enhancement and Disclosure Act of 1993; on November 20, 1993, the Senate passed S. 423, the Investment Adviser Oversight Act of 1993. An outline describing the background and provisions of the legislation is attached as Exhibit B.

[3] At the end of the last Congress, House and Senate staff members held a staff-level conference on predecessor bills to H.R. 578 and S. 423, but were unable to resolve similar differences between the bills.

[4] A copy of this letter, as sent to John D. Dingell, Chairman of the House Energy and Commerce Committee, is attached as Exhibit C.

[5] Investment Advisers Act Rel. No. 1406 (Mar. 16, 1994). The Division expects to make a recommendation with respect to these proposals later this year.

forms (which would include the brochure). Such an endeavor could be completed more expeditiously and efficiently by the Division and the states, and would be much less burdensome for investment advisers, if undertaken after the creation of a computerized one-stop filing system contemplated by the pending legislation. The National Association of Securities Dealers ("NASD") is currently developing such a system, which is expected to be operational in 1996. The relevant members of Congress understand that this matter will not be undertaken until Congress has acted on the pending legislation.

The Division is today addressing the final matter identified in Chairman Levitt's letter by recommending that the Commission issue a concept release requesting comment on possible regulatory approaches to dealing with the conflicts of interest advisers who receive transaction-based compensation have with their clients. Our recommendations, however, are not based solely on the importance of furthering the pending legislation. We believe that the issues raised in this release go to the heart of the notion of an adviser as a fiduciary and raise many of the same questions Chairman Levitt and members of the Commission have expressed with regard to broker compensation.

III. Discussion

In 1988, the Division of Investment Management prepared a study on financial planners that was submitted to the House Subcommittee on Telecommunications and Finance.[6] Among the many findings of the study was that most financial planners receive most or all of their compensation in the form of commissions on products they sell to clients who tend to be individuals rather than institutions.[7] This practice raises concerns because the financial planner has an incentive to recommend products based on the commissions it will receive rather than the needs of clients. Financial planners may be biased towards investment products with higher commissions, which tend to be riskier and less liquid.[8]

Commission rules under the Act require all registered advisers to disclose the practice of receiving transaction-based compensation in the brochure that advisers must deliver to clients before the commencement of the advisory relationship.[9] The Division believes that the current required disclosure may not be sufficient to permit clients to understand the nature of the conflicts and to protect themselves from overreaching by financial planners. Given the growing complexities of financial products and the wide array of alternatives, many clients are not likely to be in a position to second-guess the recommendations of their planners.

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6 "Financial Planners: Report of the Staff of the United States Securities and Exchange Commission to the House Committee on Energy and Commerce's Subcommittee on Telecommunications and Finance," (Feb. 1988) (hereinafter "Financial Planner Study").

7 *Id.* at 18, 59.

8 One of the most startling findings of the Financial Planner Study was that 81% of financial planners recommended and sold real estate limited partnership interests to their clients, while 62% sold other types of limited partnership interests. *Id.* at 67.

9 Rule 204-3 [17 CFR 275.204-3].

The Division is also concerned that some financial planners may be more involved in selling products than sound financial plans. A large number of planners are independently operated and registered as investment advisers, but also act as registered representatives of broker-dealers. These advisers assert that their role as registered representatives is incidental to their financial planning activities and is undertaken solely to implement their clients' financial plans. That is, they claim to be financial planners first and brokers second. We suspect some use the title financial planner as a way of gaining the trust of clients and reducing the normal client resistance to persons whose primary interest is selling securities.

The House Committee report on H.R. 578 characterized the practice of advisers receiving transaction-based compensation as "[o]ne of the most serious and frequent conflicts of interest that advisers have with clients."[10] The House bill attempts to address these conflicts of interest by requiring additional disclosure to clients about the amount of transaction-based compensation their advisers receive.[11] The bill would require advisers to provide clients with oral pre-transaction disclosure of the amount of the transaction-based compensation expected to be received followed by a written confirmation of the actual amounts after the transaction. In addition, advisers would be required to provide their clients with quarterly reports on the aggregate amount of the compensation they have received.

Although seemingly unobjectionable, these disclosure requirements have created a great deal of controversy. Industry participants have claimed that they are overly burdensome, anti-competitive and would be ineffective at achieving their goals. Each of these criticisms has some merit, but it is difficult for the Division to evaluate them because there has been no public vetting of the sort that would follow a public rulemaking proposal.[12] Therefore, the Division believes that it would be very useful to issue a concept release asking questions on the legislative proposals as well as several other possible approaches.

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10 H.R. Rep. No. 75, 103d Cong., 1st Sess. at 19 (hereinafter "House Report").

11 Section 6 of H.R. 578. The House sees the problem as clients having insufficient information about the "nature and magnitude" of the conflict of interest. House Report, *supra* note 12, at 44.

12 Industry participants have objected to the transaction disclosure requirements because of the amount of paper flow to clients that would be required. Objections appeared to wane after a provision was added to the bill that would permit clients to waive disclosure. The Division assumes that if the transaction report provisions were enacted most advisory contracts would be written to include the waiver. Thus, the transaction report provision likely would be ineffective. Industry participants also have objected strenuously to the provision requiring periodic client reports. Financial planners, particularly, have argued that fees received from many product suppliers are not attributable to particular clients, and that attribution of, for example, bonus payments would be difficult. Others have argued that the provisions would require extensive reprogramming of computer systems so that receipt of commissions on sales by affiliates could be captured and aggregated.

The attached draft release requests comment on six alternative approaches ranging from a prohibition on advisers receiving transaction-based compensation (or directing trades through affiliated brokers) to improved brochure disclosure about conflicts of interest. The draft release invites commenters to submit other approaches. We believe that publication of the release will initiate a lively debate on the fiduciary obligations of advisers under the Act and what kind of disclosure may be necessary to reconcile those obligations with advisers' receipt of transaction-based compensation. We hope that the comments will provide a basis for us to make specific recommendations.

IV. Conclusion

For the reasons discussed above and in the attached draft release, we recommend that the Commission issue a release requesting comments on alternative approaches to addressing the conflicts of interest faced by advisers who receive transaction-based compensation.

Attachments

A. Draft Release.

B. Outline of Pending Legislation.

C. January 24, 1994 letter from Chairman Levitt to members of the House Committee on Energy and Commerce and the Senate Committee on Banking, Housing, and Urban Affairs (as sent to John D. Dingell, Chairman of the House Energy and Commerce Committee).

DRAFT 09/12/94 8:20am

SECURITIES AND EXCHANGE COMMISSION

Release No. IA-

RIN

Request for Comments on Possible Regulatory Approaches to Addressing the Conflicts of Interest Faced by Investment Advisers that Sell Recommended Securities to Clients

AGENCY: Securities and Exchange Commission.

ACTION: Request for Comments.

SUMMARY: The Commission is requesting comments on possible regulatory approaches to addressing the conflicts of interest faced by investment advisers that sell recommended securities and other investment products to clients.

DATES: Comments must be received on or before [approximately 90 days after publication in the Federal Register].

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, N.W., Washington, D.C. 20549. All comment letters should refer to File No. S7- -94. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 5th Street, N.W., Washington, D.C. 20549.

FOR FURTHER INFORMATION CONTACT: Karen J. Garnett, Attorney, or Robert E. Plaze, Assistant Director, (202) 942-0721, Office of Disclosure and Adviser Regulation, Division of Investment Management, 450 5th Street, N.W., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: Investment advisers that are compensated by commissions or other transaction-based fees in connection with the sale of securities or other investment products to clients face substantial conflicts of interest with their clients. For example, an adviser receiving transaction-based compensation has an incentive to recommend securities based on the amount of compensation the adviser will receive rather than the client's needs. Because of these conflicts, the Investment Advisers Act of 1940 [15

USC 80b-1 *et seq.*] (the "Act") requires an adviser that accepts transaction-based compensation to disclose this practice to its clients. An adviser will typically make this disclosure in its brochure, which the adviser must deliver to clients before commencement of the advisory relationship. The Commission is seeking comment on whether the current regulatory requirements under the Act adequately protect investors from these conflicts of interest, whether the Commission should require additional disclosure, or whether the Commission should adopt an entirely different approach.

I. Background

1. Changes in the Advisory Industry Since 1940

The investment advisory business has changed substantially since Congress passed the Act in 1940. At that time most advisers managed the securities portfolios of institutions or wealthy individuals and were compensated on the basis of a percentage of assets under management.[1] Since 1940, the investment advisory industry has grown tremendously, evolved and segmented. Over the thirteen years between 1981 and 1994, the number of advisers registered with the Commission increased from 5,100 to approximately 21,800, an increase of over 327 percent. Assets managed by advisers rose from $450 billion to more than $9 trillion, an increase of more than 1,900 percent.

As discussed in the Commission's 1988 Staff Report on Financial Planners, a large part of the growth in registered investment advisers since the 1970s is attributable to the growth in the number of financial planners,[2] which now represent over half of all advisers

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1 *See* SEC, Investment Trusts and Investment Companies, Supplemental Report: Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services, at 5, 16, and 25 (Aug. 17, 1939) (hereinafter "Investment Counsel Report").

2 "Financial Planners: Report of the Staff of the United States Securities and Exchange Commission to the House Committee on Energy and Commerce's Subcommittee on Telecommunications and Finance," at 6-7 (Feb. 1988) (hereinafter "Financial Planners Report").

registered with the Commission.[3] Financial planners typically provide services to individuals rather than institutions and do not manage client assets.[4] Planners prepare financial strategies for their clients, which may include advice about securities (including securities offered by mutual funds), insurance, real estate, estate planning, and other personal financial matters. Having prepared the financial strategy, a planner may or may not assist in its implementation.

The financial planning industry is segmented into two groups, each of which is characterized by its form of compensation. Members of a relatively small but growing group of planners are compensated only from fees received from clients for preparation of financial plans ("fee-only financial planners").[5] Most financial planners, however, are compensated at least to some extent on the basis of commissions (or other payments) received from selling products to clients in the implementation phase of financial planning.[6] These planners are typically affiliated with brokerage or insurance companies.[7]

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[3] Of the 21,848 advisers currently registered with the Commission, 11,648 report in their Form ADV that they offer financial planning services.

[4] Financial Planners Report, *supra* note ___, at 18, 58.

[5] Among the ___ financial planners registered with the Commission as investment advisers, ___ percent report that they receive compensation based only on fees from clients. *See* Simonoff, *If You Can't Beat 'Em, Join 'Em,* Financial Planning (Jun. 1994) at 118-22 (describing growing practice of advisers giving up their broker-dealer registrations and operating as a fee-only advisers using discount brokers to effect client transaction and provide back-office services).

[6] ____ percent of financial planners registered as investment advisers report that they receive compensation in the form of commissions. An adviser that receives sales commissions or other fees charged in connection with the purchase or sale of securities on behalf of its clients generally would be required to register and be regulated as a broker-dealer under the Securities Exchange Act [15 USC 78a *et seq.* *See*, *e.g.*, Fundamental Advisers, Inc. (pub avail. Dec. 4, 1971).

[7] _____ percent of financial planners registered as investment advisers report that they are or are affiliated with brokerage or insurance companies.

Financial planners are not the only advisers compensated from the sale of products to clients. It is not uncommon for money managers to be affiliated with brokerage firms that execute at least some client brokerage. Some money managers, in fact, require clients to direct all brokerage to an affiliated broker. Although these brokerage firms may be separately incorporated and considered separate profit centers by their owners, these arrangements may raise issues and concerns similar to a single firm acting as adviser and broker.

Some financial planners operate as registered representatives of broker-dealers and are independently registered as investment advisers.[8] Frequently, the prime or sole source of compensation of these firms is commissions generated from the sale of securities and other investment products. The Commission is concerned that the primary purpose of the firms involved in these arrangements and similar ones is to sell investment products rather than provide unbiased financial planning advice.[9] The use of the term "financial planner" by these firms may cause clients to lower the skepticism with which they may otherwise deal with persons they know to be salespersons.[10]

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[8] In 1988, the Commission staff estimated that 73 percent of financial planners were either dually registered as advisers and broker-dealers or were registered representatives of broker-dealers. Financial Planner Study, *supra* note ___, at 54.

[9] The Commission has stated that a broker-dealer or registered representative who employs the term "financial planner" merely as a device to induce the sale of securities might violate the anti-fraud provisions of the Securities Act of 1933 [15 USC 77a *et seq.*] and the Securities Exchange Act of 1934. *In the Matter of Haight & Co., Inc.*, Securities Exchange Act Rel. No. 9082 (Feb. 19, 1971)[FR ( )].

[10] Consumer Federation of America, "Financial Planning Abuses: A Growing Problem," 40 (July 1987) ("In the minds of consumers, the promise of comprehensive, objective advice is what sets financial planners apart from other financial product salesmen."); *SEC Roundtable on Investment Advisers and Financial Planners (May 7, 1986)*(statement of John F. Gogan, Jr.) at 45 (unpublished transcript of proceedings) ("Sometimes a financial planner is wrapped up in a mantle of objectivity which is not there because they have affiliated relationships . . . ."). *Financial Planners: What Are They Really Selling?*, Consumer Reports, Jan. 1986,

(continued...)

2. Current Regulatory Framework

The Act regulates the activities of persons and firms that, for compensation, engage in the business of advising others about the value of securities or as to the advisability of investing in, purchasing, or selling securities.[11] Section 206(3) of the Act [15 USC 80b-6(3)][12] acknowledges that advisers sell securities to clients and addresses the practice by prohibiting advisers from effecting (1) principal transactions,[13] or (2) agency cross-transactions with clients,[14] unless the adviser notifies the client in writing before each

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[10](...continued)
at 51A (Most planners have "hidden agendas--to sell mutual funds, for example, or life insurance, or tax preparation services."); *Financial Services Industry, Hearings on H.R. 3054, H.R. 4441 and H.R. 5777 Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 101st Cong., 2nd Sess. 1990 (statement of the American Institute of Certified Public Accountants) ("Self-dealing [among financial planners] has become widespread because the public apparently believes a 'financial planner' to be objective and, therefore, less sales-oriented than a . . . broker. Consequently the public is likely to trust the recommendations of a 'financial planner.'") *See also*, *Few Financial Advisers Qualify as Unbiased*, N.Y. Times, Mar. 13, 1993, at 33, col. 1.

[11] Section 202(a)(11) of the Act [15 USC 80b-202(a)(11)]. The statutory definition of investment adviser covers most financial planners. *See* Investment Advisers Act Rel. No. 1092 (Oct. 8, 1987) [52 FR 38400 (Oct. 16, 1987)].

[12] Section 206(3) of the Act makes it unlawful for an adviser,

> acting as principal for his own account, knowingly to sell any security or to purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.

[13] In a principal transaction an adviser sells a client a security from its own account or buys a security from a client for its own account. Rule 206(3)-1 [17 CFR 275.206(3)-1] exempts registered advisers who are broker-dealers from the prohibition on principal transactions under certain circumstances.

[14] An agency cross-transaction is a transaction in which a person acts as adviser in relation to a transaction in which the adviser, or an affiliate, acts as broker for both the advisory client and the other side. Rule 206(3)-2 under the Act [17 CFR 275.206(3)-2] permits advisers to effect agency cross-transactions without obtaining client consent before each transaction under certain conditions.

transaction of the capacity in which the adviser is acting and obtains the client's consent for the transaction.[15] Other, far more common types of sales or purchases to or from clients are addressed only under the Act's general anti-fraud provisions, which require advisers to disclose conflicts of interest they have with their clients, and the rules specifying the content of adviser brochures.[16]

The Supreme Court has interpreted Section 206[17], the Act's anti-fraud provision, as imposing a duty on advisers to disclose conflicts of interest to their clients. The Court articulated this duty in *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*[18], stating:

> The Investment Advisers Act of 1940 thus reflects a congressional recognition "of the delicate fiduciary nature of an investment advisory relationship," as well as a congressional intent to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser - consciously or unconsciously - to render advice which was not disinterested.[19]

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15 Section 206(3) does not apply to "any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction."

16 Sections 206(1) and (2) [15 USC 80b-6(1) and (2)]; Rule 204-3 [17 CFR 275.204-3].

17 15 USC 80b-6.

18 375 U.S. 180 (1963).

19 *Id.* at 191-192 (quoting 2 Loss, Securities Regulation (2d ed. 1961), 1412). The Act itself does not create a fiduciary relationship, but rather a fiduciary duty is incorporated into the anti-fraud provisions of the Act by operation of law because of the nature of the relationship between the adviser and the client. *See*, *In re Arleen W. Hughes*, 27 SEC 629, 635 (Feb. 18, 1948) *aff'd sub nom.*, *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949). In contrast, Section 36(b) of the Investment Company Act of 1940 [15 USC 80a-35(b)] imposes a fiduciary duty on an investment adviser to an investment company with respect to the adviser's compensation. Similarly, Section 404 of the Employee Retirement Income Security Act of 1974 [29 USC 1104] requires plan "fiduciaries" to discharge their duties solely in the interest of plan participants and beneficiaries. Investment advisers which advise such plans are considered "fiduciaries" under ERISA and are therefore subject to this statutory fiduciary duty in addition to their duties under the Act.

In recognition of this principle, the Commission has stated that advisers must fully disclose to clients compensation arrangements that involve conflicts of interest,[20] and has brought enforcement proceedings against advisers who have failed to disclose conflicts with regard to their compensation.[21]

The Commission's rules require registered advisers to provide their clients with Part II of Form ADV (the registration form for advisers to register under the Act) or a written document containing at least the information required by Part II of Form ADV.[22] Item 1.C. of Part II asks whether the adviser offers investment advisory services for commissions, and Item 9.B. asks whether the adviser or a related person effects securities transactions as a broker or agent (for compensation) for any client. Advisers responding in the affirmative to questions in Item 9 must describe on Schedule F to Form ADV any restrictions, internal procedures, or disclosures they use for conflicts of interest in those transactions.

II. Nature of the Conflict and its Effect on Advisory Clients

An adviser receiving transaction-based compensation has an incentive to recommend securities based on the amount of compensation the adviser will receive rather than the client's investment needs. In some cases, this conflict may result in clients making clearly

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21 *E.g.*, *In re Carona & Hodges Management, Inc. and James G. Carona,* Investment Advisers Act Rel. No. 1403 (Feb. 8, 1994)(adviser invested client funds in risky, developmental-stage companies without disclosing conflicts of interest, including the receipt of undisclosed loan fees from the companies for investing client funds in those companies); *In re Westmark Financial Services Corp.*, Investment Advisers Act Rel. No. 1117 (May 17, 1988)(adviser and principal failed to state that they would receive commissions for the sale of certain securities they recommended to clients); and *In re John S. Lalonde*, Investment Advisers Act Rel. No. 1103 (Jan. 25, 1988) (adviser failed to disclose commissions received on sales of limited partnership).

22 Rule 204-3 [17 CFR 275.204-3]. Hereafter, the term "brochure" will be used to describe either Part II or the alternative written document permitted by rule 204-3.

unsuitable investments that cause substantial losses.[23] This conflict may also harm clients in more subtle ways. For example, where there is a range of similar investments suitable for clients, an adviser may recommend the investment product with the highest transaction costs or products sponsored by the adviser or a related person because they will generate the greatest commissions for the adviser.[24] For similar reasons, an adviser may recommend a limited partnership rather than a mutual fund, a whole life insurance policy rather that a term policy, or a new offering of a closed-end investment company rather than an existing closed-end company.[25] In each of these cases, plausible arguments can be made as to why the product recommended was better than the ones not recommended. Most individuals, however, do not have sufficient information to evaluate the extent to which such commissions affect advisers' recommendations.[26]

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[23] *In re Westmark Financial Services Corp., supra,* note __; *Investment Adviser Industry Reform, Hearings on H.R. 578 Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce,* 103d Cong., 1st Sess. (1993) (statements of Lee S. Mayfield and Thomas J. and Midge Bailey, investors).

[24] Pauly, *Have I Got a Deal For You,* Newsweek, Feb. 17, 1986, at 51 ("Most financial planners[']. . . upfront fees were low but their advice was generally stacked in favor of the products on which they earned commissions.").

[25] As the risk and complexity of investments increase, so do the commissions paid to the financial adviser. *Investment Adviser Industry Reform, Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce,* 102d Cong., 2d Sess. (1992) (statement of Mary Calhoun, consultant) *Financial Services Industry, Hearings on H.R. 3054, H.R. 4441 and H.R. 5777 Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 101st Cong., 2nd Sess. 1990 (statement of Mary A. Malgoire, Regulatory Representative of the National Association of Personal Financial Planners describing planners purporting to diversify client in a high commission speculative oil and gas partnership when the same diversification could have been achieved by investment in stock of a major oil company.). With respect to advice to purchase new offerings of closed-end managed investment companies rather than shares of similar existing companies, *see* Investment Company Act Rel. No. 17091 (Jul. 29, 1989) [54 FR 32993 (Aug 11, 1989)] (proposing amendments to Form N-2)(concurring statement of Commissioner Grundfest).

[26] Statement of Mary C. Calhoun, *Id.*

An adviser that receives transaction-based compensation also has an incentive to generate unnecessary transactions which, in the most egregious of cases, results in "churning" the client's account.[27] A more subtle and more difficult to detect form of churning may cause similar harm to clients. For example, a new client may be advised to sell all of his or her current investments in mutual funds and reinvest in shares offered by the financial planner or sponsored by an affiliate of the planner.[28] These transactions may needlessly cost the client sales loads and generate capital gains (or losses) that otherwise could be deferred.[29]

A congressional committee has characterized the practice of an adviser receiving transaction-based compensation as "[o]ne of the most serious and frequent conflicts of interest that advisers have with clients."[30] Many financial planning clients invest for

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27 Churning occurs when "a securities broker engages in excessive trading in disregard of his customer's investment objectives for the purpose of generating commission business . . . ." *Mihara v. Dean Witter & Co., Inc.*, 619 F.2d 814, 820 (9th Cir. 1980); *accord Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206, 1212 (8th Cir. 1990), and *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 431 (N.D. Cal. 1968), *modified,* 430 F.2d 1202 (9th Cir. 1970).

28 *Financial Services Industry, Hearings on H.R. 3054, H.R. 4441 and H.R. 5777 Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 101st Cong., 2nd Sess. 1990 (statement of Mary A. Malgoire, Regulatory Representative of the National Association of Personal Financial Planners describing recommendation of planner to liquidate holdings of blue chip stocks to invest in high-commissioned stock mutual funds and partnerships).

29 *See*, Simon, *The Broken Promise of Financial Planning*, Money, Nov. 1992, at 133.

30 H.R. Rep. No. 75, 103d Cong., 1st Sess. 19 (hereinafter "House Report"). Similarly, Commissioner Mary Schapiro, testifying before the House Subcommittee on Telecommunications and Finance in 1990 stated that the Financial Planner Study showed that "one of the principal risks to clients of financial planners derives from the conflicts of interest arising when planners sell products to clients." *Financial Services Industry, Hearings on H.R. 3054, H.R. 4441 and H.R. 5777 Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 101st Cong., 2nd Sess. 280, 287-88 (1990).

retirement and other long-term financial goals.[31] The consequences of poor investment decisions as a result of biased advice may not be apparent for many years, when the damage often cannot be undone. Older investors are particularly vulnerable to the adverse effects of biased advice because they often rely on investment income to meet basic expenses during retirement and they do not have the opportunity to recapture losses.[32]

III. Possible Alternative Approaches

1. Prohibiting Advisers from Receiving Transaction-Based Compensation

In 1940, Congress identified one form of adviser compensation -- receipt of performance fees -- that engendered such serious conflicts of interest between advisers and their clients that it was prohibited.[33] With that limited exception, however, the Act does not prohibit advisers from entering into compensation arrangements that create conflicts of interest with their clients. Rather, the Act requires that conflicts be fully disclosed on the premise that informed clients can take steps to protect their interests that may be affected by the conflict. A client fully apprised of the adviser's conflicts of interest that arise from transaction-based compensation may decide to engage another adviser that does not have this

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31 The three most important reasons that clients seek financial planning advice are retirement planning, reduction of income taxes, and planning for the client's financial future. Financial Planners Report at 29.

32 American Association of Retired Persons, "State and Federal Regulation of Financial Planners," 1 (Jul. 1993).

33 Section 205 of the Act, as enacted in 1940, prohibited an adviser from accepting performance-based compensation because this practice was perceived as encouraging advisers to take great risks with client funds with nothing to lose if unsuccessful, other than the adviser's time and the client's assets. Investment Counsel Report at 30. In 1970, the Act was amended to permit registered advisers to charge investment companies and certain wealthy clients a limited type of performance fee called a "fulcrum fee." Investment Company Amendments Act of 1970, Pub.L. No. 91-547 (codified at 15 USC 80b-5). In addition, the Commission has adopted rule 205-3 under the Act [17 CFR 275.205-3] which generally allows advisers to receive performance-based compensation from certain wealthy and knowledgeable clients, subject to certain conditions.

conflict of interest. The Commission is concerned, however, that clients who engage an adviser that accepts transaction-based compensation are typically individual investors who may not be in a position to protect themselves from the more subtle effects of the conflicts described above. Clients with even moderate amounts of financial knowledge are rarely in a position to evaluate advisers' conflicts of interest and assess the advisers' recommendations, especially in today's complex financial markets in which a vast array of financial products is available.

Comment is requested whether the Act's approach to addressing the conflicts arising from an adviser's receipt of transaction-based compensation -- full disclosure -- can today provide meaningful protection for clients. If it does not, should the Commission recommend to Congress that advisers be prohibited from receiving transaction-based compensation?[34]

What would be the effects on clients of eliminating transaction-based compensation for advisers? Those supporting the practice of advisers effecting client transactions point out that it provides convenient "one-stop shopping" for clients who otherwise would have to engage a broker that would charge a similar commission.[35] In addition, clients of fee-only financial planners tend to be more affluent than those of commission-based planners.[36]

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[34] At a public hearing conducted by the Commission in 1938, the president of the Investment Counsel Association of America ("ICAA") favored such an approach. He stated that the ICAA's code of ethics provided that "[a]n investment counsel firm should devote its time exclusively to [rendering unbiased advice] and services incidental thereto; it should not engage in the business of security merchandising, brokerage . . . [or] any activity which may jeopardize the firm's ability to render unbiased investment advice." Investment Counsel Report at 28 n. 43. Other industry representatives concurred, arguing the affiliation of brokerage firms with investment counsel organizations fosters "undesirable and irreconcilable conflicts of interest" because "the broker's interest in turnover might be a temptation to advise clients to trade more than might be to their advantage or than might be necessary in their interest." *Id.* at 29.

[35] Clients who purchase advice from a fee-only planner may have to pay once for the information and again for a stockbroker to execute the recommended transaction.

[36] [cite]

These clients, whose planning needs tend to be more complex, are more willing than less affluent clients to pay separate fees for planning services.[37] Comment is requested on whether this perception is correct, and, if so, whether elimination of transaction-based compensation arrangements might effectively deny financial planning services to a significant number of persons.

If investment advisers were prohibited from receiving transaction-based compensation, would those advisers that today receive most of their compensation from commissions begin to accept only transaction-based compensation, deregister as investment advisers, and continue to hold themselves out as financial planners?[38] Although these persons would no longer be subject to the Advisers Act, would their clients continue to be misled as to the nature of the relationship? To prevent this consequence, should the Commission consider prohibiting broker-dealers who hold themselves out as financial planners, financial consultants, or similar names, from claiming an exemption from the Advisers Act? [39]

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37 *See*, *Financial Planners Debate How They Charge Clients*, N.Y Times, May 23, 1992, at 50, col. 4.

38 These persons would then be solely registered as broker-dealers under the Exchange Act or registered representatives of broker-dealers and may be eligible under Section 202(a)(11)(C) of the Act [15 USC 80b-202(a)(11)(C)] for exception from Act because their advice is incidental to the conduct of the business of a broker-dealer and they no longer receive any "special compensation." Special compensation generally means compensation other than brokerage commissions, but can also mean a brokerage commission if there is a clearly definable charge for investment advice included within the commission. Investment Advisers Act Rel. No. 2 (Oct 28, 1940) [**FR (,1940]**; Robert S. Strevell (pub. avail. Feb. 22, 1976).

39 The Commission staff has stated on several occasions that, Section 202(a)(11)(B) [15 USC 80b-2(a)(11)(B)], the exception from the Advisers Act for lawyers and accountants whose performance of advisory services is solely incidental to the practice of their professions, is unavailable to persons who hold themselves out as providing "financial planning, pension consulting or other financial advisory services." *See, e.g.*, Investment Advisers Act Rel. No. 1092 (Oct. 8, 1987) **[cite]**. Such a position has never been taken with respect to he broker-dealer exception.

What would be the effect of eliminating transaction-based compensation on clients of other types of advisers, such as money managers? As a practical matter, Section 206(3) of the Act greatly limits the ability of an adviser to effect principal transactions with clients, and consequently imposes substantial limits on the ability of an adviser participating in an initial public offering or making a market in a security to sell clients those securities. Would a prohibition on money managers receiving transaction-based compensation have serious consequences? Should exceptions be provided?

A more limited approach would be to prohibit advisers from participating in contests for sales of investment products that award prizes, such as valuable automobiles and trips.[40] The effect of sales contests, frequently offered by brokerage firms, mutual funds, and insurance companies may be to compromise an adviser's judgement as to the appropriateness of a particular investment product for clients.[41] Typical disclosure that "the adviser may participate in contests sponsored by the seller of various investment products" may be an ineffective way to address the conflicts caused by participation in sales contests.[42] Clients

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40 In 1988, the National Association of Securities Dealers ("NASD") prohibited members and associated persons from accepting non-cash sales incentives from direct participation programs. Order Approving Proposed Rule Change Relating to the Offering of Non-Cash Sales Incentives as Inducement to Sell Interests in Direct Participation Programs, Securities Exchange Act Release No. 26185, Oct. 14, 1988 [53 FR 41262-02 (Oct. 20, 1988)]. The NASD recently requested that its members comment on a proposal that would prohibit its members or associated persons, with certain exceptions, from accepting "non-cash compensation" from investment companies or insurance companies. "Non-cash compensation" would be defined to include merchandise, gifts and prizes, and payment of travel expenses, meals and lodging. In requesting comment on the proposed prohibition, the NASD explained that receipt of such compensation "heightens the potential for loss of supervisory control over sales practices. "Special NASD Notice to Members 94-67, Aug. 22, 1994.

41 Rose, *Incentives vs. Clients: Which Ones Most Concern Financial Planners?*, Wall St. J.

42 **Explanation of current ADV disclosure requirements.**

may not understand the extent to which the adviser is motivated in its recommendation by the prospect of a valuable prize.

Comment is requested on whether the Commission should adopt a rule prohibiting investment advisers, including financial planners, from participating in sales contests. What effect would such a prohibition have on clients?

2. Written Disclosure and Prior Clearance

Currently, the Act requires advisers to disclose, before entering into an investment advisory contract with a client, the fact the adviser receives compensation from transactions in client securities.[43] The Act specifically requires subsequent disclosure and client approval only with respect to principal transactions and agency cross-transactions.[44] Congress took this approach because it believed that these types of transactions are fraught with conflicts and that clients ought to have every opportunity to reject them.[45] The Commission has stated that consent must be obtained before each separate transaction; a blanket consent in a general agreement between adviser and client would not suffice because it would not be based on the facts of the specific case.[46] Should a similar approach be taken with respect to transactions for which the adviser receives transaction-based compensation?

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43 Rule 204-3.

44 Section 206(3).

45 H.R. Rep. No. 2639, 76th Cong., 3d Sess. at 29 (1940).

46 Kidder, Peabody & Co., Inc, Investment Advisers Act. Rel. No. 232 (Oct. 16, 1968) [__ FR __ (1968)]; Investment Advisers Act Rel. No. 40 (Feb. 5, 1945)[11 FR 10997 (Feb. 5, 1945)](Opinion of Director of Division of Trading and Exchange).

3. Transaction Disclosure

Congress has over the last several sessions considered a number of bills addressing the conflicts that occur when advisers receive transaction-based compensation.[47] H.R. 578, which the House of Representatives passed on May 4, 1993, addresses these conflicts by requiring an adviser, before a purchase or sale is effected on behalf of the client, to disclose to the client the total amount of fees or other charges that may reasonably be expected to be charged in connection with the transactions and that the adviser or a related person will receive a portion of the commission, fee or charge.[48] This pre-transaction disclosure may be made orally but must be in writing if the advice is provided in writing. After the transaction the adviser must transmit to the client a written confirmation that states the actual amount of the commission, fee or charges.[49]

According to the House Report on H.R. 578, this transaction disclosure is intended to provide advisory clients with information about the "nature and magnitude of conflicts of interest caused by the receipt of transaction-based compensation . . . that might interfere with the provision of objective investment advice."[50] Comment is requested on whether, if this provision is not enacted, the Commission should adopt rules pursuant to its authority under the Act similar to the transaction disclosure that would be required by H.R. 578.

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[47] H.R. 578, 103d Cong. (1993); H.R. 5726, 102d Cong.(1992); and H.R. 2412, 102d Cong.(1991); H.R. 4441, 101st Cong. (1990).

[48] H.R. 578, Section 6(c). If a payment will be received from a third party, the adviser must disclose that it will receive such a payment.

[49] The transaction disclosure is required when the adviser or any person associated with or under common control with the adviser receives compensation. Accounts managed under discretionary authority of the adviser are excepted from these requirements. *Id.*

[50] House Report at 44.

The Commission requests specific comment on whether this information would assist advisory clients in evaluating the extent to which the adviser's recommendations are influenced by the adviser's receipt of transaction-based compensation. Could a client evaluate whether the commissions charged were too high unless the transaction costs of alternative investments were also provided? Would the success of such a requirement depend on the active involvement of clients in the management of their assets?

4. Periodic Disclosure

H.R. 578 would also require advisers to provide quarterly reports aggregating (1) all of the commissions, fees and other charges paid by the client during the period for services provided by the investment adviser and (2) any third party payments received by the adviser or any person associated or under common control with the investment adviser. The Commission would be required to prescribe rules "designed to present the required information in a manner that readily permits clients to compare the fees charged by the investment adviser with the fees charged by other advisers." The purpose of the provision is to permit clients to evaluate the total costs of advisory and transaction services provided by the adviser and any related persons.[51]

Comment is requested whether, if this provision is not enacted, the Commission should adopt rules pursuant to its authority under the Act similar to the provisions in H.R. 578 requiring such periodic disclosure. Comment is specifically requested whether this provision would achieve its purposes. For example, some advisers are compensated from a combination of fees and commissions. The cumulative amount of these fees and commissions may be greater than or less than the cost of advisory and transaction services obtained from different firms. Unless clients receive aggregate information, they may find it difficult to ascertain the real costs. Comment also is requested whether periodic reports

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[51] House Report at 47.

would assist clients in addressing any of the conflicts regarding receipt of transaction-based compensation.

In connection with congressional consideration of periodic reports, representatives of financial planning organizations have argued that such a requirement would impose a great burden on them because they do not have computer systems designed to allocate to specific clients income received from third parties.[52] For example, some mutual funds remit to the planner a single fee representing a "trail commission" for sales of shares of mutual funds attributable to clients of the financial planner. The remittance may not indicate how much of the amount is attributable to particular clients.[53] Comment is requested on the burdens that adoption of such a requirement would impose on certain types of financial planners? Would investment product suppliers change their remittance practices to permit advisers to comply with a new periodic reporting rule?

5. <u>Estimated Cost Disclosure</u>

In 1991, the National Association of Personal Financial Advisors ("NAPFA")[54] submitted a proposal to the Certified Financial Planner Board of Standards, Inc. ("CFP Board")[55] that would require all certified financial planners to provide prospective clients

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[52] *See, e.g.*, Letter dated October 1, 1992 to Kathryn Fulton, Director of Legislative Affairs, Securities And Exchange Commission from Kevin P. Howe, Vice President, IDS Financial Services, Inc.; Letter dated July 13, 1993 to Arthur Levit, (now) Chairman, Securities and Exchange Commission from Brent Neiser, CFP, Executive Director of the Institute of Certified Financial Planners, *included in* File No. S7- -94.

[53] One reason for this is that the clients' shares may be held in an omnibus account under the name of the financial planner or a custodian.

[54] NAPFA is a professional association representing fee-only financial planners.

[55] The CFP Board is an independent educational and professional organization that authorizes use of the federally registered marks "CFP" and "Certified Financial Planner." Before February 1, 1994, the CFP Board was known as the International Board of Standards and Practices for Certified Financial Planners.

with an itemized estimate of expenses associated with formulating and implementing a financial plan.[56] The CFP Board has not adopted this proposal.

A requirement to provide a pre-transaction cost estimate, such as the NAPFA approach, may give planners an incentive to recommend investment products that pay lower commissions and have lower transaction costs. This type of incentive could offset the incentive to recommend higher commission products. Comment is requested whether this type of approach would assist prospective clients in evaluating costs of different financial planners and address the conflicts of interest of advisers who accept commission-based compensation.

The approach originally recommended by NAPFA was designed for use by financial planners. Could clients of other types of advisers benefit from estimated disclosure? Should institutional clients be excepted from any such requirement because the costs of managing large amounts of money, particularly where there are large cash inflows and outflows, is not easily estimated?

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[56] *Get It in Writing: NAPFA Unveils Disclosure Forms,* Financial Services Week, Mar. 4, 1991, at 10. NAPFA's standards require financial planners to complete a pre-engagement form for each client that discloses the typical range of commissions the planner receives for investing money in life insurance, mutual funds, and limited partnerships, along with the planner's estimated fee for each type of investment. In addition, NAPFA's standards require planners to complete a second form containing a detailed listing of recommended investments and the amount and method of compensation the planner will receive if those recommendations are implemented. NAPFA adopted these disclosure standards for its own members in 1991. *Disclosure Proposal Continues to Fire Controversy,* Financial Planning, June 1991, at 18. *See also,* Simonoff, *Industry Wrestles with Disclosure Proposal*, Financial Planning, May 1991, at 64. Copies of the NAPFA disclosure forms are contained in File No. S7--94. A similar requirement was contained in H.R. 4441, a bill introduced by Representative Rick Boucher and others in the 101st Congress. *Financial Services Industry, Hearings on H.R. 3054, H.R. 4441 and H.R. 5777 Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce,* 101st Cong., 2nd Sess., at 263 (1990).

6. Improved Brochure Disclosure

As discussed above, the Commission's rules require registered advisers to provide their clients a brochure describing their background business practices and fees. The brochure may consist of Part II of Form ADV or a separate document containing at least the information required in Part II. Part II of Form ADV consists of a series of questions in check-the-box format that, among other things, require the adviser to indicate whether it offers advisory services for commissions. On a continuation sheet, Schedule F, the adviser must describe what restrictions, internal procedures or disclosures are used for conflicts of interest when the adviser (or a related person) effects transactions for clients.

The Commission recently adopted a new brochure for use by sponsors of wrap fee programs.[57] Sponsors of wrap fee programs are now required to deliver to prospective wrap fee clients a narrative brochure describing the sponsor as well as the wrap fee program. If any practice or relationship presents a conflict of interest, the nature of the conflict must be described.[58] Thus, practices involving conflicts must not only be identified, but the conflicts involved must be acknowledged.

If the Commission were to adopt a similar narrative brochure for use by all advisers, the Commission could require that conflict disclosure be highlighted and expanded.[59] For example, the Commission could require an adviser who receives transaction-based compensation to disclose that the receipt of commissions might cause the adviser or its employees to recommend products based upon the financial benefit to the adviser rather than the needs of the client, and that the client may purchase the same products through persons

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57 Investment Advisers Act Rel. No. 1411 (Apr. 19, 1994) [59 FR 21657 (Apr. 26, 1994)].

58 Item 7(l) of Schedule H.

59 Section 6 of H.R. 578 would require prominent disclosure that the adviser may receive, directly or indirectly, transaction-based compensation.

unaffiliated with the adviser who may charge lower commissions or fees. If an adviser primarily or exclusively recommends investment products on which it receives commissions, this practice could be required to be disclosed. [60] Should the Commission adopt a narrative brochure requirement for all investment advisers, including financial planners? Should the Commission adopt a narrative brochure requirement only for financial planners? Should any such brochure require expanded conflict disclosure as described above? Would expanded brochure disclosure materially improve the ability of investors to protect themselves from the conflicts of interest caused by the adviser's receipt of transaction-based compensation?[61]

IV. Conclusion

The Commission is interested in receiving a wide range of comments and suggestions on matters related to the compensation of advisers and financial planners. Therefore, commenters should not limit their comments to the alternatives suggested in this release. In addition, commenters should consider the extent to which alternatives, or portions of alternatives, should be combined.

By the Commission.

Jonathan G. Katz
Secretary

September , 1994

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[60] In addition, revised brochure requirements could address some of the current brochure disclosure deficiencies discussed in the Financial Planner Report at 9.

[61] Form ADV is a joint federal-state form used to register as an adviser with the Commission and with all states that require adviser registration, and any amendment to Form ADV would require approval by the states. See Investment Advisers Act Rel. No. 1411 *supra* note __ at n.5.