Remarks Of

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"Growth of the Investment Adviser Industry and the Regulatory Response Thereto"

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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

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Growth of the Investment Adviser Industry and the Regulatory Response Thereto

I. Introduction

I appreciate the opportunity to address this conference. During my tenure on the Commission, I have learned a great deal about the investment advisory industry. While I realize that I have a great deal more to learn, I am grateful for the contributions on the part of some of the members of ICAA thus far to my educational process. I urge you to continue to communicate to me your comments and suggestions, including constructive criticism, on issues of interest.

Today, I wish to make a few observations about the recent growth of the investment advisory industry and the implications of that growth on the regulation of the industry. As you know, the Investment Advisers Act of 1940 (the "Advisers Act") is more than half a century old. I believe that the Advisers Act has served both the industry and investors well and will no doubt continue to do so in the future. However, anything of that age can benefit from some fine-tuning. Thus, I do intend today to suggest some changes to the Advisers Act as well as to the Investment Company Act of 1940 (the "Investment Company Act") that I believe are not only appropriate, but necessary to ensure vigilant yet fair regulation of today's, and tomorrow's, investment advisory industry.

II. Industry Growth

The growth in the number of investment advisers registered with the Commission has been dramatic. In 1981 there were approximately 5,100 registered advisers; by the end of 1991 the number registered had grown to 17,500. The amount of assets under the management of advisers has grown even more rapidly, from $450 billion in 1981 to $5.4 trillion in 1991, which is more than twice the amount deposited in U.S. commercial banks.

As a result of this phenomenal growth, the Commission has fallen behind in its ability to police the industry. From 1981 to 1991, the Commission's investment adviser inspection staff grew from 36 to 46. While the number of registered advisers grew on average by more than 1000 each year during this period, the number of examiners employed by the Commission grew by only one examiner per year.

This data makes it clear that the growth in the industry has outstripped the ability of the Commission to conduct examinations with adequate frequency. In 1981 the Commission inspected advisers an average of once every 12 years; today the inspection cycle for advisers with less than $1 billion under management has become virtually nonexistent. The current Commission investment adviser inspection program, so far as these smaller investment advisers are concerned, does not, in my opinion, provide a credible enforcement threat to discourage prospective malfeasors in this or any other industry. The Commission desperately needs more examiners if it is to adequately enforce the Advisers Act and if it is to therefore fulfill its responsibilities under the Advisers Act.

III. Investment Adviser Legislation

Legislation to address this critical problem has been introduced in the United States Senate. The legislation, which was developed with the Commission's assistance, would impose an annual fee on advisers tiered based upon the amount of assets the adviser has under management. This bill, introduced by Senator Chris Dodd, (called S. 2266) would allow the Commission to retain the revenues from these fees and use them to hire enough examiners to reduce the smaller adviser inspection cycle to, on average, once every six years.

To the credit of ICAA, your organization has indicated its support for S. 2266. Such industry support is necessary to achieve passage in what I expect to be a short and rather non-productive legislative session.

The advisory industry as a whole, in my judgment, will benefit from more "cops on the beat." More frequent visits by SEC examiners would create a serious deterrent against fraud, a deterrent that is currently minor at best. A reduction in fraud in the advisory industry will prevent the loss of investor confidence in advisers and in the services they offer, a result that serves both the investing public and the investment advisory industry.

IV. Private Right of Action

While inspections are an effective policing device, increasing adviser inspections is not the only legislative improvement that should be made. I also believe it is important that Congress create a private right of action under the anti-fraud provisions of the Advisers Act. Unfortunately, S. 2266 does not contain such a provision.

A six-year inspection cycle cannot be expected to prevent or even to uncover every fraud. No inspection cycle, no matter how frequent, will uncover every fraud. In addition, the Commission will never have sufficient resources to seek redress in every case of fraud under the Advisers Act. A private right of action would provide a useful supplement to Commission enforcement actions by permitting private parties to enforce the Advisers Act in certain circumstances. This private enforcement remedy would act as a powerful deterrent against fraudulent activities by advisers.

The ICAA is on record as opposing a private right of action. It is my understanding that ICAA testified that defrauded advisory clients already have effective remedies under state law and under Rule 10b-5. This is a curious argument because, if it is correct, and a private right of action would do nothing but add an additional count to a lawsuit, there would seem to be little reason for the ICAA to oppose it. However, in my opinion, Rule 10b-5 does not provide a remedy in all cases.

It is difficult for me to understand why some clients -- those that can bring a Rule 10b-5 claim -- should have a federal anti-fraud remedy, while others have only a state remedy or no remedy at all. A defrauded client will take little comfort from such an arbitrary result, a result which I believe is to the detriment of the investment advisory industry.

V. Recommendations for Future Regulatory Changes

Improving the Commission's inspection program for investment advisers and providing for a private right of action under the Advisers Act would strengthen the way advisers are regulated at the federal level, but would not fundamentally change the statutory framework. Increasing fees would provide the Commission with more resources to enforce existing rules, while a private right of action would allow private persons to take on this enforcement role in certain circumstances. Neither proposal would change to any significant extent the rules that apply and to whom those rules apply. I would like, therefore, to take this opportunity to express at least to whom I believe the rules should apply.

First, some facts:

- More than half of all registered advisers have no assets under management, and more than half of those that do have assets under management manage less than $10 million.

- Fewer than 200 registered advisers manage more than $5 billion in assets.
- More than half of all registered advisers have fewer than 15 clients.
- Only about 275 advisers have more than 500 clients.
- More than half of all registered advisers have only one employee performing advisory functions.
- Only about 5% of registered advisers have 10 or more employees performing advisory functions.

It seems pretty clear to me that advisers come in different sizes. There are relatively few large advisers but lots and lots of small advisers.

Although fewer than 5% of all advisers manage more than $500 million in assets, these advisers are responsible for more than 70% of the assets advisers have under management. These advisers have discretionary authority over substantial amounts of the money of other individuals, and how they exercise this authority has significance not only to their clients, but to our national securities markets and to our national economy.

In contrast, most small advisers have no control over client assets or control relatively small amounts of assets. Their activities are important to their clients and their communities, but probably have little impact on the national economy. Even in the aggregate, the impact of small advisers on the national economy is much less significant than that of large advisers.

Unfortunately, the Advisers Act generally does not recognize the differences between advisers; it regulates large and small advisers in essentially identical fashion. Except for the statutory limitation on using the term "investment counsel," there is no classification under the Advisers Act. All advisers have in common is that they provide advice about securities, but the members of this diverse group are obviously not alike.

I suggest that some form of classification of advisers is needed if there is to be any fundamental and long-term improvement in investment adviser regulation. It appears to me that investment advisers should be classified on what is probably the simplest basis possible -- size. Small advisers should be subject solely to state regulation, and large advisers should be subject solely to federal regulation. While I realize that the support for this concept is just not there at the moment, the notion of a non-overlapping investment adviser regulatory scheme, divided between the states and the Commission on the basis of size, is a concept that I would be interested in pursuing in the future. Certainly, theoretically, it strikes me as a more cost effective regulatory response to the growth of the investment advisory industry than does even S. 2266.

VI. Corporate Governance

Changing gears to some extent, I wish to spend the remainder of my time here today focusing on the corporate governance requirements of the Investment Company Act as they relate to the interaction between directors and investment advisers and to suggest some modifications to those requirements, which, if implemented, at least in my judgment, would improve some aspects of the current corporate governance system.

As everyone here is aware, mutual funds are unique in that they are organized and are operated by individuals whose primary loyalty and pecuniary interest lie outside the enterprise. Consequently, conflicts of interest are inherent in the structure of mutual funds, and the potential for abuse is high.

Congress recognized these facts when it enacted the Investment Company Act, a statute whose purpose was to eliminate the pervasive abuses that were documented in the exhaustive studies of the investment company industry conducted prior to its adoption.[1] To correct these abuses, and police the conflicts of interest that engendered them, the Investment Company Act establishes a comprehensive regulatory framework predicated upon principles of corporate democracy.

The role of directors in policing conflicts of interest is central to the Investment Company Act. The Act imposes watchdog and a number of other responsibilities on the board of directors. The independent directors, in particular, are expected to "furnish an

1 SEC, Investment Trusts and Investment Companies, H. Doc. No. 279, 76th Cong., 1st Sess. pt. 3 (1939).

independent check upon management,"[2] especially with respect to fees paid to the investment company's sponsor.[3]

In addition to policing conflicts over fees paid to affiliates, investment company boards of directors also police a number of operational activities, some of which involve potentially serious conflicts as well.[4]

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[2] Burks v. Lasker, 441 U.S. 471, 484 1979.

[3] For advisory fees, the board has the responsibility for evaluating the adviser's contract with the fund and the compensation paid under the contract. The independent directors must separately evaluate and approve the advisory contract and any renewals thereof. The full board has the authority to terminate the advisory contract at any time, but such authority is not given to the independent directors. See, e.g., Sections 15(a) and 15(c) of the Investment Company Act.

Principal underwriting contracts are subject to similar board scrutiny. The board is also required to review and evaluate asset-based distribution fees. Rule 12b-1, adopted in 1980 after prolonged deliberation, permits open-end companies to use fund assets to pay for distribution expenses under a plan ("Rule 12b-1 plan") approved and monitored by the directors. Rule 12b-1 plans, and any material amendments thereto, must be approved by both the full board and the independent directors. The independent directors also are empowered by Rule 12b-1 to terminate the plan at any time. See Rule 12b-1.

[4] The independent directors are given several specific responsibilities in this regard. For example, the independent directors select the company's independent public accountants, oversee securities transactions with affiliates to the extent such transactions are (continued...)

Critics of the role assigned by the Investment Company Act to the board of directors of a fund, and particularly to the independent directors, believe that because an investment company is a creature of its sponsor/adviser, it is difficult for directors to provide effective oversight.

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[4](...continued)

permitted by various rules, determine annually whether participation in joint liability insurance policies is in the best interests of the company, and review and approve fund fidelity bonds. They are also required to select and nominate individuals to fill independent director vacancies for a period of three years following the sale of an investment advisory contract. See, e.g., Sections 32(a)(1), 10(f) and 16(b) of the Investment Company Act and Rules 17d-1 and 17g-1 promulgated thereunder.

In other cases, the full board must approve operational activities. For example, the full board values certain types of portfolio securities and sets the time of day at which net asset value is determined. With respect to a proposed merger of two or more investment companies in the same complex, the board must determine that participation is in the best interest of the company and that the interests of shareholders will not be diluted. The board annually approves custody contracts with members of national securities exchanges, clearing agencies or book-entry systems, and foreign custodians. It also makes determinations of credit quality with respect to investments in debt securities of issuers deriving more than 15% of their revenues from securities-related activities. Finally, the board approves a fund's code of ethics, which must be designed to prevent fraudulent, deceptive, or manipulative practices by fund insiders in connection with personal securities transactions. See e.g., Sections 2(a)(41) of the Investment Company Act and Rules 10f-3, 17a-7, 17c-1, 2a-4, 2a-7, 22c-1, 17a-8, 17f-1, 17f-4, 17f-5, 12d3-1, and 17j-1 promulgated thereunder.

Because a mutual fund usually is managed by its sponsor or an affiliate, they argue, the independent directors are not truly independent and have little choice but to approve the fee levels that the adviser deems necessary to properly operate and market the fund. They cite instances where independent directors have not successfully challenged or even attempted to challenge certain management actions that allegedly violated the Investment Company Act's self-dealing prohibitions. These critics also point out that independent directors almost never fire the adviser; and while they sometimes negotiate a fee rate below that proposed by the adviser, the amount of the reduction is usually marginal.[5]

Supporters of the current role of investment company boards disagree. In their view, the conflicts presented by an externally managed entity make it uniquely appropriate that independent directors of investment companies take an active role in their governance. They assert that fund shareholders need the protections provided by a third party monitor and that neither the Commission staff nor the market is capable

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[5] See Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222 (S.D.N.Y. 1990), aff'd, 928 F. 29 590 (2d Cir. 1991), cert. denied, 60 U.S.L.W. 3258 (Oct. 7, 1991).

of replacing the board in that role. These observers generally approve of the long-term trend toward a stronger role for the independent directors, believing that many independent directors have developed a high level of expertise and have proved effective as monitors for shareholders. They point out that the investment company industry has prospered under the current regulatory system and has not experienced the abuses and mismanagement that recently have plagued other financial institutions.

I am generally inclined to agree with this latter notion. It appears to me that the independent directors are generally effective in their role as watchdogs for shareholders. However, some improvements are needed to ensure their continued effectiveness. For sure, independent directors are unnecessarily burdened by requirements to make determinations that call for a high level of involvement in day-to-day fund activities -- requiring directors to "micro-manage" operational matters or to make detailed findings of fact. Investment Company Act provisions that require independent directors to conduct reviews and to make findings with respect to matters that have become routine or that involve virtually no discretion should be modified.[6] These formalistic requirements unnecessarily clutter board meetings, making it difficult for directors to devote their time and attention to areas where they can most fruitfully exercise their business judgment.

Thus, while the corporate regulatory structure embodied in the Investment Company Act appears to be fundamentally sound, it nonetheless can be streamlined and improved by changes to both the structure and the responsibilities of investment company boards of directors. It appears to me that the corporate governance system works best when the functions required of independent directors are performed by individuals who are truly independent. Measures that enhance the independence of directors, if they can be undertaken without undue expense, are consequently, in my judgment, desirable. Along those lines, I do wish to mention a few specific recommendations that do appeal to me.

First, Section 10(a) of the Investment Company Act provides that at least 40% of the board of directors of a registered investment company consist of independent directors. It is my recommendation that this

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[6] See, e.g., Rules 10f-3, 12d3-1, 17a-7, 17e-1, 17f-4, 17f-5, and 22c-1.

section should be amended to require that more than 50% of the directors be independent.

The primary reason for this recommendation relates to the trend in investment company regulation toward an increase in the oversight and policy responsibilities of independent fund directors. For example, over the past two decades, the Commission, in a series of exemptive rules, has placed increasing reliance on boards of directors to monitor fund operations. I believe that an increased measure of independence is necessary to allow boards of directors to perform their responsibilities appropriately.

A recommendation to require that a majority of directors be independent or disinterested is also consistent with the trend in large industrial or commercial companies, which do not have the unique structural conflicts faced by investment companies. Many of these companies (and their institutional shareholders) have recognized that having at least a majority of outside directors greatly improves the governance process, and consequently these companies have found it appropriate to increase the number of outside directors on their boards.

It would be anomalous if investment companies had boards with proportionately fewer independent directors than most large industrial companies. I will note that many investment company boards already have a majority of their board composed of independent directors, and all should do so.

Secondly, although independent directors are required to approve advisory contracts and rule 12b-1 plans, they have no explicit autonomous authority to terminate advisory contracts.[7] Only the full board or the shareholders can take such an action. Because I see no principled basis for this distinction, and because I believe that it is important that independent board members have separate authority to protect shareholder interests by terminating an advisory contract, I recommend that Section 15(a)(3) of the Investment Company Act be amended to provide that the independent directors can terminate advisory contracts. Frankly, such a recommendation just makes sense to me.

Finally, I also recommend requiring investment companies to provide independent directors with their own counsel. It appears to me

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[7] See note 3 supra.

that separate counsel would be beneficial to independent directors and would benefit fund shareholders, and that, in all the circumstances that I could imagine, separate counsel is necessary for the board to properly perform its responsibilities under the Investment Company Act. It is my understanding that a number of investment companies already provide separate counsel for their independent directors.

VII. Conclusion

In conclusion, the investment advisory industry has by and large been successful. The exponential growth of the investment advisory industry has mirrored that success. I pledge to continue that success by striving to maintain the integrity of the industry and by striving to improve the efficiency of the industry. I look forward to working with you on those objectives.