

SECURITIES AND EXCHANGE COMMISSION (SEC)

17 CFR Part 275

[Release No. IA-1406; File No. S7-8-94]

RIN 3235-AG06

SUITABILITY OF INVESTMENT ADVICE PROVIDED BY INVESTMENT ADVISERS; CUSTODIAL ACCOUNT STATEMENTS FOR CERTAIN ADVISORY CLIENTS

59 FR 13464

DATE: Tuesday, March 22, 1994

ACTION: Proposed rule.

SUMMARY: The Commission is proposing for comment new rule 206(4)-5 under the Investment Advisers Act of 1940 ("Advisers Act") that would expressly prohibit investment advisers from making unsuitable recommendations to clients. Proposed rule 206(4)-5 would make explicit advisers' suitability obligations under the Advisers Act.

The Commission also is proposing new rule 206(4)-6 under the Advisers Act to prohibit registered investment advisers from exercising investment discretion with respect to client accounts unless they have a reasonable belief that the custodians of those accounts send account statements to the clients no less frequently than quarterly. Proposed rule 206(4)-6 is designed to prevent certain fraudulent practices.

DATES: Comments on the proposals should be received on or before May 23, 1994.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549. All comment letters should refer to File No. S7-8-94. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 5th Street, NW., Washington, DC 20549.

FOR FURTHER INFORMATION CONTACT: W. Thomas Conner, Attorney, or Kenneth J. Berman, Deputy Office Chief, (202) 272-2107, Office of Disclosure and Investment Adviser Regulation, Division of Investment Management, 450 5th Street, NW., Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission today is proposing for comment:

(1) Rule 206(4)-5 under the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.) ("Advisers Act") to expressly prohibit investment advisers from making unsuitable recommendations to clients;

(2) Rule 206(4)-6 under the Advisers Act to prohibit investment advisers registered or required to be registered under the Advisers Act from exercising investment discretion with respect to client accounts unless they have a reasonable belief that the custodians of those accounts send account statements to the clients no less frequently than quarterly; and

(3) Amendments to rule 204-2 (17 CFR 275.204-2) under the Advisers Act to require investment advisers subject to the recordkeeping requirements of the Advisers Act to maintain (i) information about clients obtained by the investment advisers to comply with proposed rule 206(4)-5, and (ii) copies of client custodial account statements received by the advisers.

I. Introduction

The Commission is proposing two rules under the antifraud provisions of the Advisers Act. n1 Rule 206(4)-5 would make express the fiduciary obligation of investment advisers to make only suitable recommendations to a client, after a reasonable inquiry into the client's financial situation, investment experience, and investment objectives. Rule 206(4)-6 would prohibit registered investment advisers from exercising investment discretion with respect to client accounts unless they have a reasonable belief that the custodians of those accounts send account statements to the clients no less frequently than quarterly.

n1 Section 206(4) (15 U.S.C. 80b-6(4)) makes it unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative." Section 206(4) authorizes the Commission to adopt rules and regulations defining the acts, practices, and courses of business that will be deemed fraudulent, deceptive, or manipulative for purposes of section 206(4), and to prescribe means reasonably designed to prevent such conduct. The Commission has adopted four rules under section 206(4): rule 206(4)-1 (17 CFR 275.206(4)-1) (advertisements); rule 206(4)-2 (17 CFR 275.206(4)-2) (custody or possession of funds or securities of advisory clients); rule 206(4)-3 (17 CFR 275.206(4)-3) (cash payments for client solicitations); and rule 206(4)-4 (17 CFR 275.206(4)-4) (financial and disciplinary information that investment advisers must disclose to clients).

II. Suitability of Investment Advice

Investment advisers are fiduciaries n2 who owe their clients a series of duties, n3 one of which is the duty to provide only suitable investment advice. This duty is enforceable under the antifraud provision of the Advisers Act, section 206, n4 and the Commission has sanctioned advisers for violating this duty. n5 The Commission now proposes to make explicit this duty in a new rule under section 206(4) of the Advisers Act. The scope of proposed rule 206(4)-5 reflects the Commission's interpretation of advisers' suitability obligations under the Advisers Act. n6

n2 *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191, 194 (1963) ("Capital Gains").

n3 These duties include the duty of full disclosure of conflicts of interest, *Capital Gains* at 191-92; utmost and exclusive loyalty, *In re Kidder, Peabody & Co., Inc.*, 43 SEC 911, 915 (1968) ("Kidder"), *Investment Advisers Act Rel. No. 40* (Feb. 5, 1945) (staff position stating advisers' duty of loyalty requires full disclosure of adverse interests and client consent before purchase or sale of securities from clients); and the duty of best execution, *Kidder* at 915-16. See generally 2 Frankel, *The Regulation of Money Managers* 343-47 (discussing general duties of fiduciaries), ch. XIII (duty of loyalty), ch. XV (duty of care); Leavell, *Investment Advice and the Fraud Rules*, 65 Mich. L. Rev. 1569 (1967) (discussing legal controls on providing investment advice).

n4 *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979) (Advisers Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations).

n5 See, e.g., *In re David A. King and King Capital Corp.*, *Investment Advisers Act Rel. No. 1391* (Nov. 9, 1993) (investment adviser recommended investments in a risky pool of first, second and third mortgages to retirees and others of limited means); *In re George Sein Lin*, *Investment Advisers Act Rel. No. 1174* (June 19, 1989) (investment adviser with discretionary investment authority invested funds of clients desiring low-risk investments in uncovered option contracts and utilized margin brokerage accounts); *In re Westmark Financial Services, Corp.*, *Investment Advisers Act Rel. No. 1117* (May 16, 1988) (financial planner recommended speculative equipment leasing partnerships to unsophisticated investors with modest incomes); *In re Shearson, Hammill & Co.*, 42 SEC 811 (1965) (sections 206(1) and (2) violated when adviser recommended investments unsuitable to child and widow).

n6 In addition, in formulating the proposed rule, the Commission has looked to interpretations of the scope of broker-dealers' suitability obligations under the antifraud provisions of the Securities Exchange Act of 1934 [15 U.S.C. 78a et seq.] ("Exchange Act"). The federal securities laws, as well as rules of

various self-regulatory organizations ("SROs"), impose suitability requirements on broker-dealers. Under the "shingle" theory, a broker-dealer makes an implied representation to its customers that it will deal with them fairly and in accordance with the standards of the profession. Duker & Duker, 6 S.E.C. 386, 388 (1939). A broker-dealer that breaches this representation may violate certain antifraud provisions of the federal securities laws, namely, section 17(a) of the Securities Act of 1933 [15 U.S.C. 77q(a)], sections 10(b) and 15(c)(1) of the Exchange Act [15 U.S.C. 78j(b) and 78o(c)(1)], and rules 10b-5 and 15c1-2 thereunder [17 CFR 240.10b-5 and 240.15c1-2]. See, e.g., Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969); Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1943); In re Harold Grill, 41 SEC 321 (1963). A broker making unsuitable recommendations breaches this representation. See, e.g., Clark v. John Lamula Investors, Inc., 583 F.2d 594 (2d Cir. 1978) (recommended purchase of a convertible debenture was unsuitable for the needs of a widowed, retired customer, when the broker-dealer failed, among other things, to disclose the risks of the investment). This doctrine is incorporated into the rules of the SROs. National Association of Securities Dealers, Inc. ("NASD") Rules of Fair Practice, art. III, § 2, NASD Manual (CCH) (paragraph) 2152; New York Stock Exchange ("NYSE") rule 405, 2 N.Y. Stock Exch. Guide (CCH) (paragraph) 2405 (the "Know Your Customer Rule"). See also Municipal Securities Rulemaking Board ("MSRB") rule G-19, MSRB Manual (CCH) (paragraph) 3591; NYSE rule 472, 2 N.Y. Stock Exch. Guide (CCH) (paragraph) 2472.40(1) ("When recommending the purchase, sale or switch of specific securities, supporting information must be provided or offered."). Broker-dealers also are required under SRO rules to establish and enforce written supervisory procedures that are reasonably designed to achieve compliance with the applicable securities laws and regulations, including the obligation of fair dealing. See, e.g., NASD Rules of Fair Practice, art. III, § 27, NASD Manual (CCH) (paragraph) 2177. In addition, broker-dealers must comply with specialized suitability rules when recommending certain kinds of securities, such as penny stocks and options, or when offering to extend, or arrange for the extension of, credit in connection with inducing the purchase of a security. See, e.g., rules 15g-9 (17 CFR 240.15g-9) (penny stocks) and 15c2-5 (17 CFR 240.15c2-5) (extensions of credit) under the Exchange Act; NASD Rules of Fair Practice, Art. III, § 2, Policy of the Board of Governors, NASD Manual (CCH) (paragraph) 2152 (statement of policy concerning recommendations of speculative low-priced securities and recommendations of or accepting orders for options). Compliance with proposed rule 206(4)-5 would not override the obligation of an investment adviser that is also a broker-dealer to meet the requirements of these rules. Nor would a determination by a broker-dealer under these rules that a particular investment is suitable relieve an investment adviser that is acting as the purchaser's adviser in connection with the transaction from making a suitability determination under proposed rule 206(4)-5 with respect to the investment.

As discussed in more detail below, rule 206(4)-5 would prohibit an investment adviser from providing investment advice to a client unless the adviser makes a reasonable inquiry into the financial situation, investment experience, and investment objectives of the client and reasonably determines that the investment advice is suitable for the client. n7 An amendment to rule 204-2 under the Advisers Act would require investment advisers subject to the recordkeeping requirements of the Advisers Act to maintain records of the information obtained from clients in the required inquiry.

n7 A similar provision is contained in H.R. 578, the Investment Adviser Regulatory Enhancement and Disclosure Act of 1993, which is currently pending before Congress.

1. Duty To Inquire

Paragraph (a)(1) of rule 206(4)-5 would require an investment adviser, before providing any investment advice, and, as appropriate thereafter, to make a reasonable inquiry into the client's financial situation, investment experience, and investment objectives. n8 The extent of the inquiry would turn on what is reasonable under the circumstances. For example, to formulate a comprehensive financial plan for a client, an adviser may be required to obtain extensive personal and financial information about the client, including current income, investments, assets and debts, marital status, insurance policies, and financial goals. This information must be updated periodically so that the adviser can adjust its advice to reflect changed circumstances. The frequency with which the information must be updated would turn on what is appropriate under the circumstances. Among the factors to be considered in determining when to update client information would be the passage of time since the information was last updated and whether the adviser is aware of events that have occurred that could render inaccurate or incomplete the information on which it currently bases its advice. For example, a change in the tax law

or knowledge that the client has retired or experienced a change in marital status might trigger an obligation to make a new inquiry. Comment is requested on whether the proposed rule should specify the minimum frequency for making inquiries to update information concerning the client. For example, should the rule require that client information be updated no less frequently than annually?

n8 Rule 206(4)-5 would not apply to impersonal advisory services, and references to investment advice in this Release do not include impersonal advisory services. Impersonal advisory services would be defined in paragraph (b) of proposed rule 206(4)-5 as investment advisory services provided solely (1) by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts; (2) through the issuance of statistical information containing no expression of opinion as to the investment merits of a particular security; or (3) any combination of the foregoing services. This definition is derived from the definition of "contract for impersonal advisory services" in rule 204-3 under the Advisers Act [17 CFR 275.204-3]. Rule 204-3 requires an adviser to provide clients and prospective clients with a written disclosure statement or "brochure," except when advisory services are provided in connection with a contract for impersonal advisory services.

Most advisers conduct an inquiry at an initial client meeting that would generally satisfy the proposed requirement. n9 Clients are typically asked to complete questionnaires that request information about each client's current financial situation, financial goals, risk tolerance, and any other information that the adviser believes necessary to develop recommendations for a financial plan or specific investments. n10 Clients typically are requested periodically to review the information and notify the adviser of any changes.

n9 See State and Federal Regulation of Financial Planners: A Policy Overview and Model for Reform, Prepared for the American Association of Retired Persons Public Policy Institute by Barbara L.N. Roper 2-3 (1993) (describing generally accepted standards of financial planning that include, among other things, meeting with a client at the outset of the engagement to review the client's personal finances, risk tolerance, and investment objectives).

n10 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 8 (February 1988).

2. Duty To Give Only Suitable Advice

Paragraph (a)(2) of rule 206(4)-5 would prohibit an adviser from giving advice to a client unless the adviser reasonably determined that the advice was suitable to the client's financial situation, investment experience, and investment objectives. A reasonable determination of an investment's suitability for a client would require, for example, that certain kinds of particularly risky investment products be recommended only to those clients who can and are willing to tolerate the risks and for whom the potential benefits justify the risks. n11

n11 The prohibition against providing unsuitable advice would apply to advice to institutional clients as well as to individual clients. Institutional investors have experienced significant losses as a result of recommendations to invest in complex financial products that they did not fully understand. See H.R. Rep. No. 255, 103d Cong., 1st Sess. 30-34 (1993) (municipal governments and savings and loan associations experienced widespread losses in U.S. Treasury instruments, derivative products, futures transactions, options hedging, and mortgage-backed securities recommended by dealers). The rationale underlying the duty to make suitable recommendations, although developed largely in the context of investors who are not deemed to be "sophisticated," applies also to those who are ordinarily considered to be "sophisticated." See Root, Suitability-The Sophisticated Investor-and Modern Portfolio Management, Colum. Bus. L. Rev. 287 (1991).

While rule 206(4)-5 would require an investment adviser to have reasonably determined that each piece of its investment advice would be suitable for the client, n12 suitability of the advice would be evaluated in the context of the client's portfolio. n13 For example, an investment adviser may hedge a portfolio of U.S. government bonds for a client having very conservative investment objectives, in which case the

suitability of the hedging instruments would be evaluated in light of their hedging function. Thus, inclusion of some risky investments in the portfolio of a risk-averse client may not necessarily be unsuitable. n14

n12 For an account under discretionary management, each trade initiated by the adviser would constitute "advice." For a discussion of when an account is under discretionary management, see *infra* note 29.

n13 A similar standard is applied in determining the prudence of an investment made for a retirement plan under the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1001 et seq.) (see 29 C.F.R. 2550.404a-1(a)), and generally in determining the suitability of a trustee's investment decision under trust law (see Restatement (Second) of Trusts, § 227 commentary (1959)).

n14 Conversely, while advice to invest in a particular security may be suitable to the needs of a client, advice to make the same investment on margin may not be.

Proposed rule 206(4)-5's suitability obligation includes the requirement that an adviser "know his client," as well as the requirement that an adviser "know his product." Lack of actual knowledge about the client or the investment products recommended would not provide a defense for an adviser unless it would be reasonable for the adviser not to have known the information. n15 It generally would, for example, be reasonable for an adviser to rely on information provided by a client (or the client's agent) regarding the client's financial circumstances in response to the inquiry required by paragraph (a)(1) of proposed rule 206(4)-5, and an adviser should not be held to have given unsuitable advice if it is later shown that the client had misled the adviser. n16 If a client refused to provide requested information, however, the adviser could not make assumptions about the client that were not reasonable. n17 When no other information is available, the adviser may have to assume the client has no assets or source of income other than the assets the adviser manages. If the client refused to provide information upon which an adviser could base recommendations, the adviser would be permitted to rely upon trustworthy information about the client that it obtains from other reliable sources, such as a consultant to the client or other intermediary.

n15 See *In re Baskin Planning Consultants, Ltd.*, Investment Advisers Act Rel. No. 1297 (Dec. 19, 1991) (adviser failed adequately to investigate investment recommendations to clients); *In re Alfred C. Rizzo*, Investment Advisers Act Rel. No. 897 (Jan. 12, 1984) (investment adviser lacked a reasonable basis for advice and could not rely on "incredible claims" of issuer of security); *In re Winfield & Co., Inc.*, 44 SEC 810, 817-18 (1972) (investment adviser to investment company failed to make reasonable investigation before causing the company to purchase securities); *In re Shearson, Hammill & Co.*, *supra* note 5.

n16 An adviser could not disregard information concerning the client's affairs that the adviser knows or should have known.

n17 In one case involving a client that turned over approximately \$ 100,000 to a broker but refused to provide financial information, the Commission explained that the broker had a "duty to proceed with caution; to make recommendations only on the basis of the concrete information that [the client] did supply and not on the basis of guesswork as to the value of other possible assets." *In re Eugene J. Erdos*, 47 SEC 985, 988 (1983), *aff'd sub nom. Erdos v. Securities and Exchange Commission*, 742 F.2d 507 (9th Cir. 1984). See also *In re Gerald M. Greenberg*, 40 SEC 133, 137-38 (1960), petition for review dismissed on motion of petitioner *sub nom. Greenberg v. SEC*, 287 F.2d 571 (10th Cir. 1960) ("clear purpose" of NASD suitability rule would be defeated if it were construed as permitting a broker-dealer to recommend low price speculative securities to "unknown" customers "without any knowledge of or attempt to obtain information concerning the customer's other security holdings, his financial situation, and his needs so as to be in a position to judge the suitability of the recommendation" (citation omitted)).

Proposed rule 206(4)-5 would not require that knowledge of an affiliate of the adviser be imputed to the adviser if it would be unreasonable to expect the adviser to know the information. For example, section 204A of the Advisers Act (15 U.S.C. 80b-4a) requires that advisers establish, maintain, and enforce

written procedures designed to prevent insider trading, in which case the adviser may not, and should not, have access to certain information about a recommended security that an affiliated adviser might have. Comment is requested on whether the proposed rule should specify standards that would establish a presumption that the knowledge of an affiliate would not be imputed to the adviser.

3. Recordkeeping

The Commission is proposing an amendment to rule 204-2 under the Advisers Act to require any investment adviser subject to the recordkeeping requirements of the Advisers Act n18 to maintain records of the information obtained about clients from the inquiries the adviser has made in complying with paragraph (a)(1) of proposed rule 206(4)-5. n19 The proposed recordkeeping requirement would not require advisers to memorialize the suitability considerations underlying each recommendation to clients. The amendment would require advisers to maintain, as part of their records, completed client questionnaires, or any other records or documents that the advisers have obtained from their client inquiries. These records would assist the Commission in determining whether investment advisers have complied with rule 206(4)-5. Comment is requested on whether advisers should be required to document the bases upon which suitability determinations have been made, either in connection with each piece of investment advice or in the form of a list of generic investments that the adviser has determined are suitable for the client.

n18 Rule 204-2, the general recordkeeping rule under the Advisers Act, applies to every investment adviser who makes use of the mails or of any means or instrumentality of interstate commerce in connection with his or its business as an investment adviser, other than one specifically exempted from registration pursuant to section 203(b) of the Advisers Act.

n19 Proposed paragraph (a)(17) of rule 204-2.

III. Custodian Account Statements

Under typical discretionary advisory arrangements, a third-party custodian holds client assets and sends account statements to the client and copies of the account statements to the client's investment adviser. n20 These account statements provide clients with independent reports of account activity and are designed to permit clients to protect themselves against illegal or questionable conduct, including inappropriately high levels of trading in their accounts, unauthorized transactions, and unsuitable investments. n21

n20 Custodial arrangements are typically made with broker-dealers and banks. Broker-dealers are required to provide account statements to customers. For example, the rules of the NASD, the NYSE, and the American Stock Exchange ("AMEX") require member broker-dealers to provide account statements to customers at least quarterly. NASD Rules of Fair Practice, § 45, art. III, NASD Manual (CCH) (paragraph) 9440; NYSE rule 409, 2 New York Stock Exchange Guide (CCH) (paragraph) 2409; AMEX rule 419, 2 American Stock Exchange Guide (CCH) (paragraph) 9439. These rules, however, permit customers to direct delivery of statements to investment advisers holding powers of attorney over customer accounts. See, e.g., NYSE rule 409(b), 2 New York Stock Exchange Guide (CCH) (paragraph) 2409; AMEX rule 420(a), 2 American Stock Exchange Guide (CCH) (paragraph) 9440. Commission rules under the Exchange Act require a broker-dealer to send account statements to its customers under certain circumstances. See, e.g., rule 15c-6 [17 CFR 240.15c-6] (monthly account statements for penny stock customers); rule 15c3-2 [17 CFR 240.15c3-2] (quarterly statement concerning use by broker-dealer of funds arising out of free credit balance in customer's account). See also infra note 21. Commission rules under the Advisers Act require an investment adviser that has custody or possession of client funds or securities to send to clients account statements at least every three months. Rule 206(4)-2 under the Advisers Act [17 CFR 275.206(4)-2].

n21 Another means of permitting clients to monitor their accounts would be to require advisers to have a reasonable belief that brokers send confirmations to clients. The Commission is not proposing such a requirement. A broker-dealer, however, has an obligation under rule 10b-10 under the Exchange Act [17 CFR 240.10b-10] to send its customers an immediate confirmation with respect to each transaction the

broker-dealer effects. In the case of an account managed by a fiduciary, the customer, rather than the fiduciary, is considered to be the customer of the broker-dealer. Accordingly, under rule 10b-10, the broker-dealer must send an immediate confirmation to the account holder, in addition to any confirmation it may send to the account fiduciary; however, an account that has given discretionary authority in writing to its fiduciary may agree in writing with the broker-dealer effecting its trades to waive the receipt of the immediate confirmation required by rule 10b-10 if, among other things, the broker-dealer sends the discretionary account a statement no less frequently than quarterly containing all the information required to be disclosed on the immediate confirmation. The customer may not waive this quarterly statement. See Securities Exchange Act Rel. No. 33743 (March 9, 1994) [59 FR 12767 (March 17, 1994)] at note 3.

Failure of a custodian to provide account information directly to clients may facilitate fraudulent transactions in client accounts, as illustrated in the case of Institutional Treasury Management, Inc. ("ITM"), a registered investment adviser, and its controlling person, Steven Wymer. ITM attracted clients by promising above-market returns through the use of sophisticated trading strategies in U.S. Government securities. When the strategies not only failed to produce the promised returns, but also began to cause substantial losses, Wymer began to trade client accounts aggressively, often without the clients' knowledge, in an attempt to recover losses. To cover additional losses, Wymer began to divert funds from one client account to another. n22 Total client losses as a result of the fraud amounted to approximately \$ 104 million. n23

n22 On September 29, 1992, the Commission and the U.S. Attorney's Office for the Central District of California jointly announced a settlement of civil and criminal actions against Wymer. Wymer pleaded guilty to nine felony counts, including securities fraud, and was ordered to pay \$ 209 million in restitution and prejudgment interest to his defrauded clients. Litigation Rel. No. 13389 (Sept. 29, 1992) (concerning Securities and Exchange Commission v. Institutional Treasury Management, Inc., Civil Action No. 91-6715 MRR (C.D. Cal. Sept. 25, 1992) and United States v. Steven D. Wymer, No. CR 92-2-RG.) In entering his guilty plea before the court, Wymer described how he traded in options and other speculative investments for accounts with conservative investment objectives, and then sent false account statements to clients to conceal losses and misappropriation of funds. Transcript of Proceedings before the Honorable Richard A. Gadbois, Jr., United States v. Steven D. Wymer, No. CR 92-02-(A)-RG (C.D. Cal. Sept. 29, 1992), at 25.

n23 See SEC v. Institutional Treasury Management, Inc., Denman & Company and Steven D. Wymer (Civil Action No. 91-6715 RJK) (C.D. Cal.) (Commission's Motion for an Order Distributing the Steven D. Wymer Qualified Settlement Fund, filed on Dec. 22, 1993).

Crucial to Wymer's fraudulent scheme was his ability to persuade the custodians of client accounts not to send confirmations and monthly statements to his clients. n24 Because clients received no independent reports of account activities, Wymer was able to successfully fabricate false account statements to hide the losses, unauthorized transactions, and the misappropriation of client funds and securities. n25 Other investment advisers have engaged in similar fraudulent schemes resulting in substantial client losses. n26

n24 Wymer testified before a Congressional subcommittee that he selected for his clients only those custodians that agreed to make ITM the exclusive recipient of account information. Investment Adviser Industry Reform, Hearing before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, 103d Cong., 1st Sess. 88-89 (1993).

n25 Id.

n26 See, e.g., In re Thomas Walter McKibbin and Equitrust, Inc., Investment Advisers Act Rel. No. 1165 (May 1, 1989) (adviser invested clients' funds in mutual funds, which sent account statements directly to adviser, which, in turn, sent false account statements to clients concealing misappropriation of funds); In re Robert Schwarz, Inc. and Robert G. Schwarz, Investment Advisers Act Rel. No. 1248 (Aug. 31, 1990) (adviser sent false account statements to clients concealing markups on municipal bonds purchased from broker-dealer, which sent confirmations of the transactions only to the adviser).

The Commission is proposing for comment new rule 206(4)-6 under the Advisers Act as a means reasonably necessary to prevent the type of fraudulent conduct in which Wymer and other advisers have engaged. n27 Rule 206(4)-6 would prohibit an investment adviser registered or required to be registered under the Advisers Act from exercising investment discretion with respect to a client account n28 unless it reasonably believed that the custodian of the account is providing account statements to the client no less frequently than quarterly. n29 An adviser would be deemed to have a reasonable belief that the custodian is providing account statements if the adviser has received copies of client account statements indicating that they were sent to clients. n30 Comment is requested on whether the "reasonable belief" standard in the proposed rule is appropriate and consistent with the duties of a fiduciary.

n27 In addition, the Commission is proposing an amendment to rule 204-2 to require investment advisers subject to the recordkeeping requirements of the Advisers Act to maintain in their records copies of custodian account statements that are received by the adviser. Proposed paragraph (a)(18) of rule 204-2.

n28 Proposed rule 206(4)-6 would not apply to an adviser's exercise of investment discretion with respect to the assets of investment companies registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) ("1940 Act") or business development companies. The 1940 Act regulates custodial arrangements with respect to these assets. Section 17(f) of the 1940 Act (15 U.S.C. 80a-17(f)) and rules 17f-1, 17f-2, 17f-4, and 17f-5 thereunder (17 CFR 270.17f-1, 17f-2, 17f-4, and 17f-5) and Section 59 of the 1940 Act (15 U.S.C. 80a-58).

n29 For purposes of rule 206(4)-6, an investment adviser would be deemed to exercise investment discretion with respect to an account if, directly or indirectly, the investment adviser is authorized to determine what securities or other property are purchased or sold for the account, or makes decisions as to what securities or other property are purchased or sold by or for the account, even though some other person may have responsibility for those investment decisions. Paragraph (c)(2) of proposed rule 206(4)-6. This definition is the same as in section 3(a)(35) of the Exchange Act [15 U.S.C. 78c(a)(35)].

n30 Paragraph (c)(4) of proposed rule 206(4)-6. The adviser could not rely on the copy of the account statement as a basis for its reasonable belief if the adviser had reason to believe that the account statements had not been delivered. Under the proposed rule, receipt of a copy of the account statement would not be the exclusive means by which an adviser could form a reasonable belief that the custodian is providing account statements to the client.

In some cases, a client may appoint another person to monitor his account and receive communications regarding the account. In such cases, proposed rule 206(4)-6 would permit the account statement to be sent to the client's designee. In order to prevent the rule from being circumvented, the rule would not permit the designee to be the custodian, the investment adviser, a person associated with the investment adviser, or a person under common control with the investment adviser. n31 Investment advisers often act as general partners of limited partnerships that invest in various types of financial instruments. In these cases, the account statement could be sent to a designee of the partnership—another general partner, an accountant or an attorney—that is not associated with the adviser. n32 Comment is requested, however, on whether the rule should contain specific provisions to address the delivery of account statements to limited partnerships. For example, should the rule specify that the account statement may, or should, be sent to each limited partner? Comment also is requested on how the proposed rule should address shares of open-end management investment companies, which might not be held by third-party custodians.

n31 Paragraph (c)(1) of proposed rule 206(4)-6. The term "person associated with an investment adviser" is defined in section 202(a)(17) of the Advisers Act [15 U.S.C. 80b-2(a)(17)] to mean any partner, officer, or director of the investment adviser (or any person performing similar functions), or any person directly or indirectly controlling or controlled by the adviser, including any employee of the adviser.

n32 See, e.g., GBU, Inc. (pub. avail. Apr. 22, 1993); PIMS, Inc. (pub. avail. Oct. 21, 1991); Bennett Management Company, Inc. (pub. avail. Feb. 26, 1991) (general partner not deemed to have custody of client assets when it is authorized to make certain draws on partnership funds if, before making draws, the general partner provides certain information concerning the draws to an independent representative of the partnership for review and authorization).

The account statement specified in proposed rule 206(4)-6 would be required to show all transactions occurring in the account during the period covered by the account statement, and the funds, securities, and other property in the account at the end of the period. n33 The Commission requests comment on whether the rule should require other information to be provided (e.g., the value of securities positions in the account) to assure that clients receive sufficient information to monitor account activity. n34

n33 Paragraph (b) of proposed rule 206(4)-6.

n34 See, e.g., rule 15g-6(d)(2) (17 CFR 240.15g-6(d)(2)) under the Exchange Act (requiring market value of penny stocks, if determinable, to appear on account statement sent to customer that purchases penny stocks).

The Commission believes that the proposed rule reflects the business practices of most investment advisers and custodians under which an account statement showing all account transactions is generated by the custodian and delivered directly to the client. Copies of account statements are typically provided to the investment adviser, and the data is used by the adviser to verify the accuracy of the adviser's own records.

If proposed rule 206(4)-6 is adopted, the Commission anticipates delaying the effective date of the rule for a sufficient period to permit advisers to confirm that their clients' custodians are providing account statements to the clients and, if they are not, to permit clients to direct custodians to provide them with account statements. An adviser that exercises investment discretion with respect to client accounts that cannot form a reasonable belief that the custodians of those accounts are sending account statements to clients could not continue to provide investment advice to the clients on a discretionary basis. Comment is requested on whether a sixty-day delay would be sufficient.

IV. General Request for Comments

Any interested persons wishing to submit written comments on the rule proposals that are the subject of this release, suggest additional changes, or submit comments on other matters that might have an effect on the proposals described in this release, are requested to do so.

V. Summary of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis in accordance with 5 U.S.C. 603 regarding the proposed rules and rule amendments. The analysis notes that proposed rule 206(4)-5 makes explicit an adviser's current obligation under the Advisers Act to make a reasonable inquiry into a client's financial situation, investment experience, and investment objectives, and, thereafter, to reasonably determine that investment advice is suitable for the client. Proposed paragraph (a)(17) of rule 204-2 would require investment advisers to retain for Commission inspection the client questionnaire or other records or documents received by the adviser in response to the inquiry that would be required by proposed rule 206(4)-5. The Commission does not have information on how many investment advisers that are "small entities" under the Advisers Act ("small advisers") do not currently record this information. The Commission believes, however, that the costs involved in doing so would not be significant and would be outweighed by the benefits to clients.

The analysis also notes that proposed rule 206(4)-6 would prohibit a registered investment adviser from exercising investment discretion with respect to client accounts unless it has a reasonable belief that the custodians of those accounts send account statements to the clients no less frequently than quarterly. The analysis notes that most custodians already provide account statements to clients, and in many cases also send copies of account statements to the clients' investment advisers. The Commission

believes that the costs involved with sending these statements to clients and to advisers would not be significant, and would be outweighed by the benefits to clients. Proposed paragraph (a)(18) of rule 204-2 would require investment advisers to maintain copies of client custodial account statements received by the adviser. The Commission believes that the costs associated with retaining these copies would not be significant and, in any event, would be outweighed by the benefits to the Commission's adviser examination program.

The analysis notes that alternatives to the proposals were considered, including establishing different compliance or reporting requirements or timetables that would take into account the resources available to small advisers, and the simplification of compliance and reporting requirements for small advisers. The Commission also considered the use of performance rather than design standards, and the exemption of small advisers from coverage of part or all of the proposed amendments. The Commission concluded that the alternatives would not be as effective as the proposals in assuring that the suitability standard is understood and adhered to by all advisers and that all discretionary clients are provided with independent reports to monitor account activity. A copy of the Initial Regulatory Flexibility Analysis may be obtained by contacting W. Thomas Conner, Office of Disclosure and Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549.

VI. Statutory Authority

The Commission is proposing rules 206(4)-5 and 206(4)-6 under the authority set forth in sections 206(4) and 211(a) of the Advisers Act (15 U.S.C. 80b-6(4) and 80b-11(a)).

The Commission is proposing amendments to rule 204-2 under its authority in sections 204 and 211(a) of the Advisers Act (15 U.S.C. 80b-4 and 80b-11(a)).

Text of Proposed Rules and Rule Amendments

List of Subjects in 17 CFR Part 275

Investment advisers, Fraud, Reporting and recordkeeping requirements.

For the reasons set out in the preamble, title 17, chapter II of the Code of Federal Regulations is proposed to be amended as follows.

PART 275-RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1. The general authority for part 275 is revised to read as follows:

Authority: 15 U.S.C. 80b-3, 80b-4, 80b-6(4), 80b-6A, 80b-11, unless otherwise noted.

* * * * *

2. By adding paragraphs (a)(17) and (a)(18) to § 275.204-2 to read as follows:

§ 275.204-2 -- Books and records to be maintained by investment advisers.

(a) * * *

(17) With respect to each client (other than a client to which the adviser provides only impersonal advisory services), completed client questionnaires, or other records or documents received by the investment adviser in response to the inquiry made by the investment adviser into the client's financial situation, investment experience, and investment objectives required by § 275.206(4)-5.

(18) With respect to each client (other than an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) or a business development company), copies of account statements sent to such client by the custodian of such client's account that were also received by the adviser.

* * * * *

3. By adding § 275.206(4)-5 to read as follows:

§ 275.206(4)-5 -- Suitability of investment advice.

(a) It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b-6(4)) for any investment adviser to provide investment advice to any client, other than in connection with impersonal advisory services, unless the adviser:

(1) Before providing any investment advice, and as appropriate thereafter, makes a reasonable inquiry into the client's financial situation, investment experience, and investment objectives; and

(2) Reasonably determines that the investment advice is suitable for the client.

(b) For purposes of this section, the term impersonal advisory services shall mean investment advisory services provided solely:

(1) By means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts;

(2) Through the issuance of statistical information containing no expression of opinion as to the investment merits of a particular security; or

(3) Any combination of the foregoing services.

4. By adding § 275.206(4)-6 to read as follows:

§ 275.206(4)-6 -- Custodial account statements.

(a) It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b-6(4)) for any investment adviser registered or required to be registered pursuant to section 203 of the Act (15 U.S.C. 80b-3) to exercise investment discretion with respect to a client account (other than the account of an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) or a business development company), unless the investment adviser reasonably believes that the custodian of the client account is providing to the client or its designee an account statement described in paragraph (b) of this section not less frequently than once every three months.

(b) The account statement required by paragraph (a) of this section shall show, for the period of the account statement:

- (1) All transactions occurring in the account during the period; and
- (2) The funds, securities, and other property in the account at the end of the period.

(c) For purposes of this section:

(1) The client's designee shall not be the custodian, the investment adviser, a person associated with the investment adviser, or a person under common control with the investment adviser;

(2) An investment adviser exercises investment discretion with respect to an account if, directly or indirectly, the investment adviser:

(i) Is authorized to determine what securities or other property shall be purchased or sold by or for the account; or

(ii) Makes decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have responsibility for those investment decisions;

(3) A person (other than the client) is a custodian of a client account if it has custody or possession of any securities or other property in which the client has any beneficial interest; and

(4) An adviser shall be deemed to have a reasonable belief that the custodian has provided a particular account statement to the client or its designee if the adviser has received a copy of such statement indicating that it has been sent to the client, provided that the adviser has no reason to believe that the account statement has not been delivered to the client.

By the Commission.

Dated: March 16, 1994.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 94-6658 Filed 3-21-94; 8:45 am]

BILLING CODE 8010-01-P