

Comment Letter on SEC's Year 2000 Rule Proposals, August 1998

August 10, 1998

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Investment Adviser Year 2000 Reports (File No. S7-20-98)

Dear Mr. Katz:

The Investment Company Institute¹ appreciates the opportunity to comment on the Securities and Exchange Commission's proposed rule that would require most registered investment advisers to file Year 2000 readiness reports.² Proposed Rule 204-5 under the Investment Advisers Act of 1940 ("Advisers Act") would require the filing of proposed Form ADV-Y2K by each registered investment adviser that (i) has at least \$25 million of assets under management, as reported on Schedule I of the adviser's most recently filed Form ADV, or the most recent amendment to Form ADV, or (ii) is an adviser to a registered investment company.

The Institute generally supports this proposal and commends the Commission in its efforts to design a regulatory framework that provides flexibility to investment advisers in identifying and addressing Year 2000 problems. We note that the proposed rule is consistent in many respects with the Commission's recently adopted Year 2000 reporting rules for nonbank transfer agents and certain broker-dealers.³ Our comments focus primarily on Part II to Form ADV-Y2K and recommend certain modifications to make that section more workable for investment advisers with respect to the registered investment companies they advise.

According to the Release, Form ADV-Y2K would have to be filed no later than thirty days after the rule becomes effective, and an updated form would have to be filed no later than eight months from the date of the first filing. In addition, the form would have to be signed by an authorized person that participates in managing or directing the adviser's affairs, but it would not have to be accompanied by an attestation report prepared by an independent public accountant. The Institute is pleased that the Commission has determined not to include an attestation requirement in proposed Rule 204-5.⁴ We do not believe that it is necessary to impose such a requirement, or any other form of independent third party review, on registered investment advisers.⁵ The Release also notes that the form would be made available to the public. As we have stated previously, we believe that reports on Year 2000 readiness filed with the Commission should be treated confidentially.⁶ Our detailed comments on the Release follow.

Registered Investment Company Reporting

As proposed, the instructions to Form ADV-Y2K would require each registered investment adviser that advises a registered investment company or a group of registered investment companies to complete Part II of the form, which, among other things, requests certain information about an investment company's efforts to become Year 2000 compliant. The Part II filing requirement raises two areas of concern. The first involves advisers' reporting responsibilities; the second involves the nature of the information requested by the form.

Investment Advisers' Fund Reporting Responsibilities.

The instructions to Form ADV-Y2K specify that each adviser or subadviser (collectively, "adviser") to a fund must complete Part II with respect to that fund and any other fund in the same fund complex, unless another adviser is submitting a form covering the investment company. This reporting requirement raises two issues. First, we are concerned that the proposed filing requirement appears to assume that each adviser will be able to prepare and file the form on behalf of any fund it advises. In many situations this may not be feasible. For instance, where an adviser provides only portfolio management services to a fund and is neither the

sponsor⁷ nor otherwise affiliated with the sponsor, it would not possess (or be in a position to obtain) information relating to a fund's shareholder servicing, transfer agency, fund accounting, distribution, custody of fund assets, or other back-office related functions.⁸ Placing a responsibility on an adviser to provide information that is not within the scope of its responsibilities as an investment adviser clearly would be an inappropriate and unfair burden.⁹

Second, the instructions to the form require respondents to discuss remediation efforts for all computer systems used by the funds in a complex in which the respondent advises a fund. The instructions explain that advisers to a fund complex with multiple advisers can decide among themselves which adviser will complete and file the form.¹⁰ The Institute appreciates the Commission's efforts to provide maximum flexibility to investment advisers to determine who is in the best position to complete the form with respect to each investment company. We are concerned, however, that for the same reasons that an adviser whose role is limited to portfolio management will be unable to prepare the form with respect to the fund it advises, so too, in a multiple adviser context, an adviser will be unable to prepare the form on behalf of any other fund in the complex. Simply put, an adviser to one fund will not be in a position to report on remediation efforts on behalf of any fund it does not advise. By imposing a filing responsibility on all advisers, the proposed rule places an unfair burden on those advisers who simply do not know, and are not in a position to know, this information.¹¹

To address these concerns, therefore, the Institute recommends that the instructions to Form ADV-Y2K be revised to reflect that the responsibility for completing and filing the form rests with an investment adviser that is also a sponsor to a fund, unless a nonsponsor adviser or subadviser to one or more of the funds in the complex or family has agreed to complete and file the form with respect to such fund(s).¹² Our recommendation would permit investment advisers to retain the flexibility to decide among themselves which party is in the best position to complete and file the form, and is consistent with the SEC's objective to receive Year 2000 information with respect to most funds.¹³ And to address those situations where there are no registered advisers with responsibilities sufficient to enable the completion of the form on behalf of the fund advised, we further recommend that the fund itself have the responsibility for completing the form insofar as it relates to the fund.¹⁴

Contents of Part II.

The Institute notes that Part II of Form ADV-Y2K is somewhat duplicative in that most of the questions in that section merely track the questions contained in Part I. As drafted, Part II of the form seems to be based on the premise that there are two separate and distinct computer systems—one for the investment adviser, the other for the investment company. Because of the unique way in which investment companies are organized and operated, that is not the case. An investment company generally does not have its own management information system. The system that runs investment company operations is usually that of the sponsor. Accordingly, an investment company would not have a separate Year 2000 plan. Remediation efforts related to investment company operations usually are subsumed within the Year 2000 plan of the sponsor. Therefore, an investment company typically would not have dedicated computer systems of its own—mission critical or otherwise—that can be identified, inventoried, or tested. In addition, because an investment company generally has no employees, there would be no employees to approve any such plan nor any staffing to prepare for the Year 2000 project. Moreover, since the investment company has no Year 2000 plan, it likewise would have no contingency plan.

Because of this organizational arrangement, the Institute is concerned that many of the questions in Part II may go unanswered because technically they do not apply to the investment company, or the responses given may merely replicate the responses given in Part I. In order to minimize confusion and duplicative (or no) responses, and to provide the Commission with useful and relevant information, the Institute recommends that Part II be modified to more accurately reflect the investment company organizational structure. Given that a sponsor's management information system (and, hence, its Year 2000 plan) is not specifically organized by line of business (e.g., investment company operations vs. institutional accounts), one possibility would be to revise Part II to include only those questions that relate specifically to investment company operations, such as the frequency in which the board of directors is apprised of the investment company's Year 2000 progress, and the amount of investment company assets that are covered by the report.¹⁵

Multiple Systems Reporting

The instructions to Form ADV-Y2K also provide that, where there are multiple computer systems for which different amounts of progress have been made in preparing for the Year 2000 problem, the responses should be based on a qualitative average of the systems. The Institute supports this provision as it allows advisers and investment companies flexibility in assessing the status of their systems on a firm-wide or complex-wide basis.

Facsimile Filing

As proposed, advisers would be required to file Form ADV-Y2K by fax; no paper filings would be accepted. The Release adds that

the Commission would provide specified fax numbers and asks for comment on whether its assumption that each investment adviser has access to a facsimile machine is valid. The Institute believes that every adviser has access to a facsimile machine; however, there is some question as to the consequences for late filings, particularly if an adviser is precluded from completing a timely filing because the Commission's facsimile machine is busy due to heavy volume or some other communication glitch occurs. The Institute requests clarification in this area, including whether a safe harbor is available should a good faith attempt to complete a timely filing be unsuccessful. We also request clarification as to what would constitute acceptable verification of receipt by the Commission. In particular, the Commission should clarify whether the adviser may be permitted to rely on a confirmation printed by its facsimile machine, or whether instead the Commission would send some form of return acknowledgment indicating receipt of the form.

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The Institute appreciates the opportunity to comment on the Release. Any questions on our comments may be directed to the undersigned at (202) 326-5923 or to Frances M. Stadler at (202) 326-5822.

Sincerely,

Barry E. Simmons
Assistant Counsel

cc: Barry P. Barbash, Director
Robert E. Plaze, Associate Director
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Richard R. Lindsey, Director
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ENDNOTES

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,301 open-end investment companies ("mutual funds"), 436 closed-end investment companies, and 9 sponsors of unit investment trusts. Its mutual fund members have assets of about \$5.097 trillion, accounting for approximately 95% of total industry assets, and have over 62 million individual shareholders. Many of the Institute's investment adviser members render investment advice to both investment companies and other clients. In addition, the Institute's membership includes 501 associate members which render investment management services exclusively to noninvestment company clients. A substantial portion of the total assets managed by registered investment advisers are managed by these Institute members and associate members.

² Investment Adviser Year 2000 Reports, SEC Release No. IA-1728; IC-23293; File No. S7-20-98 (June 30, 1998) (the "Release").

³ See Year 2000 Readiness Reports To Be Made by Certain Transfer Agents, SEC Release No. 34-40163; File No. S7-8-98 (July 2, 1998); and Reports To Be Made by Certain Brokers and Dealers, SEC Release No. 34-40162; File No. S7-7-98 (July 2, 1998).

⁴ In our comment letter to the Commission regarding the transfer agent and broker-dealer Year 2000 reporting proposals, we opposed the proposed attestation requirement because: (1) having independent public accountants conduct a thorough review of a firm's systems and operations in order to opine on the reasonableness of management's assertions could be very costly, time-consuming, and operationally disruptive; (2) independent public accountants may not have the requisite expertise to perform an attestation engagement given that their focus primarily is on financial audits; (3) the Year 2000 readiness reporting rules do not provide criteria against which to measure the quality of management's actions—such as the reasonableness of a Year 2000 plan, the accuracy and validity of related test results, etc.; (4) independent public accountants may not have the capacity collectively to perform all of the attestations that would be required given that the followup reports for all nonbank transfer agents (and certain broker-dealers with the same fiscal yearend) would have to be filed at the same time; and (5) the purpose and conclusions of the attestation report could be misunderstood and uninformed users of the reports would place undue reliance on them. See Letter from Barry E. Simmons, Assistant Counsel, Investment Company Institute to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated April 13, 1998. The same concerns would arise if an attestation requirement were proposed with respect to investment adviser Year 2000 readiness reports.

⁵ We note that the Commission has re-opened the comment period to obtain additional views on the attestation proposal with respect to broker-dealers and transfer agents. In particular, the Commission has requested comments on the feasibility and desirability of an agreed-upon procedures engagement, an alternative approach suggested by the American Institute of Certified Public Accountants

(AICPA). See Year 2000 Readiness Reports to be Made by Certain Transfer Agents, Release No. 34-40165; File No. S7-8-98 (July 2, 1998); and Reports to be Made by Certain Brokers and Dealers, Release No. 34-40164; File No. S7-7-98 (July 2, 1998). As indicated in our comment letter responding to these releases, which we are also filing today, the Institute does not support this approach. For the reasons stated in that letter, this approach also would not be appropriate with respect to investment advisers.

⁶ Our April 13 comment letter expressed concern that, among other things, because of the technical nature of the reports' subject matter, investors could misperceive certain information and draw erroneous conclusions from it, even though the firm could be on schedule with its Year 2000 plan. The letter added that this is especially likely with respect to the exceptions reporting requirement, which requires disclosure of exceptions resulting from systems testing.

⁷ As used herein, "sponsor" includes an investment adviser, administrator, service provider, or other similar entity that provides administrative services to a fund.

⁸ Similarly, this situation would also occur in a multi-manager context where different advisers provide advisory services to the same fund.

⁹ Regarding the systems an adviser might utilize in managing portfolio assets (such as trading systems used for fund and nonfund clients), the status of those systems with respect to Year 2000 remediation would be addressed in Part I of the adviser's Form ADV-Y2K.

¹⁰ Although not stated in the instructions, the Release contemplates that the adviser with the most administrative responsibilities will most likely prepare and file the form.

¹¹ These concerns also raise an important liability issue. Requiring advisers to file Part II of the form in situations where they lack the requisite knowledge to properly gauge the accuracy or completeness of the information reported could potentially subject them to liability under Section 207 of the Advisers Act, which, as noted in the form, deems unlawful the filing of any report with the Commission that contains any untrue statement of a material fact or fails to contain any material fact required to be disclosed.

¹² Amending the form in this way would satisfy the Section 207 concerns noted above.

¹³ In a related situation, we note that advisers to funds underlying variable insurance contracts similarly would not be appropriate entities to provide Year 2000 information regarding systems supporting the contracts and the separate accounts and insurance companies issuing the contracts. Because the systems supporting the contracts and the separate accounts and the insurance companies issuing the contracts are the responsibility of the insurance companies themselves, the level of Year 2000 reporting by advisers to funds underlying variable insurance contracts should be limited to the adviser's own systems and any potential effects on the fund itself.

¹⁴ We previously recommended against imposing filing requirements for investment companies because, among other reasons, these entities are externally managed and do not have their own employees or computer systems. While this will certainly be the case in most circumstances, we believe it would not be inappropriate to place the responsibility for coordinating and reporting on a fund's Year 2000 remediation efforts with the registered fund in those limited circumstances described above where there is no registered adviser with sufficient knowledge to enable it to prepare and file the form.

¹⁵ Of course, consistent with our comments above, in situations where the responsibility for completing the form is imposed upon the fund because there is no registered adviser capable of completing the form, an expanded Part II, or a separate stand-alone form, may be required. It is important, however, that the form elicit information only with respect to the fund, and not any other business activity of the nonregistered sponsor. In a related matter, in order to minimize duplicative reporting, the Institute requests that the Commission consider permitting dual-registered entities (such as a registered investment adviser that is also a registered broker-dealer) that have the same or integrated systems to file a single Year 2000 readiness report. Similarly, in those situations where the investment adviser is preparing the report on behalf of a fund, and where the adviser is affiliated with a registered transfer agent, a registered broker-dealer, and/or another registered adviser, any combination of which is connected by the same or integrated systems, we request that the Commission consider permitting a consolidated filing that includes these entities as well.