The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 7311

October 3, 1995

INSTITUTE COMMENT LETTER TO SEC ON REPROPOSED RULE 3A-4

1 See Institute Memorandum to Investment Advisers Committee No. 33-95, SEC Rules Committee No. 89-95, dated August 1, 1995; Investment Adviser Associate Members No. 29-95, dated August 1, 1995. October 3, 1995 TO: INVESTMENT ADVISER ASSOCIATE MEMBERS No. 40-95 INVESTMENT ADVISERS COMMITTEE No. 41-95 SEC RULES COMMITTEE No. 106-95 RE: INSTITUTE COMMENT LETTER TO SEC ON REPROPOSED RULE 3a-4 _____ As we previously informed you, the Securities and Exchange Commission recently reproposed Rule 3a-4 under the Investment Company Act of 1940 to provide a nonexclusive safe harbor from the definition of "investment company" for certain investment advisory programs. 1 The Institute recently submitted the attached comment letter to the Commission on the proposal. Significant portions of the Institute*s letter are summarized below. The letter notes that the Institute opposed the Commission*s 1980 proposal of Rule 3a-4, out of a concern that it would permit the creation of unregulated mutual funds. While the Institute continues to have concerns over the proposed safe harbor, we recognize that many of the conditions of the original proposal have become de facto law since 1980 through the no-action process and it does not appear that these conditions have permitted widespread evasion of the Act. Consequently, the Institute*s letter generally supports reproposed Rule 3a-4. The Institute*s letter does, however, recommend that the Commission include as an express condition of the rule a requirement that investment managers make individualized suitability determinations, because this requirement would provide a critical distinction between private investment adviser accounts and investment companies. The letter notes that the scope of any portfolio manager*s suitability obligation must depend, at least in part, upon the nature of the services being provided. For example, the mere fact that a portfolio manager similarly invests the accounts of various clients who have been determined to have similar characteristics that are relevant to a suitability analysis would not by itself demonstrate that the portfolio manager failed to provide those clients with individualized investment advice. In response to the Commission*s request for comments, the Institute*s letter opposes the substitution of a minimum account size requirement for the other conditions of the rule and questions the practicality of even adding such a requirement to the other conditions. The Institute generally supports the proposed requirements for procedures, recordkeeping, and filing of new Form N-3a4 because they would serve a valid regulatory purpose without imposing an unnecessary burden on program sponsors. At the same time, the Institute urges the Commission*s staff, in inspecting advisory programs under the new rule, to take into account the diversity of these programs and to permit each program to craft standards appropriate in light of its particular characteristics. The Institute*s letter has three comments concerning proposed requirements that each client be able to impose reasonable restrictions on the

management of the client*s account. First, the Institute recommends that the adopting release clarify that these requirements would not authorize clients to direct their investments. Second, as a practical matter the authority to exclude investments could cause special problems with respect to mutual fund asset allocation programs. Therefore, the Institute supports a position of the reproposing release, that the adviser may decline accounts that are accompanied by restrictions that the adviser deems unreasonable. Third, the adopting release should clarify that the reasonable costs of complying with the client*s instructions may be passed along to the client, provided that the client is informed of these charges before entering into the program. The Commission requested comment on various issues concerning wrap fee and other similar programs under the Investment Advisers Act (e.g., best execution and applicability of Section 206(3) of the Advisers Act), which will be addressed in a future interpretive release. In response, the Institute*s letter recommends that the Commission (1) consider these issues in the context of the general principles applicable to any client-adviser relationship and (2) issue a concept release or similar statement soliciting more detailed information concerning these matters before issuing an interpretive release. Thomas M. Selman Associate Counsel Attachment

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