The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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SEC PROPOSES AMENDMENTS TO INVESTMENT ADVISERS ACT RULES

1 Investment Advisers Act Release No. 1681 (Nov. 13, 1997) (proposing the multi-state adviser exemption and revisions to the definition of the term "investment adviser representative"); Investment Advisers Act Release No. 1682 (Nov. 13, 1997) (proposing amendments to Rule 205-3 under the Advisers Act). In Release No. 1681, the SEC also has proposed several technical amendments to clarify some of the rules adopted last May to implement the Investment Advisers Supervision Coordination Act (Title III of the National Securities Markets Improvement Act of 1996). [9428] November 19, 1997 TO: INVESTMENT ADVISERS COMMITTEE No. 33-97 RE: SEC PROPOSES AMENDMENTS TO INVESTMENT ADVISERS ACT RULES

_____ The Securities and Exchange Commission has proposed three amendments to the rules under the Investment Advisers Act. The proposed amendments would: (1) exempt certain multi-state investment advisers from the prohibition on SEC registration for advisers with less than $25 million of assets under management; (2) revise the definition of "investment adviser representative" to allow supervised persons to accept a greater number of "accommodation clients" without being subject to state qualification requirements; and (3) amend Rule 205-3 under the Act, the performance fee rule, to increase the criteria for clients eligible to enter into performance fee arrangements and to eliminate provisions specifying required contract terms and disclosures. The proposed rule amendments are summarized below and a copy of the SECs releases are attached.1 Comments are due to the SEC on the proposed amendments by January 20, 1998. Please provide your comments on the proposals to the undersigned by December 10, 1997. My direct number is 202/326-5825, the fax number is 202/326-5827 and my e-mail address is tamara@ici.org. A. Multi-State Exemption The SEC has proposed to amend Rule 203A-2 under the Advisers Act to permit investment advisers to register with the SEC that do not have $25 million of assets under management but have a multi-state practice that requires them to be registered with 30 or more state securities authorities. Under the proposed amendment, an adviser applying for registration in reliance on the exemption would be required to submit a representation that it has reviewed its obligations under state law and concluded that it is required to register as an investment adviser in at least 30 states. Once registered with the SEC, an adviser would continue to be eligible for the exemption so long as it is annually able to provide a 2 The criteria for determining high net worth individuals is based on the criteria in Rule 205-3 for determining those clients with whom an investment adviser may enter into a performance fee arrangement. As noted above, the SEC has proposed amendments to increase the criteria in Rule 205-3; see Section C below for a more detailed discussion of these amendments. Conforming changes would be made to the definition of "investment adviser representative" to reflect any such changes to Rule 205-3. 2

representation that the adviser has determined that, but for the exemption, it would be obligated to register in at least 25 states. The SEC has requested comment on whether the 30 state threshold should be increased or decreased and whether the five state difference is sufficient to prevent transient registration problems. Comment is also requested on whether advisers should be required to make a representation that counsel has reviewed the applicable state and federal laws and concluded that the adviser is eligible for the exemption and whether a newly formed adviser should be able to rely on the exemption based on a reasonable expectation that it would be required to register in 30 or more states within 120 days. B. Definition of Investment Adviser Representative Rule 203A-3(a) under the Advisers Act defines "investment adviser representative" as a supervised person more than ten percent of whose clients are natural persons, other than certain "high net worth" individuals.2 The ten percent allowance was designed to permit supervised persons to accept so-called "accommodation clients" without being subject to state qualification requirements. In adopting the ten percent allowance, the SEC recognized that it may pose a problem for supervised persons with one or a few institutional clients who would not be able to have any accommodation clients. To resolve this issue, the SEC has proposed two alternative amendments to the definition of investment adviser representative to allow supervised persons who provide services to one or a few institutional clients to continue to have accommodation clients without being subject to state qualification requirements. The first alternative would retain the ten percent allowance in the rule and add a provision to allow supervised persons to accept at least five natural person clients. (High net worth individuals would not be counted towards the ten percent allowance or the five person limit.) Under this approach, a supervised person could have the greater of five natural person clients or the number of natural person clients permitted under the ten percent allowance without being subject to state qualification requirements. Under the second alternative, the SEC would eliminate the ten percent allowance, and a supervised person could have an unrestricted number of clients who are natural persons without being subject to state qualification requirements, so long as such clients are either (i) high net worth individuals, or (ii) persons who are (A) partners, officers, or directors of the investment adviser for whom the supervised person works or of a business or institutional client of the investment adviser for whom the supervised person works, (B) relatives, spouses, 3 As noted in the Release, the second alternative is similar to but narrower than the ICIs recommendation to the staff that, in addition to the ten percent allowance, a supervised person be permitted to accept "accommodation clients" who are affiliated with non-natural clients. See Memorandum to Investment Advisers Committee No. 27-97, dated August 13, 1997. 4 This definition was enacted in connection with new Section 3(c)(7) of the Investment Company Act, which exempts from regulation under that Act certain investment pools whose interests are not offered to the public and whose shareholders consist primarily of "qualified purchasers." 3 or relatives of spouses of such partners, officers or directors, or (C) relatives or spouses, or relatives of spouses of the supervised person.3 With respect to the second alternative, comment is requested on the scope of the proposed accommodation client exception, and in particular, whether there are additional relationships between the investment adviser, supervised person, and client that suggest the client is an accommodation client. Comment is requested on the advantages and disadvantages of the two approaches and on whether additional approaches should be considered. C. Performance Fee Rule 1. Qualified Clients - Rule 205-3 under the Advisers Act permits investment advisers to charge performance fees to clients with at least $500,000 under the advisers management or with a net worth of more than $1,000,000. To reflect the effects of inflation since the rule was first adopted in 1985, the SEC has proposed to increase the amounts of the assets under management and net worth tests from $500,000 and $1,000,000 to $750,000 and $1,500,000, respectively. The SEC also is

proposing to permit advisers to enter into performance fee contracts with natural persons who are "qualified purchaser[s]" under Section 2(a)(51)(A) of the Investment Company Act, which includes natural persons with at least $5,000,000 of investments.4 The Release notes that although in most cases clients who are qualified purchasers under Section 2(a)(51)(A) would meet the eligibility thresholds in Rule 205-3, there may be instances when such persons would not. Comment is requested on whether the SEC should revise the assets under management and net worth criteria from becoming less meaningful as a result of inflation, whether the criteria should be indexed to prevent future effective lowering of the amounts, and whether the SEC should adopt more detailed criteria to assure the financial sophistication of qualified clients if the objective thresholds are effectively decreased as a result of inflation. In addition, comment is requested on whether the SEC should consider alternative criteria for "qualified clients" (e.g., should the SEC use the "qualified purchaser" threshold in lieu of the assets under management and net worth tests, rather than including it as a third alternative test?). Comment is also requested on whether these thresholds are sufficient for the SEC to make the required finding under Section 205(e) that qualified clients do not need the protections of the statutory prohibitions on performance fee arrangements. The Release notes that in addition to financial sophistication and knowledge and experience in financial matters, Section 205(e) of the Advisers Act permits the SEC to consider 4whether a client may not need the protections of the Act by virtue of its relationship with the adviser. Comment is requested on whether the SEC should exempt advisers that have pre-existing relationships with clients that suggest that the abuses Congress sought to prevent by prohibiting performance fee arrangements are unlikely to occur. If so, what should be the nature of those relationships? 2. Specific Contractual and Disclosure Requirements - Rule 205-3 currently requires certain terms to be included in contracts providing for performance fees and specific disclosures to be made to clients entering into these contracts. The SEC has proposed to eliminate these requirements based on its view that they may not be necessary to protect sophisticated clients of the type contemplated by the rule. Thus, an adviser would be free to negotiate all of the terms of a performance fee contract with a client. The Release emphasizes, however, that an adviser charging a performance fee would continue to be subject to the Advisers Acts prohibitions against fraud. Comment is requested on whether Rule 205-3 should be amended to eliminate all of the contractual and disclosure requirements for sophisticated clients, whether any of the provisions should be retained and whether any alternative conditions should be considered. 3. Identification of the Client - Rule 205-3 provides that with respect to certain clients entering into performance fee contracts with an adviser, such as private investment companies, registered investment companies and business development companies, the adviser must "look through" the legal entity to determine whether each equity owner of the company would be a qualified client. The proposed amendments would retain the "look through" provision and clarify that any equity owners that are not charged a performance fee would not be required to meet the qualified client test. Comment is requested on whether this "look through" provision should continue to be included in Rule 205-3 and whether the rule should specifically address the application of the "look through" provision to other entities. 4. Transition Period - The proposed amendments would add a transition rule permitting investment advisers and their clients to maintain their existing performance fee arrangements notwithstanding the clients failure to meet the increased eligibility thresholds, so long as the arrangements were entered into before the effective date of the amendments and they satisfied the requirements of the rule as in effect on the date the arrangements were entered into. Tamara K. Reed Associate Counsel Attachments