

MEMO# 9671

February 11, 1998

RECOMMENDATIONS FOR REVISIONS TO THE ADVISERS ACT ANTI-FRAUD RULES AND FORM ADV

[9671] February 11, 1998 TO: INVESTMENT ADVISERS COMMITTEE No. 7-98 RE: RECOMMENDATIONS FOR REVISIONS TO THE ADVISERS ACT ANTI-FRAUD RULES AND FORM ADV _____ The

Institute is in the process of developing proposals to submit to the SEC for revisions to the anti-fraud rules under the Investment Advisers Act and to Form ADV. We have retained outside counsel to assist us in both of these projects. Set forth below is an outline of our proposals, which we plan to discuss at the upcoming Investment Advisers Committee meeting on February 17. If you are not planning to attend the meeting, please provide your comments on the proposals outlined below to me by the morning of February 17. I can be reached at 202/326-5824, by e-mail at amy@ici.org or by fax at 202/326-5827. A. Proposed Revisions to the Advisers Act Anti-Fraud Rules Section 206(4) of the Investment Advisers Act grants the SEC authority to adopt rules to "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." Pursuant to this authority, the SEC has adopted rules that include specific, detailed prohibitions that go beyond the SEC's statutory authority and impose undue (and, in many cases, outdated) burdens on advisers. The Institute plans to propose that the SEC revise the rules adopted under Section 206(4) and return to the general anti-fraud principles upon which they are based. Specifically, we will propose that the SEC amend the anti-fraud rules as follows: 1. Advertising Rule (Rule 206 (4)-1) - The SEC should repeal the specific restrictions and prohibitions in the rule and replace them with general guidelines for advisers to follow to ensure that they do not disseminate false and misleading advertising materials. The rule should be patterned after Rule 156 under the Securities Act of 1933, which contains general guidelines for the preparation of investment company advertising materials. 2. Custody Rule (Rule 206(4)-2) - The rule should be revised to broaden the list of eligible entities that may be utilized by an adviser that maintains custody of customer funds or securities. The rule should require that the account be maintained for the exclusive benefit of the adviser's customers, and that the adviser could not commingle its own proprietary funds or securities with this account. In addition, the adviser or the designated custodian should be required to maintain current and accurate records reflecting the holdings of each individual account. The rule also should define "custody" to include only those situations where the adviser has actual physical custody of customer funds or securities. Finally, we would recommend that the custody rules not apply where the custody arrangement is governed by the contract between the adviser and the client, providing there is full and fair disclosure concerning the arrangement. 3. Cash Referral Fee (Rule 206(4)-3) - The SEC should repeal the rule. To the

extent deemed necessary, state law should govern any disclosure requirements applicable to third-party solicitors. 4. Financial and Disciplinary Disclosure (Rule 206(4)-4) - The SEC should repeal the rule and require appropriate disciplinary/financial condition disclosures in the brochure delivered to clients. B. Proposed Revisions to Form ADV The Institute would recommend that the brochure be required to be in narrative format and that advisers have the option of using a two-part brochure, similar to the prospectus and SAI format. The first part of the brochure would include key information and would be required to be provided to clients. The second part of the brochure would supplement the information included in the first part and would be made available promptly upon request. A separate document with appropriate information should be required to be filed with the SEC. The brochure provided to clients should include information regarding: (a) the nature of services offered; (b) the type of clients to whom the adviser provides services (e.g., pension plans) and any minimum requirements for assets under management; (c) the fees and expenses; (d) the background of the adviser; (e) material conflicts of interest; and (f) disciplinary history and financial condition. In addition, the Institute would recommend that advisers file their Form ADVs and brochures electronically, such as through EDGAR or other means. Attached is an outline prepared by outside counsel regarding the proposed revisions to Form ADV. * * *

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