MEMO# 10102

July 8, 1998

INSTITUTE RECOMMENDS CHANGES TO ANTIFRAUD RULES UNDER THE ADVISERS ACT

* See Memorandum to Investment Advisers Committee No. 21-98, dated May 28, 1998, for a copy of the draft submission. [10102] July 8, 1998 TO: INVESTMENT ADVISERS COMMITTEE No. 25-98 RE: INSTITUTE RECOMMENDS CHANGES TO ANTIFRAUD RULES UNDER THE ADVISERS ACT

____ The Institute submitted to the Securities and Exchange Commission recommendations to certain rules under the antifraud provisions of the Investment Advisers Act of 1940.* Specifically, the Institute suggested changes to Rule 206(4)-1 (the "Advertising Rule"), Rule 206(4)-2 (the "Custody Rule") and Rule 206(4)-4 (the "Financial and Disciplinary Rule") to update, simplify and, most importantly, bring these rules back in line with the statutory purpose of Section 206 of the Act. The proposals are summarized below; a copy of the submission is attached. Rule 206(4)-1 (the "Advertising Rule") The Institute recommends amending Rule 206(4)-1 to eliminate the current "laundry list" of specific advertising practices that are defined to be per se fraudulent and therefore prohibited. In its place, we recommend that the SEC adopt a rule similar to Rule 156 under the Securities Act of 1933 relating to investment company sales literature. Under this approach, the rule would continue to make unlawful false, misleading or manipulative advertisements. However, rather than making certain practices per se fraudulent, it would identify certain practices and items of information that may potentially mislead investors unless presented in an appropriate context and with clear explanations and qualifications. For example, we recommend that the new rule provide that portrayals of an investment adviser's past performance results may be misleading if an adviser fails to disclose the effect on those results of material market or economic conditions, the deduction of fees and expenses, or the inclusion of reinvested dividends and other earnings. Rule 206(4)-2 (the "Custody Rule") The Institute suggests significant revisions to Rule 206(4)-2 to provide greater flexibility and to eliminate the confusion and inefficiencies of the rule caused by the various no-action and interpretive letters issued by the SEC staff since the rule was first adopted. First, the Institute recommends amending paragraph (a)(1) of the rule to provide greater flexibility in establishing custody arrangements by allowing advisers to keep custody of client assets directly, through an affiliate of the adviser, or with another entity, provided that the custodian is a regulated financial institution, the arrangement is governed by a written contract containing specified provisions and certain other protective conditions are met. As proposed by the Institute, the rule would also permit an adviser to maintain custody pursuant to an arrangement that does not comply with the requirements of paragraph (a)(1) provided that the advisory client has given his or her informed written consent to the arrangement. Finally, we recommend that the rule be updated to provide that an adviser will not be deemed to have custody of client assets solely because the adviser's fees are deducted from the client's account, so long as certain conditions are met. The Institute also recommends that the SEC clarify in its release adopting the rule amendments that an adviser will not be deemed to have custody of client assets solely because the adviser temporarily comes into possession of the assets, provided that the adviser did not seek possession of the assets and promptly takes steps to deliver them to the proper custodian. Rule 206(4)-4 (the "Financial and Disciplinary Disclosure Rule") The Institute recommends that the SEC repeal Rule 206(4)-4 and replace it with a requirement that the appropriate disciplinary/financial conditions be disclosed in the brochure delivered to clients. Amy B.R. Lancellotta Senior Counsel Attachment