The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 14619

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DRAFT ICI REGULATORY REFORM INITIATIVES RELATING TO INVESTMENT ADVISER REGULATION

[14619] April 9, 2002 TO: INVESTMENT ADVISERS COMMITTEE No. 5-02 RE: DRAFT ICI REGULATORY REFORM INITIATIVES RELATING TO INVESTMENT ADVISER REGULATION In connection with plans to undertake a comprehensive review of the federal securities laws, SEC Chairman Harvey Pitt has invited the industry to make recommendations for possible regulatory changes. In response to this invitation, the Institute has prepared a draft package of regulatory reform proposals. Summarized below and attached are the four recommendations in the Institute's packet that relate to investment adviser regulation. Each of which is consistent with recommendations previously submitted to the Commission. Please review the attached proposals and provide the undersigned by the close of business on Friday, April 19th any comments you have on them. Comments may be provided by phone (202) 326-5839 or e-mail (tamara@ici.org). I. AMEND RULE 3a-4 RELATING TO THE STATUS OF CERTAIN ADVISORY PROGRAMS Rule 3a-4 under the Investment Company Act provides a nonexclusive safe harbor from the definition of "investment company" for certain investment advisory programs. Since the rule was adopted, various developments have called into question the extent to which investors in these programs are, in fact, receiving the individualized treatment that was deemed critical by the SEC when it adopted the rule. The draft submission recommends that the staff revisit Rule 3a-4 to determine whether conditions should be added to the rule or interpretive guidance should be issued to ensure that individualized investment advisory services are being provided by the programs relying on this safe harbor. One change that we recommend that the Commission consider is adding an express condition to the rule requiring that investment managers be required to make individualized suitability determinations for investors in these programs. II. REDUCE THE FREQUENCY OF FILING REPORTS ON FORM 13F Section 13(f) of the Securities Exchange Act and Rule 13f-1 thereunder generally require institutional investment managers to file quarterly reports on Form 13F with the Commission if they exercise investment discretion over accounts holding more than $100 million in "13(f) securities." In order to minimize potential abuses resulting from the availability of information 2 contained in 13F reports, such as front running or freeriding, the draft submission recommends that the Commission amend Rule 13f-1 to require semi-annual, rather than quarterly, reporting of the information and to increase the lag time for reporting from 45 days to 60 days after the end of the relevant period. III. AMEND THE ADVERTISING AND CUSTODY RULES UNDER THE ADVISERS ACT In 1998, the Institute submitted to the Division of Investment Management recommended revisions to update and modernize two rules under the Advisers Act: Rule 206(4)-1, which governs advertising practices, and Rule 206(4)-2, which governs custody or possession of customer funds or securities. The draft

submission summarizes and reaffirms our 1998 recommendations, as described briefly below. A. Advertising: Rule 206(4)-1 The submission notes that, as a result of developments in the industry, this rule today unnecessarily restricts the communication of information by advisers to clients and prospective clients. To address this concern, the Institute recommends that the Commission repeal the current rule and replace it with a rule, similar to Rule 156 under the Securities Act, that would: (1) prohibit advisers from using advertising that is materially false or misleading; (2) define as materially false or misleading any advertisement that contains an untrue statement of material fact or a material omission; and (3) provide general guidance on the presentation of advertisements, including a list of some factors and kinds of information or statements that may make an advertisement false or misleading, depending on the context in which it is used and how it is presented, explained, and qualified. In addition, the Institute recommends that the definition of “advertisement” in the rule be narrowed. B. Custody: Rule 206(4)-2 The submission notes that the application of this rule, and staff interpretations under it, have proved to be complex, confusing, and sometimes incomprehensible. To address this concern, the Institute recommends that the rule be revised to permit an adviser to keep custody of client funds or securities directly, through an affiliate of the adviser that meets certain specified conditions provided that: (1) notice of the arrangement is provided to clients; (2) the arrangement is governed by a written contract containing specified provisions; and (3) clients are provided a quarterly itemized account statement showing all activity in the client account. Alternatively, the Institute’s letter recommends that the rule allow an adviser to maintain custody if the client is provided specified disclosure and has given his or her informed written consent to the alternative arrangement. The Institute also recommends that the rule be amended to clarify that an adviser would not be subject to the rule solely because it or an affiliate may withdraw client assets from the client’s account to pay advisory, custodial or administrative fees provided: the arrangement is authorized in advance by the client in writing; the client may terminate authorization at any time without penalty; and the client receives periodic statements from the adviser detailing the amount of and basis for all fees deducted from the account. In addition, the Institute recommends that the release adopting the rule amendments provide that certain specified arrangements would not be deemed to be custody for purposes of the rule; that all existing 3 custody arrangements be grandfathered under the revised rule; and, that client securities may be maintained in book-entry form. Tamara K. Reed Associate Counsel Attachment Attachment (in .pdf format)
