The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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DIVISION NO-ACTION RESPONSE REQUIRES SPECIFIC DISCLOSURES BY ADVISER AND QUESTIONS SOLICITOR'S FEE

December 6, 1989 TO: SEC RULES MEMBERS NO. 66-89 INVESTMENT ADVISER MEMBERS NO. 58-89 INVESTMENT ADVISER ASSOCIATE MEMBERS NO. 58-89 RE: DIVISION NO-ACTION RESPONSE REQUIRES SPECIFIC DISCLOSURES BY ADVISER AND QUESTIONS SOLICITOR'S FEE _____ On February 3, 1989, the Securities and Exchange Commission's Division of Investment Management issued a no-action response to a letter submitted by an investment adviser/broker- dealer concerning cash payments for client solicitations. A copy of the letter and response by the Division are attached. The adviser proposed to offer an asset allocation investment strategy for its clients by investing in a variety of no-load mutual funds. The adviser proposed to use the services of unaffiliated solicitors to refer prospective clients to the adviser. The cash payment for client solicitation, which would not exceed 3% of the invested funds, would be deducted from the client's investment. In addition, the advisory fee would range from 1.5% to 2% depending on the account size. The adviser stated that no additional charge would be made to clients for transaction charges in connection with the purchase and sale of no-load mutual funds and all incurred transaction costs would be paid out of the management fee. In compliance with Rule 206(4)-3, the adviser stated that each client would receive a separate written disclosure statement from the solicitor disclosing that the referral fee would be charged to the client's account in addition to the management fee. A continuing referral fee arrangement with the solicitor would also be fully disclosed. The letter indicates that the SEC regional office staff raised the following issues: (1) whether the referral fee, in addition to the management fee, could be deemed an excessive management fee in violation of Section 206 of the Advisers Act, and (2) whether the 3% referral fee constituted a transaction charge for the purchase of no-load mutual fund shares in violation of Section 22(d) of the Investment Company Act of 1940. In its response, the Division stated that the following factors should be considered in determining whether a fee is reasonable in relation to the services provided: (1) the customary fee charged by other advisers for comparable services, (2) whether the same services could be obtained by the client directly without the adviser's assistance and cost, and (3) whether the adviser has a reasonable belief that his services would generate gains in excess of the fee charged. Moreover, an adviser must disclose to clients that: (1) in addition to the advisory fee charged by the investment adviser (and the solicitation fee it pays), each investment company in which a client's funds may be invested also pays its own investment advisory fees and other expenses and (2) if the client deals directly with the no-load fund, he or she would neither

pay a transaction fee nor a separate advisory fee. The Division also addressed whether the management fee, because it includes transaction fees, violates Section 22(d) of the 1940 Act, which prohibits a dealer from selling fund shares at other than the current offering price described in the fund's prospectus. Generally, to the extent that an adviser/broker raises his advisory fee by the commission it foregoes on a client's purchase of fund shares, the arrangement would violate Section 22(d) of the 1940 Act. The Division stated, however, that such an arrangement would only violate Section 22(d) if the advisory fee charged is higher than the "bona fide" advisory fee and the difference is primarily attributable to the client's cost of fund shares. Robert L. Bunnen, Jr. Assistant General Counsel Attachment

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