The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 8503

December 26, 1996

SEC PROPOSALS RELATING TO INVESTMENT ADVISERS UNDER THE NATIONAL SECURITIES MARKETS IMPROVEMENT ACT OF 1996; JANUARY 14 MEETING

December 26, 1996 TO: INVESTMENT ADVISER ASSOCIATE MEMBERS No. 50-96 INVESTMENT ADVISER MEMBERS No. 48-96 SEC RULES COMMITTEE No. 138-96 RE: SEC PROPOSALS RELATING TO INVESTMENT ADVISERS UNDER THE NATIONAL SECURITIES MARKETS IMPROVEMENT ACT OF 1996; JANUARY 14 MEETING

_____ The Securities and Exchange Commission has issued the attached two releases to implement those provisions in the National Securities Markets Improvement Act of 1996 (the “NSMIA”), relating to investment advisers. In the first release, Release IA-1601, the Commission has proposed for comment new rules and rule amendments that would implement provisions in the NSMIA that, effective April 9, 1997, will reallocate regulatory responsibilities between the Commission and the states in the regulation of investment advisers. The second release, Release IA-1602, announces that, as a result of the proposed adoption of a new Form ADV-T in Release IA-1601, the Commission is indefinitely suspending the use of Form ADV-S, the annual report filed by all federally registered investment advisers, and staying Rule 204-1(c) under the Investment Advisers Act of 1940 (the “Advisers Act”), which requires the filing of Form ADV-S. A copy of each of these releases is attached. Release IA-1602 shall be effective upon its publication in the Federal Register. Comments on Release IA-1601 are due to the Commission by February 10, 1997. In summary, the rules proposed by Release IA-1601 would: • Amend Form ADV to add a new Schedule I and create new form ADV-T to be used to screen advisers as to eligibility for Commission registration; •• Establish the process by which advisers would withdraw from Commission registration; • Address the valuation of assets under management; • Relieve advisers with fluctuating assets from switching their registration back and forth between the states and the Commission; • · Permit certain additional investment advisers to register with the Commission; • Define, terms such as “investment adviser representative” and “place of business”, and “place of business”; and • Clarify how advisers should count clients for purposes of the new national 2 Each of these provisions is discussed in more detail below. A. Determining Eligibility for SEC Registration 1. Proposed Form ADV-T and Rule 203A-5 The Commission has proposed a transition rule, Rule 203A-5, and Form ADV-T, to assist investment advisers in determining their eligibility for Commission registration as of April 9,

1997 and to provide for the orderly withdrawal from Commission registration for ineligible advisers. Under proposed Rule 203A-5, all advisers registered with the Commission would be required to file Form ADV-T with the Commission no later than April 9, 1997. Form ADV-T would require each adviser to declare whether it remains eligible for Commission registration. For those that declare their ineligibility for such registration, the Form would serve as the adviser's request for withdrawal from registration as of April 9, 1997. Advisers that do not file the form or that fail to voluntarily withdraw from Commission registration would be subject to a cancellation proceeding under the Advisers Act. Comment is requested on proposed Form ADV-T and the proposed process to de-register advisers that would no longer be eligible for Commission registration. 2. Valuing Assets Under Management Instructions to Form ADV-T would provide advisers guidance in determining and valuing their assets under management. Proposed Instruction 7(a) to the Form would provide that a "securities portfolio" is an account at least fifty percent of the total value of which (less cash and cash equivalents) consists of securities. Under Instruction 7(b), once the adviser has determined that an account is a "securities portfolio," the entire value of the account, including cash and any non-securities positions, would be included in the value of the adviser's assets under management. Instruction 7(c) to Form ADV-T provides advisers guidance, including examples, concerning what constitutes "continuous and regular supervisory or management services." As proposed, the Commission would consider accounts over which an adviser has discretionary authority and for which it provides ongoing management services to receive continuous and regular supervisory or management services and therefore the assets of such accounts to be "assets under management." Instruction 7(d) would address the method and timing of the valuation of the adviser's securities portfolios. As proposed, the value of the portfolio would be required to be determined as of a date no more than ten business days before the filing of Form ADV-T. The valuation methodology would be the same as that used for purposes of client reporting or to determine fees for investment advisory services. Comment is requested on the Commission's proposed interpretation of "assets under management," the proposed instructions to Form ADV-T, and whether the proposed form and instructions would allow manipulation of the amount of assets under management to evade the eligibility requirements. 3. Treatment of Advisers with Fluctuating Assets As proposed by the Commission, Rule 203A-1 would permit investment advisers with assets under management between $25 million and $30 million to elect to be registered either under state law or with the Commission. This flexibility is intended to avoid "transient" registration problems under which an adviser with fluctuating assets might otherwise be 3 subjected to registering and de-registering with the SEC. Advisers with at least $30 million in assets under management would be required to register with the SEC. The option to make an election between state and federal registration would not be available to an investment adviser that (1) has less than $25 million in assets under management; (2) is not registered or required to be registered in the state in which it maintains its principal office and place of business, whether the lack of registration is the result of an exemption, an exclusion, or the lack of a statute requiring such registration; (3) is an investment adviser to a registered investment company; or (4) is exempted by proposed Rule 203A-2 from the prohibition on registering with the Commission. For an adviser that is state-registered based upon a reasonable belief that it is prohibited from registering with the Commission because it has insufficient assets under management, the Commission is proposing Rule 203A-4 to provide a safe harbor from Commission registration. To be eligible for such safe harbor, however, the adviser must be registered with the state in which it has its principal office and place of business. Comment is requested on whether the proposed $5 million "window" would provide advisers with sufficient flexibility to avoid having to register and de-register with the Commission and the states. 4. Additional Persons Eligible

for Commission Registration Proposed Rule 203A-2 would permit certain advisers to register with the Commission without regard to assets under management. The persons that would be eligible to register with the Commission under this proposed rule would be (1) nationally recognized statistical rating organizations; (2) certain pension consultants; (3) any adviser that directly or indirectly controls, is controlled by, or is under common control with, an investment adviser that is registered with the Commission, provided the principal office and place of business of the adviser is the same as that of the affiliated registered adviser; and (4) advisers that reasonably expect to be eligible for Commission registration within 90 days after their registration becomes effective. Comment is requested on the appropriateness of these proposed exemptions and whether there are other classes of advisers that the Commission should exempt. The Commission has also requested comment on whether it should recommend that Congress amend the Advisers Act to prohibit an adviser from registering with the Commission if it has its principal office and place of business in a state that has enacted an investment adviser statute. B. Persons Who Act on Behalf of Investment Advisers The NSMIA preserves the authority of states to require the registration of any "investment adviser representative" who has a "place of business" in such state. Because the NSMIA does not define "investment adviser representative" or "place of business", the SEC has proposed to define such terms in Rule 203A-3. 1. "Investment Adviser Representative" As proposed, "investment adviser representative" would mean a supervised person "if a substantial portion of the business of the supervised person is providing investment advice to clients who are natural persons." (Emphasis added.) Expressly excluded from this definition are those representatives who do not, on a regular basis, solicit, meet with, or otherwise communicate to clients of the investment adviser or who provide only impersonal investment advice. A representative shall be considered to conduct a substantial portion of its business in providing investment advice to natural persons if, during the preceding 12 months, natural 4 persons comprise more than 10% of the representative's clientele or if more than 10% of the assets managed by the representative are from clients who are natural persons. Comment is requested on this proposed definition; whether supervised persons, a substantial portion of whose business is providing service to natural persons who have a high net worth or meet other indicia of financial sophistication should be excepted from the definition; whether representatives that are registered representatives of a broker-dealer should be excluded from the definition; and whether the criteria for determining whether a substantial portion of the representative's business is providing advice to retail persons are workable. 2. "Place of Business" The SEC proposes to define "place of business" as any "place or office from which the investment adviser representative regularly provides advisory services or otherwise solicits, meets with, or communicates to clients." While a place of business need not be a formal office, it cannot be merely an office of an agent for service of process or a mail box. A place of business may, however, include a hotel room, temporarily rented office space, or even the home of a client, if the adviser representative regularly provides advisory services or solicits, meets with, or otherwise communicates to the client at that location. As proposed, an investment adviser representative may be required to register in multiple states if the representative has multiple places of business. Additionally, for any representative without a regular place of business or office, the Commission would define the place of business of such representative to be the residence of each client. According to the Commission, "this provision [in Rule 203A-3(b)] is designed to prevent itinerant investment adviser representatives from claiming they have no place of business and thus are not subject to any state's registration or qualification requirements." Comment is requested on whether the proposed definition will provide clear guidance for determining whether a representative has a place of business in a particular state and whether additional guidance or criteria would be appropriate to address investment adviser

representatives that provide services to clients through electronic media. 3. Solicitors According to the Release, the Commission takes the view that the NSMIA "does not generally preempt state registration of a solicitor for a Commission registered adviser, unless the solicitor is independently registered [or exempt from registration] with the Commission as an investment adviser." C. National De Minimis Standard The Commission has proposed Rule 222-2 to define "client" for purposes of the NSMIA's national de minimis exemption. [Under this exemption, an investment adviser that is otherwise eligible for state registration cannot be required to register in any state in which the adviser has fewer than six clients who are residents of such state.] As proposed, the following shall be deemed a single client for purposes of the exemption: a natural person and any relative, spouse or relative of the spouse of the natural person who has the same principal residence; a legal organization that receives investment advice based on its investment objectives rather than on the individual investment objectives of its shareholders, partners, members, or beneficial owners; and limited partnerships. The Commission has requested comment on its proposed definition and 5 whether such definition should apply to Section 203(b)(3) of the Advisers Act, which exempts from registration with the Commission certain advisers having fewer than fifteen clients during the preceding twelve months. D. Amendments to Form ADV; Elimination of Form ADV-S The Commission has proposed to add a Schedule I to Form ADV, which would be substantially similar to Form ADV-T. Schedule I, which would be used by the Commission to determine eligibility for registration with the Commission, would be required to be filed with all new registrations after April 9, 1997 and by all registrants annually within 90 days of the registrant's fiscal year end. Unlike Form ADV-T, Schedule I would not operate as a request for withdrawal from Commission registration. Accordingly, Commission-registered advisers who, according to their Schedule I, are no longer eligible for Commission registration, must file a Form ADV-W to withdraw such registration. To allow advisers being de-registered with the Commission sufficient time to register under applicable state law, the Commission is proposing to provide a "grace period" of 90 days before instituting proceedings to cancel the adviser's registration. Comment is requested on whether this 90-day period would allow advisers sufficient time to register with the states. Finally, because the adoption of Schedule I obviates the need for advisers to annually file Form ADV-S, the Commission has proposed Release IA-1602 to eliminate the Form ADV-S. E. Miscellaneous Amendments to Adviser Act Rules The Commission has proposed to amend Rule 204-2, relating to books and records, to (1) limit its applicability to Commission registered advisers and (2) require advisers that register with the Commission after April 9, 1997 to preserve any books and records the adviser was previously required to maintain under state law. Additionally, the Commission is proposing to amend Rule 205-3, which provides an exemption from the general prohibition on performance fee arrangements, to make it available to state-registered investment advisers. Finally, the Commission has proposed to adopt four rules pursuant to its antifraud authority under Rule 206(4) to (1) prohibit certain abusive advertising practices (Rule 206(4)-1); (2) govern the adviser's custody of customer funds and securities (Rule 206(4)-2); (3) address the payment of cash to persons soliciting on behalf of the adviser; and (4) require certain disclosure to clients regarding the adviser's financial condition and disciplinary history (Rule 206(4)-4). As a result of these amendments, these rules would apply only to Commission registered advisers. According to the Release, the Commission is not suggesting that the practices prohibited by these rules would not be prohibited if they were engaged in by an adviser not registered with the Commission. Instead, the Commission recognizes that the application of these provisions to state-registered advisers may be more appropriately a matter for state law. 6 F. Provisions of the Advisers Act Applicable to State Registered Advisers According to the Release, several provisions of the Advisers Act would continue to apply to state-registered advisers. These include the Act's prohibition on advisory contracts

that (1) contain certain performance fee arrangements, (2) permit an assignment of the advisory contract without client consent, and (3) fail to require an adviser that is a partnership to notify clients of a change in the membership of the partnership. Additionally, state registered advisers must comply with provisions in the Advisers Act requiring the establishment, maintenance, and enforcement of written procedures reasonably designed to prevent the misuse of material nonpublic information. Comment is requested on whether the Commission should recommend that Congress amend the Advisers Act to make some or all of these provisions inapplicable to state-registered advisers. * * * Tamara Cain Reed Associate Counsel Attachments

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