The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

June 14, 2000

Comment Letter on SEC Proposed Revisions to Form ADV, June 2000

June 13, 2000

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Proposed Revisions to Form ADV and Related Rules
File No. S7-10-00

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the proposal by the Securities and Exchange Commission to amend Form ADV and related rules under the Investment Advisers Act of 1940.[2] In particular, this proposal would substantially revise the form to reflect regulatory changes since the form was last amended, improve the quality of the information advisers must provide to clients and prospective clients, and adapt the form for use in the Investment Adviser Registration Depository ("IARD"), an electronic filing system currently being developed by the Commission. In addition, the Commission has proposed amendments to rules under the Advisers Act to accommodate the revisions to Form ADV and to provide for the implementation of the IARD.

As proposed, Form ADV, which currently is comprised of two parts—Part I, which provides the Commission necessary information about the adviser, and Part II, which sets forth information to be disclosed to clients—would be replaced with a five-part form consisting of the following:

- Part 1A, which would be required of all federally-registered and state-registered advisers, would elicit information describing the adviser and its business through a series of fill-in-the-blank, multiple choice, and check-the-box questions;
- Part 1B, which would only be required of state-registered advisers, would require information about bonding, additional disciplinary actions, and passage of state qualifying examinations;
- Part 2A, which would set forth the disclosure requirements to be included in the firm's brochure, would be a narrative document in plain-English containing specified information about the adviser and its business practices;

- Part 2A Appendix, which would replace Schedule H of current Form ADV, would contain the disclosures that must be included in a wrap fee program brochure; and
- Part 2B, which would set forth the disclosure requirements to be included in the brochure supplement that would accompany the firm's brochure and provide information in a narrative, plain-English format about the firm's advisory personnel.

We applaud the Commission's efforts to modernize Form ADV and provide for its electronic filing. The Commission's current initiative is consistent with disclosure reforms implemented over the past few years under the Investment Company Act of 1940.3 Such reforms have noticeably improved the quality of mutual fund disclosure by making it more comprehensible, informative and useful to investors. As a result of the Commission's current proposal, we would expect to see similar results in the disclosure provided to clients under the Advisers Act. As with the disclosure reforms under the Investment Company Act, the proposed amendments to Form ADV are designed to ensure that material information is provided to clients in a more user-friendly and meaningful manner. The revisions also would eliminate disclosure that, while perhaps useful in the past, today is either immaterial or irrelevant. By doing so, the Commission's proposed amendments will modernize and improve the current disclosure system. Moreover, they are especially timely in view of the fact that more and more investors rely on the services of investment advisors.4

For these reasons, the Institute supports the proposed amendments to Form ADV and the disclosure rules under the Advisers Act relating to the form. In recognition of the variety of types of investment adviser clients and advisory services, and in view of the ever-evolving nature of the financial marketplace, we do, however, recommend that the Commission build greater flexibility into the disclosure rules under the Advisers Act in order to ensure both the present and the long-term success of the Commission's proposed reforms. In addition, we recommend various revisions to certain of the items in the form. The Institute's recommendations are discussed in more detail below.

I. The Brochure Rule under the Advisers Act

A. The Need for Flexibility

To be successful today and in the future, the rules governing the disclosure requirements for investment advisers, as well as their administration and interpretation, must be flexible. The challenge to the Commission in updating the disclosure requirements under the Advisers Act is to design a rule that simultaneously (1) is flexible enough to take into account the variety of advisers, clients, and services in the industry; 5 (2) ensures that, irrespective of this variety, each advisory client receives disclosure that is meaningful and that sets forth all material facts relevant to the services to be provided to that client; (3) takes into account how the adviser's services will be delivered to the client,6 and (4) is able to respond to any future changes that may take place in the industry without the need to constantly revise Form ADV or the "brochure rule."7

To ensure the current and long-term success of the Commission's proposal, we recommend that the brochure rule be amended to provide for greater flexibility. Specifically, the rule should permit advisers to use multiple brochures and omit from a brochure any information that is immaterial. In addition, we recommend that the Commission clarify the level of detail that must be provided in the brochures in response to specific disclosure items.

1. The Use of Multiple Brochures

Under the current brochure rule and under proposed Rule 204-3(g), an adviser may use

multiple brochures, but only when the adviser provides "substantially different advisory services to different clients." To ensure the continued utility of Form ADV, we recommend that this provision be revised to permit advisers to use multiple brochures irrespective of whether the adviser is providing "substantially different services to different clients." An adviser should be able to use multiple brochures, which may be targeted at specific types of clients or related to specific types of services, so long as the brochure a client receives complies with the disclosure requirements of Part 2 of Form ADV. This flexibility is necessary to enable Parts 2A and 2B of the form to accommodate a variety of types of clients, of advisory services provided, and of the manner in which services are delivered.8

Revising Rule 204-3(g) to permit the use of multiple brochures is entirely consistent with the Commission's goal in revising Part 2 of the form, to make sure that the disclosure provided to the client is meaningful and clear. It is also consistent with the Commission's decision to leave "advisers . . . generally free to structure the disclosure and order the topics in a manner that best conveys the required information." 9 Importantly, this approach would also make the disclosure requirements under the Act better able to respond to future changes in the industry and marketplace.

2. Omission of Immaterial Information

In order for advisers to use multiple brochures and to tailor their brochures consistent with their client base or services offered, they must be able to omit from their brochures irrelevant information. We note that the proposed amendments to the brochure rule would continue to permit advisers "to omit any information required [in the brochure] if the information does not apply to the advisory services or fees that [the adviser] will provide or charge . . . to that client."10 The proposed amendment would not, however, permit an adviser to omit from its brochure information that would be irrelevant or immaterial to the client receiving the brochure. As a result, even in those instances in which the adviser knows, because of the type of client receiving the brochure or the nature of the services provided to such client, that certain information would be irrelevant or meaningless to the client, the adviser's brochure would have to include such information.11

To avoid advisers having to include information in a brochure that, while meaningful to one type of client, is unnecessary for another, the Institute recommends that the Commission provide greater flexibility in the brochure rule by amending it to permit an adviser to omit from a brochure information that would not be meaningful to the client receiving the brochure, either because of the nature of the client or because of the type of service provided to that client. As with our recommendation above that advisers be permitted to use multiple brochures, this recommendation is consistent with the Commission's goal to improve the quality of information provided to investors. It will also enable advisers to adapt their brochures to changing circumstances in the future without a need for the Commission to revisit Form ADV in response to such changes.

3. The Level of Detail Required

In view of the fact that an adviser's brochures will be required to include both additional information and more detailed information than currently required, the Institute recommends that the Commission expressly encourage advisers to limit the length of their disclosure to ensure that brochures do not become so lengthy that they discourage client review. Specifically, the Commission should clarify in the adopting release and make explicit in the instructions to Part 2 of the form that the level of detail required to be included in the brochure is the level necessary for a client to evaluate material information

about an adviser (such as its fees, business practices, and conflicts of interest) and determine whether to utilize its services. So, for example, while proposed Item 7 would require disclosure of an adviser's methods of analysis, investment strategies, and risk, this item would not necessitate the adviser having to discuss in detail each risk associated with each type of security the adviser recommends. Instead, a general summary of the risks associated with investing in the various types of securities recommended by the adviser would suffice. Similarly, while an adviser may have very detailed (and perhaps lengthy) procedures relating to the voting of proxies or personal trading by advisory personnel, the adviser's brochure could satisfy the disclosure requirements by succinctly summarizing the adviser's policies or practices in these areas.

B. Comments on the Disclosure Proposed in Part 2A of Form ADV; The Firm Brochure

The Institute generally supports the Commission's proposals relating to the disclosure statement that advisers must provide to clients and prospective clients and offer to clients annually. The revisions proposed by the Commission to the content requirements of the brochure, coupled with the requirement that advisers use a narrative brochure written in plain English, should improve the quality and relevance of the information provided to clients. To further improve the quality and usefulness of this information, the Institute recommends additional revisions to the disclosure items in Part 2. Our recommendations are set forth below in the order in which these items appear in the form.

1. Item 4—Advisory Business—List of Periodicals or Periodic Reports About Securities

As proposed, new Item 4(E) would require an adviser to list and describe each of the periodicals or periodic reports about securities that the adviser publishes. The Institute is uncertain as to (1) the purpose behind this requirement and (2) what information would need to be disclosed pursuant to it. The list that would be required by this item would not seem to be material to an investor that is considering whether to utilize the services of the adviser. Nor would it seem to be material to an adviser's existing clients. To ensure that the disclosure that is required to be included in the brochure is limited to the information that would be material and meaningful to most clients, we recommend that proposed Item 4(E) be eliminated.[12] Notwithstanding elimination of this requirement, those advisers that want to list and describe in their brochure each of their periodicals and reports would be able to do so.

2. Item 5—Fees and Compensation

As proposed, subsection (C) of Item 5 would require disclosure about the fees a client may pay in connection with the adviser's advisory services.[13] While the types of information that this item is intended to elicit would be meaningful to clients, we are concerned that the specific information that would be required may result in disclosure of meaningless information. In particular, while this item would require the disclosure of "custodian fees or mutual fund expenses" that a client may pay, an adviser is specifically directed to disclose the "range" of such fees. And yet, disclosure of the "range" of these fees would likely be too general to be meaningful to clients. For example, with respect to mutual fund expenses, if the adviser recommends a variety of funds, grouping these funds' expenses together to produce a broad range would not provide the client meaningful information about the specific expenses of the mutual funds in which that client may invest. What would be meaningful to the client is for the brochure to inform the client that the mutual funds

recommended by the adviser may charge fees and that such fees are set forth in the fund's prospectus, which will be delivered to the client at or before the time he or she purchases shares of the fund.14

Accordingly, we recommend that subsection (C) of Item 5 be revised to eliminate the requirement that advisers disclose the "range" of custodian fees or mutual fund expenses and instead require disclosure along the lines noted above.15 This recommendation is consistent with the Commission's goal of ensuring that investors are aware that they may incur fees in addition to the adviser's fee.

3. Item 8—Disciplinary Information

The Institute opposes the provision in Item 8 that would require an adviser to deliver to clients and prospective clients a copy of any Commission order resulting from an administrative proceeding involving the adviser. While certain advisers may have previously been required to send copies of Commission orders to existing and prospective clients, this requirement, as noted in the Release, has been imposed "as a condition of settlement."16 We recommend that it remain an issue for negotiation between the Commission and the respondent in an administrative proceeding and not be something that is imposed on all advisers merely because certain advisers have agreed to this condition to settle previous administrative proceedings. Moreover, not all Commission orders would be material to clients.17

The Institute also recommends that the Commission clarify that the disclosure in the adviser's brochure about any disciplinary proceeding should be a succinct summary of the proceeding and need not include all of the information that must be included on a Disclosure Reporting Page ("DRP"). We note that, were an adviser to include in its brochure all of the information required on a DRP, such disclosure would be unduly lengthy and, as a result, give undue attention to matters that do not warrant such attention. Limiting the disclosure in the brochure to the cogent details of any disciplinary proceeding would ensure that clients are informed of such proceedings and able to evaluate their materiality in determining whether to engage the services of the adviser.

In the Proposing Release, the Commission has sought comment on whether, pursuant to Item 8, advisers should be required to disclose certain arbitration proceedings.18 Because arbitration proceedings typically do not result in any findings of fact or conclusions of law (instead they merely determine whether to award an aggrieved party monetary relief), the Institute recommends that such proceedings not be required disclosure. We question the value of this information to clients and note that if any such arbitration proceeding had led the Commission or other regulator to sanction the adviser for violating federal or state law, such regulatory sanctions would be required disclosure.

4. Item 11—Brokerage Practices

a. Soft Dollars
The Commission has proposed to require disclosure about an adviser’s policies and practices in selecting brokers for client transactions. As part of that disclosure, proposed Item 11, like Item 12(b) of the current Form ADV, would require an adviser to disclose its policies and practices with respect to "soft dollars."19 Unlike the current form, however, an adviser accepting soft dollar benefits would have to, among other things, (i) explain that the adviser benefits because it does not have to produce or pay for the research, other products, or services acquired with soft dollars (proposed Item 11(A)(1)(a)) and (ii) explain

that the adviser therefore has an incentive to select or recommend broker-dealers based on the adviser's interest in receiving these benefits, rather than on the client's interest in getting the best execution services at the lowest available rates (Item 11(A)(1)(b)). In addition, an adviser would have to disclose whether it seeks to allocate soft dollar benefits to client accounts proportionately to the soft dollar credits the accounts generate (Item 11(A)(1)(d)).

The Institute agrees with the Commission that soft dollar arrangements may create certain conflicts of interest between an adviser and its clients. We also believe that the most appropriate way to address these potential conflicts is through disclosure. We are concerned, however, that the disclosure requirements of proposed Items 11(A)(1)(b) and 11(A)(1)(d) are misguided and therefore recommend that these provisions be revised. For example, the negative connotations of the disclosure that would be required by Item 11(A)(1)(b) could lead a client to conclude that soft dollar arrangements are harmful, and therefore, adverse to the client's interest. While such arrangements may, in fact, present a potential conflict of interest, they do afford advisers the opportunity to obtain valuable research products and services from a wide variety of sources to which they may not otherwise have access and, thus, benefit clients.

We therefore have serious concerns with the Commission requiring an adviser that receives soft dollar benefits to disclose that it has an incentive to select certain broker-dealers based on the adviser's interest in receiving those benefits, rather than on the client's interest in getting the best execution services at the lowest available rates. Such disclosure seems to imply that an adviser could select a particular broker-dealer even if that selection caused the adviser to violate its best execution obligation. Moreover, such disclosure overlooks the fact that some soft dollars may have been provided to the adviser on an unsolicited basis and may not have even been used by the adviser. Consequently, this proposed disclosure would be misleading to investors and highly prejudicial to advisers. Therefore, we recommend that it be eliminated from this item.

We are also concerned with the proposed disclosure in Item 11(A)(1)(d) regarding whether the adviser seeks to allocate the benefits to client accounts proportionately to the brokerage credits those accounts generate. In many instances, this item would result in an adviser disclosing that it does not seek to make such allocation. Such negative disclosure could unduly alarm clients and prospective clients even though advisers are not required under the federal securities laws to make such allocations and even though advisers may not be able to do so. Advisers may be unable to do so because they typically aggregate client trades in order to seek a lower commission or more advantageous net price.[20] Moreover, because no single trade is likely to result in generating soft dollars and because soft dollars may be provided based on the trades directed to the broker over a year, it would be difficult, if not impossible, to allocate the soft dollars based on discrete trades in a particular account. We therefore recommend that this provision be revised to require advisers to disclose only whether research is used to service all of its accounts or just those accounts paying for it, as currently required.

b. Commission Recapture

Proposed Item 11(A)(4) would require an adviser to disclose certain information regarding commission recapture. We recommend deletion of this requirement as unnecessary. Commission recapture programs, because they involve funds being returned directly to clients, do not carry the same potential for conflicts of interest that the other brokerage practices covered by this item might (e.g., soft dollars). Moreover, because commission-recapture arrangements generally involve an arrangement between the client and the

broker-dealer, it would not seem appropriate to require the client's investment adviser to provide disclosure regarding that arrangement. Accordingly, we recommend deletion of this item.

5. Item 14—Custody

Rule 206(4)-2 under the Advisers Act imposes various regulatory requirements on advisers with custody or possession of customer funds or securities. Paragraph (a)(3) of this rule requires an adviser, "immediately after accepting custody or possession of such funds or securities from any client [to notify] such client in writing of the place and manner in which such funds and securities will be maintained . . ."21 To avoid the need to provide the client an additional document relating to custody, the Institute recommends that the Commission revise Item 14 of the proposed form to permit (but not require) an adviser to satisfy the disclosure requirements of Rule 206(4)-2 by disclosing the information required by such rule under this item. We note that the updating requirements of proposed Rule 204-3(f), which would require an adviser to notify its clients promptly whenever any information in the brochure becomes materially inaccurate, are consistent with those of Rule 206(4)-2. Accordingly, if the adviser were to change the custodial arrangements that had been disclosed previously in its brochure, the adviser would have an obligation to promptly update its brochure to correct such information.

In addition, the Institute recommends that any federal savings association or federal savings bank that has registered under the Advisers Act as an investment adviser be treated as a "bank" for purposes of Item 14.22 (Treating these institutions as banks would relieve them of the obligation to disclose in their brochures that clients face greater risk by such institutions holding their asset than they would if an independent custodian held them.) Federal savings associations and federal savings banks that engage in investment advisory activities are subject to capital standards and regulatory requirements equivalent to those imposed on national banks.23 Specifically, such associations and banks are required to segregate fiduciary assets from their own assets and are subject to audit and recordkeeping requirements.24 These requirements are intended to protect customers from the same types of losses that Rule 206(4)-2 was designed to prevent. For these reasons, we recommend that such institutions be accorded the same treatment as banks under the Commission's proposal.25

6. Item 16—Proxy Voting

New Item 16 would require an adviser to disclose specific information regarding its proxy voting policies. Under the Employee Retirement Income Security Act of 1974 ("ERISA"), a plan fiduciary, including an investment manager that manages plan assets pursuant to a delegation by a named fiduciary, is required to vote proxies that are appurtenant to shares of corporate stock held by an employee benefit plan. Although the investment manager would be required to comply with any investment policies mandated by the plan fiduciary, in all instances, any investment decision (including a proxy voting decision) must be consistent with the provisions of ERISA.26 Accordingly, the Institute recommends that the Commission clarify that an adviser that is an investment manager to an employee benefit plan subject to ERISA may satisfy its disclosure requirements under this Item by simply stating that it will vote any proxies on behalf of the plan in accordance with the requirements of ERISA. It should not be necessary for such adviser to have to describe in detail the requirements of ERISA relating to proxy voting.27

7. Item 17—Investment Performance

This item of proposed Form ADV would require an adviser that advertises or reports its investment performance to describe any standards it uses to calculate or present such performance and to disclose whether any person has reviewed the performance information. The Institute recommends that the Commission provide greater flexibility as to where this information appears by revising this item to allow an adviser to provide it in either the adviser's brochure or in any document that contains the performance information. Under this approach, the client would be assured of receiving the requisite information, but the adviser would be able to determine where the placement of such information would be most meaningful to the client.28

In addition, we recommend that the portion of this item that would require the adviser to disclose "whether any third party reviews this performance information" be omitted. There is no requirement under the Advisers Act for an adviser to have its performance information reviewed or audited. And yet, if an adviser must disclose in its brochure that it does not have its performance information reviewed, such disclosure may create a negative inference in the mind of the customer. To avoid this, and to avoid advisers reading this disclosure requirement as the Commission's implying that such performance information should be audited, we recommend that this disclosure be omitted.29

8. Item 19—Index

The Commission has proposed to require all advisers to include with the filing of their brochure an index of the items required by Part 2A. (The index, which is not required to be provided to clients, would inform the Commission where in the brochure the adviser addresses each required item of disclosure.) The Institute recommends that, inasmuch as each brochure is required by Item 3 of Part 2B to include a table of contents, Item 19 of the form be deleted.30

C. Part 2B—Brochure Supplements

1. Scope of the Delivery Requirement

As proposed by the Commission, new to an adviser's disclosure requirements would be a duty to prepare and deliver a brochure supplement for "each supervisory person who will provide advisory services to clients"31 and for each supervised person who on a regular basis communicates investment advice to a client. The Institute is uncertain how this requirement would apply in situations where the supervised person with whom a client may communicate has no involvement in the rendering of investment advice. 32 For example, some larger advisers have a retail sales force that markets the adviser's services to clients. It is not uncommon for such persons to perform functions that are more akin to marketing or soliciting and that involve no rendering of advice.33 In such instances, it would seem unnecessary—and most likely meaningless to a client—for such person to have to deliver a brochure supplement detailing his or her background. Indeed, we note that, as proposed by the Commission, the duty to deliver a brochure supplement would not apply to third party solicitors of an adviser.34 We recommend that solicitors who are supervised persons be accorded similar treatment. Accordingly, we recommend that the Commission clarify that advisers are not required to prepare and deliver a brochure supplement on supervised persons who are not involved in the rendering of investment advice, particularly in those instances where such persons may market the adviser's services or answer incoming calls from clients.35

2. Item 3—Disciplinary Information

Item 3 of proposed Part 2B of Form ADV would require a supervised person's brochure supplement to disclose certain disciplinary information. The Institute is concerned, however, that, while the required disciplinary information in Part 2B appears to be derived from Question 22 of Form U-4 (which requires disclosure of a representative's disciplinary history), in several instances the questions asked in Part 2B would require disclosure beyond those of Form U-4.36

The lack of uniformity between the disciplinary disclosures of Item 3 and their counterparts in Question 22 of Form U-4 will increase a firm's compliance burdens and make it more difficult for a firm to ensure that it provides the requisite disclosure in the brochure supplement.37 Inasmuch as the disciplinary information required by Form U-4 is the information that state and federal regulators have already determined is necessary to determine whether to approve, limit, or deny a representative's registration, there is no apparent justification for the brochure supplement to require the disclosure of additional disciplinary proceedings. Accordingly, we strongly urge the Commission to revise the questions in Item 3 of Part 2B to conform them to their counterparts in Question 22 of Form U-4.38

3. Item 6—Investment Advice and Supervision

This item would require, in part, the brochure supplement to include the name, title, and telephone number of the person responsible for supervising the supervised person. The Institute recommends that, in lieu of having to include the name and title of a supervisor, this item permit the adviser to list a supervisor's name "and/or"} title. This revision would make this provision consistent with Item 1(B) of Part 2A, which requires an adviser to list "name and/or title" of the adviser's contact person on the cover page of the adviser's brochure. Moreover, it would eliminate the need for advisers to have to revise and republish their brochure supplements whenever the name of the supervised person's supervisor changes. We further recommend that the Commission provide advisers the option of placing such contact information on the cover of the brochure supplement, where it would be readily available to clients.

In addition, in those instances in which several people may have responsibility for directly supervising a supervised person, the Institute recommends that the Commission clarify that (1) it is not necessary to list each supervisor and (2) the adviser may determine the person or persons who should be listed in the supplement. This change would avoid the inclusion of unnecessary information while still providing the name of a supervisor the client may contact with any questions or concerns regarding the account.

4. Item 7—Financial Information

As proposed, Item 7 would require a supervised person who has been the subject of a bankruptcy petition within the past ten years to disclose this fact in its brochure supplement. The Institute opposes this requirement as unduly prejudicial or invasive and not particularly meaningful to a client. Including this as a required item of disclosure seems to imply that involvement in a bankruptcy proceeding is somehow indicative of that person's acumen when it comes to rendering investment advice. We do not believe this is a fair implication. Indeed, the bankruptcy could have been the result of factors completely out of the control of the supervised person—such as medical or divorce expenses. Moreover, requiring such potentially prejudicial disclosure runs contrary to the "fresh-start"

the U.S. system of bankruptcy is intended to provide to debtors.

We are concerned that requiring disclosure in a brochure supplement of a bankruptcy could result in either (1) the supervised person having to explain the circumstances leading up to the filing of bankruptcy, which may by necessity include disclosure of related personal information (medical, marital or financial), or (2) in the absence of the supervised person revealing such details, having the client presume that the bankruptcy reflects on the supervised person's financial acumen or ability to manage his or her own finances. We do not believe that any benefit to clients of requiring the disclosure of the supervised person's bankruptcy would outweigh the unduly personal or prejudicial nature of such information and therefore recommend that this item be deleted from the supplement.

D. Additional Comments on the Proposed Revisions to the Brochure Rule

1. Proposed Rule 204-3(d)—Delivery to Limited Partners

The Commission has proposed to amend the brochure rule to add a new provision, proposed Rule 204-3(d), that would, in part, require an adviser that is a general partner of a limited partnership to provide each limited partner of the partnership its brochure. The Institute opposes this new regulatory requirement. We note that limited partners to a partnership receive an offering document (e.g., a private placement memorandum) that sets forth all material facts concerning the partnership, its operation, and expenses. Accordingly, there would not appear to be a public policy served by requiring an advisory brochure in addition to the disclosures the limited partners already receive under the federal and state securities laws.

In addition, proposed Rule 204-3(d) would require an adviser that is the trustee to a trust to treat each beneficial owner of the trust as a client. The Institute recommends that the Commission limit this provision to require an adviser to deliver its brochure only to primary beneficiaries of the trust. This recommendation would ensure that the disclosure required under the brochure rule is provided to the appropriate persons and eliminate any confusion about how broadly the adviser needs to distribute its brochure to ensure compliance with the proposed rule.

2. Proposed Rule 204-3(f)—Updates and Amendments

As proposed, Rule 204-3(f) would require an adviser to update its brochure and brochure supplements "and deliver the amendments to clients promptly when information contained in the brochure or brochure supplement becomes materially inaccurate." The Institute recommends that the Commission clarify two issues related to this new requirement.

a. Providing Updates "Promptly"
First, we request clarification of the requirement that clients be provided updates "promptly." To avoid unnecessary costs, the Institute recommends that, for those advisers that issue quarterly statements to clients, the Commission allow an adviser to satisfy this requirement by delivering the update no later than at the time of the next quarterly statement.[39] This would obviate the need for the adviser to produce and send duplicative mailings to inform clients of brochure updates, while ensuring that clients receive the updates in a timely fashion.

b. The Duty to Inform Clients of Updates

Second, we request clarification of an adviser's updating obligations. As proposed in Rule 204-3(f), an adviser would be required to amend its brochure and any brochure supplements and deliver the amendments to clients promptly when the information in such brochure or brochure supplement becomes materially inaccurate. We understand, however, based upon the experience of our members, that some clients may not be interested in receiving every material change to the adviser's brochure. To accommodate these clients while ensuring that all clients are informed of the existence of all material changes to an adviser's brochure or brochure supplements, the Institute recommends that proposed Rule 204-3(f) be revised to permit an adviser to satisfy the update delivery requirements by informing clients (e.g., by e-mail, postcard, or otherwise) that (1) there has been a material change to the information in the adviser's brochure; (2) the subject matter of the revision; and (3) how the client may obtain the revised information promptly and at no charge (e.g., through the adviser's website or by requesting a copy of the update). This approach would ensure that those clients who are interested in the revised information would have ready access to it without burdening those clients who have no interest in the information.

In addition, we recommend that the Commission clarify when an adviser has a duty to update clients of a material change in information in a brochure. In particular, if the information in the brochure that has become materially inaccurate would be, in the adviser's determination, wholly irrelevant to particular clients based upon either the nature of the clients or the services provided to them, the Institute recommends that the adviser not be required to provide the amended information to such clients promptly, but rather at the next annual update. For example, if an adviser uses one brochure for both retail and institutional clients and the information in the brochure that changed materially would only impact retail clients, the adviser should not have to promptly inform each of its institutional clients of the change. Because the intent of the brochure is to provide clients with material information concerning an adviser and its services as they relate to particular clients, it would seem in keeping with the intent of Rule 204-3(f) to limit the notification requirement to only those clients who may be impacted by the change.

3. Deeming a Brochure "Filed" with the Commission

According to the Release, notwithstanding the fact that the Commission would not, during the initial implementation of the IARD, require the filing of paper copies of brochures and brochure supplements with the Commission, the Commission will consider such documents to be "filed" with the Commission so the states can require their filing. The Institute strongly opposes this. If the Commission, the agency with sole registration and regulatory jurisdiction over federally registered investment advisers, does not deem it necessary to receive and review such brochures, we do not understand why states would need to receive them. Moreover, this would be unnecessarily burdensome to federally registered advisers. While an adviser would be able to make a complete filing with the Commission by filing Part 1 of Form ADV through the IARD, it would have to make individual hardcopy filings of its brochure (i.e., Part 2 of the form) with those states that require such filing, thereby undermining the efficiencies that are expected from the IARD for federally registered advisers.40 In keeping with the spirit of the National Securities Markets Improvement Act of 1996 ("NSMIA") and in the interest of ensuring that states receive only that information that is necessary for them to be notified of the advisers doing business in their states (and the concomitant notice filing fees), the Institute strongly opposes the Commission deeming an adviser's brochure as "filed" with the Commission prior to the time such brochures may be filed through the IARD.

II. Specific Comments on the Proposed Registration Portion of Form ADV; Part 1A, Item 11—Disciplinary Information

The Institute has one comment on Part 1 of the form, which would contain the information that must be disclosed to the Commission in connection with the adviser's registration. We recommend that the Commission revise the disciplinary information that must be disclosed pursuant to proposed Item 11 of Part 1A of the form.

A. Scope of the Disclosure

As proposed, Item 11 of Part 1A of the form would require disclosure of the disciplinary history of the adviser and of all of its advisory affiliates.41 The Institute recommends that, in lieu of requiring disclosure of the disciplinary history of all advisory affiliates, the Commission revise this item to:

(1) limit the required disclosure to the disciplinary information on (a) each person listed on Schedule A or B to Form ADV,42 and (b) any person affiliated with the adviser in a managerial or supervisory capacity; and

(2) require disclosure of disciplinary information concerning those advisory affiliates not covered by (a) or (b) only when such information would be material to the Commission's evaluation of the adviser's advisory business or the integrity of management.43

This recommendation is intended to address those advisers that have thousands of employees located throughout the United States.44 Because the disciplinary history of an individual investment adviser representative, far removed from the management or control of the company, would likely not have any impact either on the management or operations of the adviser, or on the Commission's determination of whether to utilize its authority under Section 203 of the Advisers Act to deny registration to the adviser or to suspend, limit, or revoke its registration with the Commission, it seems unnecessary to require such disclosure in the form.45 Under our recommendation, the Commission would be alerted to the existence of such additional disciplinary information and, consequently, could request it from the adviser or examine the adviser's file memorandum when reviewing an application or inspecting the adviser. This would ensure that the Commission is aware of all material information necessary for purposes of Section 203 of the Act while relieving advisers from having to disclose irrelevant disciplinary information on their forms.

B. Criminal Charges

The Institute strongly opposes Items 11(A)(2) and 11(A)(3) of the form, which would require an adviser to disclose whether it or any of its advisory affiliates have been charged with any felony or any of the listed misdemeanors. We oppose any inquiry into such charges because it is intrusive, prejudicial, and inconsistent with the presumption of innocence that underlies the U.S. legal system. Moreover, we understand from our members that they have been instructed by their employment counsel that they may not inquire into criminal charges in hiring or retaining employees. Accordingly, at the instruction of their counsel, they may be wholly unaware of whether their advisory affiliates were ever charged with a crime. As a result of these concerns, we recommend that the disclosure of criminal actions in Item 11 be limited to convictions or pleas of guilty or nolo contendere. We note that, if criminal charges had not resulted in such a plea or conviction, they would be of no probative value to the Commission inasmuch as they would not provide a basis for the

Commission to commence any proceeding under the Advisers Act.

C. Stale Disciplinary Proceedings

The Institute supports the proposal to limit the disclosure of disciplinary matters pursuant to Item 11 of Part 1A to proceedings occurring within the past ten years. As drafted, this new ten-year limitation, however, may be confusing inasmuch as it appears at the end of Item 11—approximately two and one-half pages after the initial instructions to the item. This confusion may be exacerbated by the fact that, notwithstanding this ten-year limitation, several of the questions within Item 11 expressly require disclosure of proceedings without regard to when the proceeding occurred.46 To avoid the confusion that may result from this item, we recommend that, consistent with the instructions to this section, the Commission either:

- Clarify at the beginning of this item that only those proceedings or events occurring within the preceding ten years be disclosed and eliminate all references to "in the past ten years" within the various questions in this item; or
- Preface each question in this Item with the limitation "in the past ten years . . ."

This approach would ensure that the disclosure provided by federally registered advisers to this item is consistent with the Commission's requirements.47

III. Transition Issue

As proposed by the Commission, advisers would have a 30-day transition period, beginning on the date by which all advisers must have re-submitted Part 1A of Form ADV to the IARD, to provide their new brochures and brochure supplements to existing advisory clients.48 The Institute recommends that this transition period be expanded from 30 to 90 days in order to permit those advisers that send information to clients quarterly to include the new brochures and brochure supplements with their next delivery of such information.

IV. The Investment Adviser Registration Depository (IARD)

The Institute strongly supports the Commission's development and implementation of the IARD. As proposed by the Commission, the IARD should simplify the current process for submitting filings to the Commission and the individual states that impose notice filing requirements. To ensure maximum utility of the IARD, the Institute is supportive of requiring those states that impose notice filings to receive them electronically through the IARD system.

* * *

The Institute appreciates the opportunity to offer these comments on the Commission's proposal. If you have any questions concerning them, please contact the undersigned at (202) 326-5824 or Tamara Reed at (202) 326-5825.

Sincerely,

Amy B.R. Lancellotta
Senior Counsel

cc: Paul F. Roye, Director
Robert E. Plaze, Associate Director
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Lori H. Price, Senior Counsel
Division of Investment Management

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Many of the Institute's investment adviser members render investment advice to both investment companies and other clients. In addition, the Institute's membership includes 380 associate members which render investment management services exclusively to non-investment company clients. A substantial portion of the total assets managed by registered investment advisers are managed by these Institute members and associate members.

2 Investment Advisers Act Release No. 1862 (April 5, 2000)(the "Proposing Release").

3 1998, for example, the Commission adopted comprehensive amendments to Form N-1A and also permitted the use of a fund "profile." See Investment Company Act Release No. 23064 (March 13, 1998)(release adopting amendments to Form N-1A); Investment Company Act Release No. 23065 (March 13, 1998)(release adopting the "profile" rule).

4 A 1999 study found that 64% of the 78.7 million owners of equity securities seek advice from financial service professionals when making equity purchase and sales decisions. See Equity Ownership in America, Investment Company Institute and Securities Industry Association (Fall 1999) at p. 7.

5 A recent study of the advisory industry identified the following six different categories of investment advisers, each of which cater to different types of clients and provide different services: (1) independent financial advisers; (2) independent broker/dealer affiliated registered representatives; (3) high net worth money managers; (4) institutional money managers; (5) hedge fund advisers; and (6) asset management organizations. See The Cerulli Report, RIA: The State of the Fee-Based Financial Advisor Market (1999).

6 For example, since Form ADV was last significantly revised in 1985, the technology available to both advisers and their clients has dramatically changed and impacted the manner in which advice is rendered and delivered. One recent study predicts that technology will continue to impact the advisory industry in the future: "[W]ith more than 8,500 registered investment advisers ("RIA") in the marketplace, there is plenty of market share to go around, and we expect the RIA Web presence to balloon in the wake of recent full-service Internet activity." See The Cerulli Report -- Internet and Financial Product Distribution, Cerulli Associates, Inc. (2000) at p. 205. According to this report, "Cerulli Associates believes that online advice and guidance tools will proliferate rapidly during 2000." Id. at p. 206.

7 Rule 204-3 under the Advisers Act. In the future, when revisions are made to Form ADV, corresponding revisions will need to be made to the IARD. The additional costs of reprogramming the IARD to accommodate any future changes to the form will likely impact the Commission's decision to consider such changes.

8 For example, if the adviser has clients, some of which receive advice exclusively in-

person and others exclusively on-line, the adviser should be able to design brochures tailored to each type of client. A client that elects to receive advice on-line would likely expect to receive the adviser's brochure electronically. No doubt an on-line brochure, where information may be hyperlinked to the brochure, would look very different from a brochure produced on paper.

9 See Proposing Release at pp. 35-36.

10 See proposed Rule 204-3(g). This provision is substantially similar to subsection (d) of the current brochure rule.

11 For example, assume an adviser produces different research reports tailored to its various types of clients, one type of which is clients planning for retirement. If the adviser elects to use a separate brochure for these clients, it should be able to limit its disclosure pursuant to Item 4(E) of Part 2A of the form (which would require the adviser to list each of its periodic reports), to those research reports that would be relevant to such clients. (Please note, however, that the Institute recommends that the Commission eliminate in its entirety the disclosure that would be required by Item 4(E). See discussion under section I(B)(1) of this letter, below.)

12 Moreover, for those advisers that do not provide all of their periodicals or periodic reports to all of their clients, this requirement may result in the adviser either (1) having to use multiple brochures detailing the reports that are available to the type of client receiving such brochure or (2) including in the list reports that would not be available to all clients receiving the brochure.

13 We note that some of the fees that are collected from advisory clients in addition to advisory fees may be transaction-based (e.g., brokerage commissions). In such instances, because the adviser likely would not be able to include in the brochure specific information concerning the amount or range of such fees, it may be more meaningful to the client for the brochure disclosure to be limited to a description of the types of fees the client may incur in addition to the adviser's fee and where additional information about these fees and their amounts will be disclosed (e.g., in the advisory contract or the confirmations received from the broker-dealer).

14 Similarly, requiring the brochure to include the "range" of custodian fees a client might pay would not seem to provide the client with meaningful information. Instead, the information that would likely be meaningful to the client is the existence of such fees, how they are assessed, and where the specific amount of such fee(s) will be disclosed (e.g., in the advisory contract).

15 The Commission has also sought comment as to whether it should additionally require disclosure under Item 5 of the adviser's conflict of interest in charging performance or incentive fees, or, instead rely on the anti-fraud provisions under the Advisers Act to require disclosure when such fee structure presents a material conflict of interest. The Institute recommends that the Commission not require such additional disclosure under this item but instead permit advisers to determine when (and where) such disclosure should be provided to avoid running afoul of the anti-fraud provisions of the Advisers Act.

16 See Proposing Release at footnote 156.

17 For example, if the proceeding were the result of a recordkeeping violation that had no

impact on clients, it would seem inappropriate for the Commission to compel the adviser to alert its clients to such proceeding.

18 See Proposing Release at p. 51.

19 The Institute notes that in the discussion of soft dollars in the Proposing Release, it defines the term to mean "the receipt of benefits such as research for the allocation of client brokerage." See Proposing Release at p. 55. Consistent with the Commission's long-standing interpretation, we recommend that the adopting release clarify that the term also includes the receipt of execution services. See, e.g., Securities Exchange Act Release No. 34-23170 (April 23, 1986).

20 In addition, in the case of proprietary research, it generally is impossible to identify the commissions that are allocated for research since the adviser usually receives bundled services (including execution and research).

21 This provision also requires the adviser to provide its clients written notice of any change to the information previously reported to the client.

22 We additionally recommend that federal savings associations and federal savings banks that have registered as investment advisers be treated as a bank for purposes of Item 18, relating to financial statements. As such, these institutions would be relieved of having to include a balance sheet with their brochure if they have custody of client funds or securities or require prepayment of more than $1200 in fees per client, six months or more in advance.

23 E.g. compare 12 CFR Part 567 to 12 CFR Part 3 and 12 CFR Part 550 to 12 CRF Part 9.

24 See 12 CFR 550.440 and 12 CFR 550.410-430.

25 We also recommend that the Commission consider according the same treatment to foreign banks subject to capital and segregation requirements.

26 See Department of Labor Interpretive Bulletin 94-2, 29 C.F.R. 2509.94-2 (Published in the Fed. Reg. July 29, 1994), which discusses ERISA's requirements in this area in more detail.

27 An adviser in this instance would be required, pursuant to ERISA, to vote such proxies in accordance with the written statement of investment policy provided by the named fiduciary. Therefore, it would seem unnecessary for the adviser to recite to such fiduciary the fiduciary's own proxy policies.

28 In addition, we recommend that the Commission clarify how much detail an adviser must include in the description of the standards used to calculate performance. For example, for those advisers that utilize the standards of the Association for Investment Management and Research (AIMR), will it suffice for the adviser merely to disclose that it calculates its performance in accordance with such standards; or, must the adviser summarize the AIMR standards? For those advisers that do not utilize the AIMR standards, how much detail must they provide pursuant to this Item?

29 Notwithstanding the omission of this requirement, those advisers that want to include such disclosure could do so.

30 This recommendation is consistent with a previous action of the Commission in which it found it unnecessary to include a similar type of index in Form N-1A in view of the fact that "similar information is available in the table of contents required in the prospectus." See Release Nos. 33-7398, 34-38346, and IC-22528, 62 Fed. Reg. 10898 at 10921 (March 10, 1997)(release proposing amendments to Form N-1A).

31 See Instruction 1 to Part 2B of Form ADV.

32 We also are uncertain as to how broadly the Commission intends interpret the phrase "communicates investment advice to a client." We note, for example, that some supervised persons' involvement with advisory clients is limited to answering incoming telephone calls from clients and responding to client requests without rendering advice to such clients. It does not appear from the Proposing Release that the Commission intended to require advisers to produce and deliver brochure supplements on such persons.

33 We understand that it is not uncommon for an adviser that utilizes a retail sales force to prohibit such persons from rendering advice or providing any portfolio management services to clients. Instead, such persons' activities may be limited to providing a client the firm brochure, assisting the client in completing the preprinted advisory agreement, transmitting the information to the firm, and, when the persons in the firm who render investment advice develop such advice for a particular client, delivering such information to the client.

34 Such third party solicitors would be required, however, to provide clients the written disclosure required by Rule 206(4)-3 under the Advisers Act (the cash solicitation rule), which requires disclosure different from that proposed under Part 2B of Form ADV.

35 If, however, the Commission determines it is necessary for the adviser to produce and deliver brochure supplements on such persons, to ensure that the disclosure is limited to meaningful information, we recommend that it consist of: (1) a description of the role of such person as it relates to the adviser and the rendering of investment advice; (2) any additional compensation from awards, contests, or prizes the person receives (Item 5 of Part 2B); and (3) the name of the representative's supervisor and contact information.

36 For example, unlike Form U-4, the first series of questions in subsection (A) of Item 3 of Part 2B inquire whether the supervised person is the subject of certain criminal proceedings. This subsection also inquires whether the supervised person "was the subject of any order, judgment, or decree [by a domestic, foreign, or military court of competent jurisdiction] permanently or temporarily enjoining, or otherwise limiting, the supervised person from engaging in any investment-related activity or from violating any investment-related statute, rule, or order." By contrast, Question 22(H)(1) of Form U-4 asks the applicant whether any domestic or foreign court has ever "enjoined you in connection with any investment-related activities."

37 Specifically, the adviser could not merely rely on the information reported on Form U-4 in preparing the representative's brochure supplement. Instead, the adviser would have an on-going duty to elicit additional information from the representative to ensure its compliance with the requirements of the supplement.

38 The Institute concurs with the Commission's view that it is not necessary for a supervised person to disclose all of the disciplinary information required by Form U-4, and our above recommendation should not be read otherwise. Instead, we are recommending

that the information from Form U-4 that has been incorporated into Item 3 be revised to ensure that it is substantively identical to the similar provision in Form U-4 so that an adviser preparing a brochure supplement need not look beyond Form U-4 to respond to Item 3 of Part 2B of Form ADV.

39 In connection with Item 14, relating to custody, the Institute has recommend previously in this letter that the Commission permit an adviser to incorporate into its brochure the disclosure required by Rule 206(4)-2 relating to custodial arrangements. Rule 206(4)-2 requires that when there is any change in the place of manner in which the client's funds or securities are maintained, the adviser give "each client written notice thereof." We presume that, consistent with our recommendation to the proposed updating requirement, providing such notice no later than the adviser's next quarterly statement would satisfy the requirement of Rule 206(4)-2.

40 We note that, in the absence of a filing requirement, states would have authority under NSMIA to request an adviser's brochure when investigating or bringing an enforcement action with respect to fraud or deceit.

41 According to this item, "advisory affiliates" includes: (1) all of the adviser's current employees (other than clerical or administrative employees); (2) all of the adviser's officers, partners, or directors (or any persons performing similar functions); (3) all persons directly or indirectly controlling the adviser or controlled by the adviser; and (4) any other person providing investment advice on the adviser's behalf. The Institute notes that, while Item 11 of the current Form ADV excludes from the definition of "advisory affiliates" those employees who perform only "support" or similar functions, the new form would not provide a similar exclusion. There is no explanation of this change in the Proposing Release and we are unable to come up with one ourselves. Therefore, to avoid support persons being subjected to the disclosures relating to advisory affiliates and any confusion about their status, we recommend that the definition of "advisory affiliate" in the new form be amended to expressly exclude employees who provide support or similar functions.

42 These schedules require information on the direct and indirect owners of the adviser and on its executive officers and directors.

43 To evaluate the materiality of a disciplinary event for purposes of (2), we recommend that the Commission utilize the same materiality standard of Item 8 of Part 2B. As with Item 8 of Part 2B of the form, the adviser's determination would not be binding on any other person and the adviser would be required to keep a file memorandum of its decision. If the Commission determines it is necessary to inform the Commission that the adviser has determined that such disciplinary information is immaterial, Item 11 of Part 1A could inquire whether there is additional disciplinary information on the adviser's employees or controlled persons that has not been disclosed because the adviser has determined that such information is not material.

44 As a result of enactment of NSMIA, and as recognized in the Proposing Release, it is primarily large advisers that are registered with the SEC. If the states are interested in obtaining the disciplinary information on all persons associated with advisers that are subject to state registration requirements, this could be addressed through Part 1B of the form, which must be completed by all advisers that are subject to state registration.

45 We recognize that this disciplinary information would only be required to be disclosed pursuant to Part 1 of the form and would not, under the Commission's proposal, be required

to be included in the adviser's brochure pursuant to Part 2A of the form. Notwithstanding this, however, it is anticipated that all information from Part 1 of the form would be readily available and accessible to clients and prospective clients through the IARD. In light of this fact, the Institute recommends that the disciplinary disclosure in Part 1 be limited to those persons whose disciplinary history may be material to an evaluation of the adviser.

46 For example, Question C(2) asks whether the SEC has ever found the adviser to have been involved in a violation of SEC regulations or statutes. By contrast, Question A(1) asks whether, "in the past ten years," the adviser has been involved in certain criminal proceedings.

47 We understand that the inconsistency between the wording of certain questions in Item 11 and the ten-year limitation mentioned in the instructions to this item result from the fact that the states are interested in receiving information on those proceedings involving state-registered advisers that occurred more than ten years ago. To address the concern of the states, the Institute recommends that a new item be added to Part 1B of the form, which, as proposed, requires disclosure by state-registered advisers about disciplinary proceedings beyond those required to be disclosed by federally registered advisers. Such new item could, for example, inquire whether the state-registered adviser has been the subject of any event or proceeding described in Items 11(C), 11(D), 11(E), 11(F), or 11(G) of Part 1A that was not disclosed in Part 1A because such event or proceeding occurred more than ten years ago. This approach, which would enable states to inquire about these older disciplinary proceedings so long as they do so in the portion of the form devoted only to state-registered advisers, would eliminate from Part 1A of the form information required only of state-registered advisers.

48 See Proposing Release at footnote 65 and Note to Paragraph (c) in Proposed Rule 204-1(c) at p. 128.
