SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 270 and 274

[Release No. IC–21260; IA–1510; S7–24–95]

RIN 3235–AG07

Status of Investment Advisory Programs Under the Investment Company Act of 1940

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule and form; request for comment.

SUMMARY: The Commission is publishing for public comment revised proposed rule 3a–4 under the Investment Company Act of 1940, which would provide a nonexclusive safe harbor from the definition of investment company for certain programs under which investment advisory services are provided to clients. Programs that are organized and operated in a manner consistent with the rule's conditions would not be required to register under the Investment Company Act or to comply with the Act's substantive requirements. The Commission also is proposing Form N–3a4 under the Investment Company Act, which would be filed with the Commission by sponsors of programs intending to rely on rule 3a–4. The rule and form are intended to provide guidance regarding the status of investment advisory programs under the Investment Company Act, and to facilitate Commission examination of persons involved in the operation of these programs. Finally, in connection with the preparation of an interpretive release, the Commission is requesting comment regarding the application of certain provisions of the Investment Advisers Act of 1940 to investment advisers participating in investment advisory programs.

DATES: Comments on the revised proposed rule and the proposed form should be received on or before October 2, 1995.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549. All comment letters should refer to File No. S7–24–95. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.

FOR FURTHER INFORMATION CONTACT: Rochelle Kauffman Plesset, Senior Counsel, or Eric C. Freed, Special Counsel, (202) 942–0660, Office of Chief Counsel, Division of Investment Management, 450 Fifth Street NW., Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission (''Commission'') is publishing for comment revised proposed rule 3a–4 [17 CFR 270.3a–4] under the Investment Company Act of 1940 [15 U.S.C. 80a–1 *et seq.*] (the ''Investment Company Act''). Rule 3a–4 would provide a nonexclusive safe harbor from the definition of investment company for certain programs under which investment advisory services are provided to clients (''investment advisory programs''). The Commission also is proposing new Form N–3a4 [17 CFR 274.222] under the Investment Company Act, which would be filed by sponsors of investment advisory programs that intend to rely on rule 3a–4. Finally, the Commission is requesting comment with respect to certain issues that investment advisory programs raise under the Investment Advisers Act of 1940 (the ''Advisers Act'').

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Executive Summary

The Commission is publishing for public comment revised proposed rule 3a–4 under the Investment Company Act to provide a nonexclusive safe harbor from the definition of investment company for certain investment advisory programs. Investment advisory programs typically are designed to provide the same or similar professional portfolio management services on a discretionary basis to a large number of individual clients.

Revised proposed rule 3a–4 would exclude any investment advisory program from the definition of investment company provided that the program is organized and operated in compliance with the rule's conditions.[1] The revised proposed rule would require that: (i) Each client's account be managed on the basis of the client's financial situation, investment objectives, and instructions; (ii) the sponsor of the program obtain information from each client that is necessary to manage the client's account individually; (iii) the sponsor and portfolio manager be reasonably available to consult with clients; (iv) each client have the ability to impose reasonable restrictions on the management of the account; (v) each client be provided with a quarterly statement containing a description of all activity in the client's account; (vi) each client retain the indicia of ownership of all securities and funds in the account; (vii) the sponsor establish and effect written procedures that are reasonably designed to ensure that each of the conditions of rule 3a–4 is met; (viii) if the sponsor designates another person to perform certain obligations under the rule, the sponsor obtain from that person a written agreement to perform those obligations; (ix) the sponsor maintain and preserve the policies, procedures, agreements and other documents relating to the program in the manner set forth in the rule; and (x) the sponsor furnish to the Commission upon demand copies of specified documents. The conditions of the revised proposed rule are based on the conditions of a previously proposed rule, as modified and interpreted in a series of no-action letters issued by the Commission staff over the past thirteen years.

Programs that are organized and operated in a manner consistent with the rule would not be required to register under the Investment Company Act or be subject to that Act's provisions. The rule is intended to be a nonexclusive safe harbor; it is not intended to create any presumption about a program that is not organized and operated in compliance with the rule.

The Commission also is proposing Form N–3a4 under the Investment

[1] If revised proposed rule 3a–4 is adopted, interests in investment advisory programs that are organized and operated in compliance with the conditions of the rule would not require registration under section 5 of the Securities Act of 1933 (15 U.S.C. 77e).

Company Act. Revised proposed rule 3a–4 would require Form N–3a4 to be filed by sponsors of programs intending to rely on the rule.

Finally, the Commission is requesting comment with respect to the application of certain provisions of the Advisers Act to investment advisers participating in investment advisory programs. These comments will be considered in the preparation of an interpretive release dealing with certain issues raised under the Advisers Act by investment advisory programs.

I. Background

In recent years, there has been a proliferation of investment advisory programs that typically are designed to provide professional portfolio management services to a large number of individual clients. These programs have historically been marketed to clients who are investing an amount of money less than the amount otherwise required by portfolio managers but more than the minimum account size of most mutual funds.

Investment advisory programs typically are organized and administered by a sponsor, which provides, or arranges for the provision of, asset allocation advice and administrative services.[2] In some programs, the sponsor or its employees also provide portfolio management services, including the selection of particular securities, to the program's clients. In other programs, the sponsor selects, or provides advice to clients regarding the selection of, a portfolio manager (which may or may not be affiliated with the sponsor).[3] In these programs, the sponsor generally is responsible for continuously monitoring the portfolio manager selected and its management of client accounts. The sponsor, rather than the portfolio manager, often serves as the primary contact for the client in connection with the program.[4] The sponsor and the portfolio managers usually meet the definition of ''investment adviser'' under the Advisers Act[5] and are required to register under that Act,[6] unless they are excepted from the definition of investment adviser[7] or exempted from registration.[8]

Included among these investment advisory programs are those commonly referred to as ''wrap fee programs.'' In a wrap fee program, the client is typically provided with portfolio management, execution of transactions, asset allocation, and administrative services for a single fee based on assets under management.[9] As of year-end 1994, assets in wrap fee programs totaled approximately $116.8 billion, an increase of 42 percent over a two-year period.[10]

Under wrap fee and other investment advisory programs, a client's account typically is managed on a discretionary basis in accordance with pre-selected investment objectives. Clients with similar investment objectives often receive the same investment advice and may hold the same or substantially the same securities in their accounts. In light of this similarity of management, some of these investment advisory programs meet the definition of investment company under the Investment Company Act, and can be deemed to be issuing securities for purposes of the Securities Act of 1933 (''Securities Act'').[11]

Section 3(a)(1) of the Investment Company Act defines the term investment company generally to include any ''issuer'' which is engaged primarily in the business of investing, reinvesting, or trading in securities.[12] The definition of issuer includes any organized group of persons, whether or not incorporated, that issues or proposes to issue any security.[13] An investment advisory program could be considered to be an issuer because the client accounts in the program, taken together, could be considered to be an organized group of persons.[14] Investors in the program could be viewed as purchasing securities in the form of investment contracts.[15] If an investment advisory

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[2] The sponsor is often a broker-dealer or mutual fund adviser or, in some instances, a bank or money management firm. See, *e.g.*, Wall Street Preferred Money Managers, Inc. (pub. avail. Apr. 10, 1992) (broker-dealer); Strategic Advisers Inc. (pub. avail. Dec. 13, 1988) (mutual fund adviser); Atlantic Bank of New York (pub. avail. June 7, 1991) (bank). The sponsor also may execute some or all of the transactions in client accounts.

[3] More than one portfolio manager may manage the client's assets, depending on the program, the client's investment objectives, and the size of the client's account. *See, e.g.*, Westfield Consultants Group (pub. avail. Dec. 13, 1991); Rauscher Pierce Refsnes, Inc. (pub. avail. Apr. 10, 1992); Wall Street Preferred Money Managers, Inc., *supra* note .

[4] Some investment advisory programs, however, are marketed by the sponsor through unaffiliated investment advisers, such as small financial planners. In some of these programs, the unaffiliated investment adviser rather than the sponsor may serve as the primary contact for its clients that participate in the program. *See, e.g.*, Westfield Consultants Group, *supra* note .

[5] 15 U.S.C. 80b-1 *et seq.*

[6] Section 203(a) of the Advisers Act (15 U.S.C. 80b–3(a)) requires any person who meets the definition of investment adviser and is not otherwise exempt from registration to register with the Commission. Section 202(a)(11) of the Advisers Act (15 U.S.C. 80b–2(a)(11)) defines ''investment adviser'' as ''any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities . . . .''

[7] See section 202(a)(11)(A)–(F) of the Advisers Act (15 U.S.C. 80b–2(a)(11)(A)–(F)) (persons excepted from the definition of investment adviser). A sponsor of an investment advisory program that is a broker-dealer or a registered representative of a broker-dealer generally cannot rely on the exception from the definition of investment adviser for broker-dealers in section 202(a)(11)(C) of the Advisers Act. *See, e.g.*, National Regulatory Services, Inc. (pub. avail. Dec. 2, 1992). That exception is available only to a broker-dealer that provides investment advice that is ''solely incidental'' to its brokerage business and that does not receive special compensation for the investment advice. Id. The staff is of the view that an investment advisory program generally is not incidental to a sponsor's broker-dealer business and, at least in a wrap fee program, the sponsor's portion of the wrap fee is special compensation. *Id.*

[8] *See* section 203(b) of the Advisers Act (15 U.S.C. 80b-3(b)) (persons exempted from registration). Unlike a person excepted from the definition of investment adviser, a person that meets the definition but is exempted from registration remains subject to the Advisers Act's antifraud provision, section 206 (15 U.S.C. 80b–6). The exemption from registration provided in section 203(b)(3) of the Advisers Act would not be available as a general matter to the sponsor or portfolio manager of an investment advisory program because participation in the program would cause the sponsor or portfolio manager to be holding itself out to the public as an investment adviser. *See, e.g.*, Resource Bank & Trust (pub. avail. Mar. 29, 1991).

[9] *See* paragraph (g)(4) of rule 204–3 under the Advisers Act (17 CFR 275.204–3(g)(4)) (defining wrap fee program for purposes of wrap fee brochure requirement).

[10] The Cerulli Report, The State of the Wrap Account Industry 3 (1995). According to this report, assets in mutual fund wrap programs, also called mutual fund asset allocation programs, represented 11% of total assets in wrap fee programs as of year-end 1994. These programs differ from traditional wrap fee programs, in part, in that a client's assets are allocated only among specified mutual funds.

[11] 15 U.S.C. 77a *et seq.* See In the Matter of Clarke Lanzen Skalla Investment Firm, Inc., Investment Company Act Release No. 21140 (June 16, 1995); *SEC* v. *First National City Bank*, Litigation Release No. 4534 [1969–1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92592 (Feb. 6, 1970).

[12] 15 U.S.C. 80a–3(a)(1).

[13] Section 2(a)(22) of the Investment Company Act defines issuer generally to include any person who issues any security (15 U.S.C. 80a–2(a)(22)). Under section 2(a)(28), a person includes a company, and under section 2(a)(8), a company includes any organized group of persons, whether incorporated or not (15 U.S.C. 80a–2(a)(28), 2(a)(8)).

[14] The accounts managed by a particular portfolio manager also can be considered an organized group of persons under certain circumstances. The legislative history of the Investment Company Act explained that one type of investment company involves ''an agency relationship between the individual contributors to the fund and the management upon whom they confer substantially a power of attorney to act as agent in the investment of the moneys contributed. The group of individual investors is not a legal entity but rather constitutes in essence a combination of distinct individual interests.'' H.R. Doc. No. 707, 75th Cong., 3rd Sess. 24 (1939). In *Prudential Insurance Co. of America* v. *SEC*, the court, citing this legislative history, found that an organized group of persons does not refer only to identifiable business entities. 326 F.2d 383 (3rd Cir.), *cert. denied*, 377 U.S. 953 (1964).

[15] The definition of security in both section 2(a)(36) of the Investment Company Act (15 U.S.C.

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program is deemed to be an ''issuer,'' it also would be deemed to be an investment company because it is engaged in the business of investing, reinvesting, or trading in securities.

The status of investment advisory programs under the Investment Company Act and the Securities Act has been a subject of debate for twenty-five years. In 1972, the Commission established the Advisory Committee on Investment Management Services for Individual Investors (''Advisory Committee'') to assist the Commission in developing policies regarding these programs.[16] The Advisory Committee published a report generally concluding that an investment advisory program should not be required to register under the Investment Company Act as long as the program's clients maintain all indicia of ownership of the securities in their accounts, thereby avoiding the ''pooling'' of client assets.[17]

In 1980, the Commission proposed rule 3a–4 under the Investment Company Act, which would have provided a safe harbor from the definition of investment company for investment advisory programs meeting the conditions of the rule.[18] The proposed rule would have required that: (i) The client receive continuous advice based on its individual needs; (ii) the persons authorized to make investment decisions have significant contact with the client, as described in the rule; (iii) each client maintain all indicia of ownership of the securities in its account; and (iv) each client have the opportunity and authority to instruct the person managing its account to refrain from purchasing particular securities that otherwise might be purchased. The Commission expressed the view that when an investment manager provides each client with individualized treatment, the likelihood of a common enterprise existing among a group of advisory clients is substantially reduced and no investment company is created.[19]

Commenters generally opposed the proposed rule, arguing, among other things, that the rule's conditions were burdensome, would cause unnecessary changes in industry practice, and were too detailed for purposes of a safe harbor rule.[20] In contrast, one commenter argued that the proposed rule would have permitted programs that are *de facto* investment companies to be excluded from regulation under the Investment Company Act merely by meeting ''mechanistic and ritualistic conditions,'' the performance of which is not indicative of individualized investment advice being provided.[21] The proposed rule was never adopted.

Since the proposal of rule 3a–4, the Division of Investment Management (''Division'') has responded to numerous inquiries with respect to the status of wrap fee and other types of investment advisory programs under the Investment Company Act. The Division has issued over 20 letters to persons requesting assurance that the Division would not recommend that the Commission bring enforcement action with respect to investment advisory programs that are not registered under the Investment Company Act (the ''no-action letters'').[22] Each of these letters was conditioned on representations that were based primarily on the terms of proposed rule 3a–4.[23]

II. Discussion

The investment advisory program industry has developed and matured since the original proposal of rule 3a–4 in 1980. During this time period, the Commission has acquired substantial experience with the organization and operation of investment advisory programs. This experience has come from the review of numerous requests for no-action relief, as well as from examinations of sponsors and other registered investment advisers that are involved with operating these programs. For many of these programs, registration and regulation under the Investment Company Act would not appear to be necessary.[24] Nevertheless, that the law in this area has been defined and redefined principally through a series of no-action letters has created some uncertainty regarding the status of these programs under the federal securities laws. While counsel can (and frequently does) offer advice and issue opinions based on the no-action letters, those letters do not provide the same degree of certainty that would be provided by a Commission rule and may not be as readily accessible. The Commission is therefore publishing for comment revised proposed rule 3a–4 to provide a regulatory safe harbor from investment company regulation for programs that satisfy certain conditions. The Commission also is proposing new Form N–3a4, which would be filed with the Commission by sponsors of

80a–2(a)(36)) and section 2(1) of the Securities Act (15 U.S.C. 77b(1)) includes an ''investment contract.'' The Supreme Court, in *SEC* v. *W.J. Howey Co.*, defined an investment contract for purposes of the Securities Act as a scheme that ''involves an investment of money in a common enterprise with profits to come solely from the efforts of others.'' 328 U.S. 293, 301 (1946). The Commission has taken the view that an investment advisory program could satisfy the common enterprise element of the *Howey* test if the accounts are discretionary, the investors receive the same or substantially overlapping investment advice, and the investment advice is not ''individualized.'' *See* Individualized Investment Management Services, Investment Company Act Release No. 11391 (Oct. 10, 1980), 45 FR 69479 (Oct. 21, 1980) (''Release 11391''). *See also* In the Matter of Clarke Lanzen Skalla Investment Firm Inc., *supra* note ; SEC v. First National City Bank, *supra* note.

[16] The Advisory Committee was established after the Commission instituted an enforcement action against an investment adviser and broker-dealer for operating an unregistered investment company in the form of an investment advisory program. While the program was advertised as offering individualized advice, the adviser invested client funds in a virtually identical manner and made investment decisions in a generally uniform manner to all clients. SEC v. First National City Bank, *supra* note . The Division subsequently denied no-action relief to similar investment advisory programs. *See, e.g.*, Wheat & Co., Inc. (pub. avail. July 9, 1971); Finanswer America/Investments, Inc. (pub. avail. Apr. 26, 1971); Jacobs Persinger & Parker (pub. avail. Mar. 8, 1971).

[17] Advisory Committee on Investment Management Services for Individual Investors, Small Account Investment Management Services (Jan. 1973). The Advisory Committee also concluded that the interests in the program (*i.e.*, the client accounts) should not be required to be registered as securities under the Securities Act if the program provides each client with individualized treatment.

[18] See Release 11391, *supra* note . Release 11391 also stated that the Commission's Division of Corporation Finance had indicated that if rule 3a–4 was adopted, that Division would not recommend that the Commission take enforcement action under the Securities Act with respect to the interests in an investment advisory program operated in accordance with the proposed rule's requirements. *Id.* at n.15.

[19] *Id.* at note and accompanying text. Although the statements in the Release 11391 focused on the necessity for each client to be provided with individualized treatment, the proposed rule also would have included conditions designed to avoid the ''pooling'' of client assets.

[20] E.g., Letter from the American Bar Association to George A. Fitzsimmons, Secretary, SEC 1–2, 4 (Jan. 9, 1981), File No. S7–854; Letter from the Investment Counsel Association of America, Inc. to George A. Fitzsimmons, Secretary, SEC 3–4 (Jan. 9, 1981), File No. S7–854; Letter from Neuberger and Berman to George A. Fitzsimmons, Secretary, SEC 2 (Jan. 12, 1981), File No. S7–854.

[21] Letter from the Investment Company Institute to George A. Fitzsimmons, Secretary, SEC 2, 4 (Jan. 9, 1981), File No. S7–854. This commenter also pointed out that the proposed rule would have permitted commercial banks, which are excepted from regulation under the Advisers Act, to sponsor investment advisory programs without being subject to the Advisers Act's prohibitions against conflicts of interest, the Act's brochure requirements, and inspection by Commission staff. Id. at 2.

[22] In each case, the Division of Corporation Finance also has granted no-action relief with respect to registration of interests in the programs under the Securities Act.

[23] *See, e.g.*, Wall Street Preferred Money Managers, Inc., *supra* note ; Rauscher Pierce Refsnes, Inc., supra note .

[24] The Commission, however, recently brought an enforcement action against a sponsor of an investment advisory program that was operating as an unregistered investment company. In the Matter of Clarke Lanzen Skalla Investment Firm, Inc., supra note .

investment advisory programs intending to rely on rule 3a–4.[25]

A. Revised Proposed Rule 3a–4

Revised proposed rule 3a–4 would provide a nonexclusive safe harbor from the definition of investment company for investment advisory programs that are organized and operated in a manner consistent with the rule's conditions.[26] The revised proposed rule would include a number of conditions intended to ensure that clients in programs that rely on the rule receive individualized treatment. While the Commission believes that an investment advisory program that meets the rule's conditions need not be regulated as an investment company, the Commission acknowledges that there may be investment advisory programs that do not comply with all of the rule's conditions and yet also should not be regulated as investment companies. Thus, revised proposed rule 3a–4 is intended to be a nonexclusive safe harbor, and is not intended to create any presumption about a program that is not organized and operated in compliance with the rule's requirements.[27]

1. Role of the Sponsor

Generally, the rule would require the ''sponsor'' of the program or another person designated by the sponsor to perform the duties and responsibilities set forth in the rule. Under paragraph (b), ''sponsor'' would be defined as any person who receives compensation for sponsoring, organizing, or administering the program, or for selecting, or providing advice to clients regarding the selection of, persons responsible for managing the client's account in the program. This definition is the same as the definition of sponsor used in paragraph (f) of rule 204–3 under the Advisers Act, which sets forth a separate brochure requirement for sponsors of wrap fee programs.[28] The definition of sponsor is broad, and, in some investment advisory programs, more than one person performing services for the program may meet the definition. Accordingly, paragraph (b) would provide that if a program has more than one sponsor, the sponsors must designate one person as the principal sponsor, and that person would be responsible for carrying out the sponsor's duties and responsibilities under the rule.[29]

2. Individualized Treatment

Revised proposed rule 3a–4 would contain four provisions that are intended to ensure that clients of investment advisory programs that are organized and operated in reliance on the rule receive individualized treatment. These provisions are based on provisions of rule 3a–4 as originally proposed, as those conditions were applied in the no-action letters.

i. Management of Client Accounts. Paragraph (a)(1) would require that each client's account be managed on the basis of the client's financial situation, investment objectives, and instructions.[30] This paragraph is derived from a provision in the originally proposed rule that would have required each client to be furnished with continuous advice as to the investment of funds on the basis of the client's individual needs.[31]

Paragraph (a)(1) is intended to delineate one of the key differences between clients of investment advisers and investors in investment companies. Each client of an investment adviser typically is provided with individualized advice regarding the management of the client's account that is based on the client's financial situation and investment objectives. The investment adviser of an investment company, on the other hand, need not consider the individual needs of the company's shareholders when making investment decisions regarding the company's portfolio, and has no obligation to ensure that each security purchased for the company's portfolio is an appropriate investment for each shareholder. Thus, the clients of an investment advisory program complying with paragraph (a)(1) would receive individualized advice of a type not typically provided to investment company shareholders.

Unlike the originally proposed rule, paragraph (a)(1) of the revised proposed rule would not require a portfolio manager to make separate determinations regarding the appropriateness of each transaction for each client prior to effecting the transaction.[32] The revised proposed rule also would modify the Commission's prior view that the use of model portfolios is ''presumptively inconsistent with individualized treatment.'' [33] The Commission believes that an investment advisory program in which clients with similar investment objectives hold substantially the same securities in their accounts in accordance with the portfolio manager's model does not necessarily indicate that the clients in the program have not received individualized treatment, particularly if the program is operated in a manner consistent with revised proposed rule 3a-4.[34]

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[25] The Commission previously has adopted amendments to rule 204–3 (17 CFR 275.204–3) and Form ADV under the Advisers Act to require sponsors of wrap fee programs to provide prospective clients of these programs with specified information. Disclosure by Investment Advisers Act Regarding Wrap Fee Programs, Investment Advisers Release No. 1411 (Apr. 19, 1994), 59 FR 21657 (Apr. 26, 1994).

[26] If revised proposed rule 3a–4 is adopted, interests in investment advisory programs that are organized and operated in compliance with the conditions of the rule would not require registration under the Securities Act. See Preliminary Note to revised proposed rule 3a–4.

[27] *Id*. In addition, adoption of revised proposed rule 3a–4 would not affect the status of no-action letters previously issued by the Division with respect to investment advisory programs. Therefore, investment advisory programs that operate in a manner consistent with these letters would not be required to register under the Investment Company Act. If rule 3a–4 is adopted, the Division as a general matter will not consider requests for no-action or exemptive relief with respect to programs that do not comply with the rule.

[28] The sponsor of an investment advisory program usually is required to register under the Advisers Act and comply with the substantive provisions of that Act and the rules thereunder. *See supra* notes—and accompanying text. Revised proposed rule 3a–4 would be available to any sponsor of investment advisory programs, even if the sponsor is excepted from the definition of investment adviser under the Act (e.g., banks) or is exempt from registration. Persons wishing to rely on the revised proposed rule, however, would be required, among other things, regardless of their status under the Advisers Act, to furnish certain specified records to the Commission upon demand. *See infra* section II.A.4. (Written Procedures and Agreements).

[29] Paragraph (b) would not specify which sponsor must be designated as the principal sponsor. However, the principal sponsor would be responsible for carrying out the duties of the sponsor under the rule, which would include establishing and effecting written procedures and entering into agreements with other persons. *See infra* section II.A.4. (Written Procedures and Agreements). Typically the principal sponsor would be the person or entity that is responsible for the overall organization and operation of the program. The person designated as the principal sponsor would be the person whose name appears on the program's Form N–3a4. *See infra* section II.B. (Form N–3a4).

[30] Under paragraph (a)(1), a sponsor or portfolio manager would have to comply with any instructions given by a client concerning the management of the client's account in an investment advisory program, unless the instructions are so extensive or burdensome to the management of the account as to be unreasonable, or the sponsor or portfolio manager believes that the instructions are inappropriate for the client. *See infra* section II.A.2.iii. (Reasonable Management Restrictions). In these cases, the sponsor or portfolio manager must notify the client that, unless the instructions are modified, the client will not be permitted to participate in the program.

[31] *See* proposed paragraph (a)(1).

[32] See Release 11391, *supra* note 15, at text accompanying n.18.

[33] *See id*., at text following n.18.

[34] The Division has issued no-action letters with respect to programs that allocate client assets in accordance with computerized investment allocation models. *See, e.g.*, Qualivest Capital Management Inc. (pub. avail. July 30, 1990) (sponsor will use computerized investment allocation model to allocate and reallocate client assets among money managers); Atlantic Bank of

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ii. Client Contact—Initial and Ongoing

Paragraph (a)(2) would contain four requirements that generally are intended to ensure that the sponsor has sufficient contact with each client to be able to obtain the information necessary to manage the client's account in accordance with paragraph (a)(1). Paragraph (a)(2)(i) would require that, at the opening of the account, the sponsor or a person designated by the sponsor [35] obtain information from the client concerning the client's financial situation and investment objectives. The client must at that time also be asked to provide specific instructions, if any, concerning the management of the account. The provision permits the sponsor (or its designee) to obtain this information through interviews (either in person or by telephone) and/or through questionnaires that clients must complete and return prior to the opening of the account.[36]

Paragraph (a)(2)(ii) would require that, at least annually, the sponsor or a person designated by the sponsor contact the client to determine whether there have been any changes in the client's financial situation, investment objectives, or instructions. This contact need not be made in any particular way and could be made, for example, in person, by telephone, or by letter requesting the client to provide the information.[37] The provision would require sponsors to request current information about clients of the program that is necessary for the individualized management of a client's account.

Paragraph (a)(2)(iii) would require that, at least quarterly, the sponsor or a person designated by the sponsor notify the client in writing that the sponsor or designated person should be contacted if there have been any changes in the client's financial situation, investment objectives or instructions.[38] The paragraph also requires the sponsor or designated person to provide the client with a means in which such contact is to be made (e.g., by giving a telephone number or an address). Like paragraph (a)(2)(ii), this provision is intended to provide a procedure by which sponsors can obtain current information about clients of the program. However, unlike paragraph (a)(2)(ii), paragraph (a)(2)(iii) would require the sponsor or designated person only to remind the client to contact the sponsor or designated person if any changes have occurred in the client's financial situation, investment objectives, or instructions. The client would be responsible for contacting the sponsor or designated person if changes had occurred.[39]

Paragraphs (a)(2)(i)-(iii) would place the obligations to contact or notify the client on the sponsor or a person designated by the sponsor. In contrast, the originally proposed rule would have required the portfolio manager to contact the client.[40] The revised proposed rule recognizes that, in many investment advisory programs, the sponsor is the person primarily responsible for client contact.[41] The revised proposed rule, however, would permit a person other than the sponsor to fulfill these obligations, so long as the sponsor specifically designated the person to do so.[42]

Regardless of the person responsible for contacting the client and obtaining the information necessary to manage the client's account, the Commission expects that, in most cases, the information obtained would be provided to the client's portfolio manager. If such information is not provided to the portfolio manager, the manager may not be able to manage the client's account on the basis of the client's financial situation, investment objectives, and instructions, as would be required under paragraph (a)(1). The Commission, however, requests comment whether the sponsor or designated person should be explicitly required by rule 3a-4 to convey this information to the portfolio manager.

Paragraph (a)(2)(iv) would require the sponsor and the client's portfolio manager to be reasonably available to consult with the client concerning the management of the client's account. This provision is intended to provide for reasonable client access to the sponsor and the portfolio manager to ask questions or to seek additional information about an investment advisory program. Even if a program's sponsor serves as the primary contact for clients in the program, a procedure must be provided by which the client has reasonable access to the portfolio manager.[43] Individualized treatment would not be provided if a program's procedures do not provide an opportunity for reasonable availability of the portfolio manager.[44]

New York, *supra* note 2 (sponsor's asset allocation recommendation will be based on client's investment needs and sponsor's model portfolios).

[35] *See infra* note 63.

[36] *See, e.g.*, Rauscher Pierce Refsnes, Inc., *supra* note 3 (prospective client will be interviewed and client will complete questionnaire during interview); Strategic Advisers, Inc., *supra* note 2 (prospective client will be interviewed over the telephone); Manning & Napier Advisors, Inc. (Apr. 24, 1990) (prospective client initially will submit written questionnaire followed by interview over telephone).

[37] The Commission recognizes that in some circumstances the sponsor or designated person may be unable to reach the client. The Commission would not take any enforcement action under this provision if the sponsor or designated person is unsuccessful in obtaining this information from the client, provided the sponsor or designated person makes reasonable efforts to contact the client and documents these efforts. Sponsors may wish to include the procedures for contacting clients and documenting these efforts in the procedures enacted pursuant to paragraph (a)(6)(i) of the rule. *See infra* section II.A.4. (Written Procedures and Agreements).

[38] The notice need not be included as a separate piece of paper, but could be included on another mailing sent to the client. For example, the notification could appear in the quarterly statement that would be sent to clients in accordance with proposed paragraph (a)(4). *See infra* section II.A.2.iv. (Quarterly Account Statements). The notice also could be delivered to the client by e-mail or other electronic means consented to by the client.

[39] *See, e.g.*, Scudder, Stevens & Clark Ltd. (pub. avail Aug. 17, 1988) (quarterly statement will include a reminder that client should contract sponsor if client needs or objectives change); Qualivest Capital Management, Inc. *supra* note 34 (client will be sent reminders to notify sponsor of any change in client's financial situation or investment objectives).

[40] Paragraph (b) of proposed rule 3a-4.

[41] *See, e.g.*, Strategic Advisers, Inc., *supra* note (sponsor primarily responsible); Wall Street Preferred Money Managers, Inc., *supra* note (same).

[42] The revised proposed rule would permit persons such as portfolio managers or advisers that refer clients to the program to be primarily responsible for client contact. Paragraph (a)(6)(i) would require the sponsor to obtain from each designated person an agreement in writing to perform these duties. In addition, paragraph (a)(6)(i) would require the sponsor to establish written procedures that are reasonably designed to ensure that each of the conditions of the rule is met. The procedures might, for example, describe in detail the manner in which paragraphs (a)(2)(i)-(iii) are to be effectuated, specify the persons primarily responsible for client contact, and include provisions designed to monitor and record the actions taken by such persons. *See infra* section II.A.4. (Written Procedures and Agreements).

[43] *See, e.g.*, Rauscher Pierce Refsnes, Inc., *supra* note 3 (the portfolio manager, when necessary, will be available to discuss more complex questions regarding the client's account); Westfield Consultants Group, *supra* note 3 (client will be furnished the name and direct telephone number of manager, who will be reasonably available during business hours). In one no-action request, a representation was made that the client would be able to contact an unaffiliated adviser, the sponsor or the portfolio manager to obtain information or assistance during normal business hours, but the client might be charged hourly fees whenever the client requests the services of investment officers to answer specific questions regarding investment strategies with respect to its account. Manning & Napier Advisors, Inc., *supra* note 36. Sponsors of programs complying with revised proposed rule 3a–4 may impose similar procedures, provided the client is informed prior to entering the program that such fees may be charged.

[44] Whether a sponsor or portfolio manager is ''reasonably available'' would depend on an analysis of the facts and circumstances. The procedures required under paragraph (a)(6)(i) may include provisions detailing the manner in which the sponsor and the portfolio manager intend to meet this requirement. Such procedures could, for example, describe the manner in which the sponsor and portfolio manager will be reasonably available to clients while still allowing for time to perform their duties. However, a sponsor or portfolio

iii. Reasonable Management Restrictions

Paragraph (a)(3) would require each client to have the ability to impose reasonable restrictions on the management of its account. These restrictions could include, for example, the designation of particular securities or types of securities that should not be purchased for the client's account.

The originally proposed rule would have required that each client have the ability to instruct its portfolio manager to refrain from purchasing particular securities that otherwise might be purchased.[45] Under the revised proposal, the client must be able to impose reasonable restrictions on the management of its account. The revised proposal specifically states that restrictions may include prohibitions with respect to the purchase or sale of particular securities or types of securities.

Whether a particular restriction is reasonable would depend on an analysis of relevant facts and circumstances, including the nature of the restriction and the portfolio manager's investment strategy.[46] For example, the exclusion of individual stocks, stocks of an industry group, or stocks from a specific country generally would be considered to be reasonable restrictions. A restriction would not be unreasonable simply because it placed administrative burdens on the manager or could affect the performance of the accounts. Nonetheless, a restriction would be unreasonable if it was clearly contradictory to the adviser's investment philosophy or strategies. For example, it may be unreasonable for a client to instruct a portfolio manager whose investment strategy is to achieve long-term capital appreciation through investments in equity securities to purchase only short-term debt securities. Restrictions also may be deemed unreasonable if the client changes the restrictions on the account with such frequency that it interferes with the orderly management of the account. This may be true even if each individual restriction, taken alone, would be reasonable.[47]

The ability of clients of a program to place restrictions is a critical factor in determining whether individualized treatment is provided under that program. This ability is a crucial difference between a client receiving investment advisory services and an investor in an investment company.[48]

iv. Quarterly Account Statements

Paragraph (a)(4) would require that each client be provided, on a quarterly basis, with a statement describing all activity in the client's account during the preceding quarter, including all transactions made on behalf of the account, all contributions and withdrawals made by the client, and all fees and expenses charged to the account. The statement also would be required to include the value of the account at both the beginning and end of the quarter. The originally proposed rule also would have required quarterly statements, but did not specify the information to be included in such statements.[49]

v. Minimum Account Size

Like the proposed rule, the revised proposed rule would not specify a minimum size for client accounts in the program, leaving the account size for each program up to the sponsor of the program.[50] The conditions of the revised proposed rule should be sufficient to ensure individualized treatment. In addition, innovations in computer technology may permit individualized treatment to be provided to clients, including those with relatively small accounts, with greater efficiency and minimal costs. A requirement for a minimum account size also could effectively deny certain investors the opportunity to participate in investment advisory programs that may be appropriate for them. Nonetheless, providing individualized advice to a large number of small accounts may be so costly and time-consuming as to render individualized treatment impracticable.

The Commission requests comment whether a minimum account size should be required. Commenters favoring this requirement should specify the minimum size that they believe that would be most appropriate (*e.g.*, $50,000, $100,000, $200,000), and address whether the minimum amount should be required to be met only at the time the account is opened, or whether the minimum or some lesser amount should be required to be maintained while the client remains in the program. Commenters favoring a requirement that a client maintain a minimum account size while in the program also should comment whether the client should be removed from the program if the account size fell below the initial minimum due to investment loss rather than withdrawal. In addition, commenters favoring a minimum size requirement should address whether the minimum should apply to the client's aggregate investment in the program, or to each account managed by a portfolio manager. Commenters should also address whether any or all of the conditions of the revised proposed rule would be rendered unnecessary by a minimum account size requirement. Finally, commenters should address whether programs with small account minimums should be subject to additional conditions not imposed on programs with larger minimums, and if so, what those conditions should be.

3. Indicia of Ownership

Paragraph (a)(5) would require that a client in an investment advisory program retain certain indicia of ownership of all securities and funds in the client's account. The paragraph lists specific attributes of ownership that the client must retain.

The proposed rule would have required clients to maintain all indicia of ownership of the funds in their accounts, and specified certain requisite attributes of ownership.[51] The revised proposed rule would not require the client to maintain all indicia of ownership, but would require the client

manager would not be ''reasonably available,'' for example, if a client's contact with the sponsor or portfolio manager were limited to viewing or listening to recorded interviews.

[45] Proposed paragraph (d). The no-action letters involving investment advisory programs typically have included representations that were based on the proposed provision. *See, e.g.*, Rauscher Pierce Refsnes, Inc, *supra* note; 3.

[46] The procedures required by paragraph (a)(6)(i) may define what restrictions are considered unreasonable. To the extent that the ''unreasonableness'' of restrictions is a matter of judgment, the procedures, for example, may identify the person or persons responsible for this determination and specify the factors to be considered by those persons. *See infra* section II.A.4. (Written Procedures and Agreements).

[47] If particular restrictions sought to be imposed by a client are found to be unreasonable, the client should be notified and given a chance to restate the restriction more reasonably. If unable or unwilling to do so, the client may be removed from the program.

[48] Under paragraph (a)(2), a sponsor or person designated by the sponsor would be required to ask the client for instructions regarding the management of its account. The request for instructions is intended, in part, to give the client the opportunity to convey any investment restrictions it wishes to impose on the management of its account.

[49] Proposed paragraph (b)(3). A number of the no-action letters have specified the content of the quarterly reports. *See* Westfield Consultants Group, *supra* note 2 (quarterly statements will contain a review and analysis of client account); Strategic Advisers, Inc., *supra* note 2 (quarterly statements will contain a description of investments); Republic National Bank of New York (pub. avail. Aug. 23, 1982) (quarterly statements will show holdings, value and change in value since preceding quarter).

[50] The Division has granted no-action relief to investment advisory programs with varying minimum account sizes. *See, e.g.*, Qualivest Capital Management, Inc., *supra* note 34 ($5 million); Atlantic Bank of New York, *supra* note 2 ($500,000); Wall Street Preferred Money Managers, Inc., *supra* note 2 ($100,000); Strategic Advisers, Inc., *supra* note 2 ($50,000).

[51] Proposed paragraph (c).

to maintain, at a minimum, those indicia listed. The Commission believes that these specific indicia of ownership, which are based on those represented as being retained by clients of programs described in the no-action letters, provide clients with the ability to act as owners of their securities.[52]

i. Ability to Withdraw and Pledge Securities

Paragraph (a)(5)(i) would require that the clients be able to withdraw securities or cash from their accounts. Paragraph (a)(5)(ii) also would specify that clients must be able to pledge the securities in their accounts.[53] Under some circumstances, programs may require a client to withdraw the securities from his or her account before using them as collateral. Such a requirement would be consistent with the rule.

ii. Right to Vote Securities

Paragraph (a)(5)(iii) would require that the client have the right to vote the securities in his or her account. Implicit in this requirement is the requirement that the client receive proxies in sufficient time to permit the client to consider how to vote and to submit the proxy. The provision would permit clients to delegate the authority to vote securities to another person, such as the portfolio manager or other fiduciary.[54] However, the client must be permitted to revoke the delegation at any time.[55]

iii. Right to Receive Confirmations and Other Documents

Paragraph (a)(5)(iv) would provide, in part, that the client must have the right to receive in a timely manner confirmations of securities transactions of the type required by rule 10b–10[56] under the Securities Exchange Act of 1934.[57] Proposed rule 3a–4 would have required clients to receive a ''notification of each security transaction.''[58] In subsequent no-action letters, the Division modified this position, permitting monthly account statements to be provided to clients unless more frequent confirmations were requested.[59]

Under the revised proposal, clients could waive receipt of individual confirmations to the extent the waiver would otherwise be permitted under rule 10b–10. Thus, paragraph (a)(5) effectively would provide a client in an investment advisory program with the option to receive either individual confirmations for each transaction or periodic statements, delivered no less frequently than quarterly, that include the information required by rule 10b–10 with respect to all transactions that occurred within the period covered by the statement.[60]

Paragraph (a)(5)(iv) also would require the client (or the client's agent) to be provided with other documents that the client (or its agent) would receive had the same securities been owned by the client outside the program. These documents may include prospectuses, periodic shareholder reports, proxies, and any other information and disclosure required by applicable laws or regulations.[61]

iv. Rights as Securityholders

Paragraph (a)(5)(v) would require that a client have the right to proceed directly as a securityholder against the issuer of any security in the client's account without having to join any person involved in the operation of the program or any other client of the program as a condition precedent to proceeding against an issuer. This provision, which is based on conditions in several no-action letters,[62] is intended to ensure that the client would have the same rights as any person holding the same securities outside an investment advisory program. The right to proceed against an issuer of securities in a client's account is another important difference between a client of an investment adviser and an investment company shareholder, as the latter generally would not be able to proceed directly against an issuer of securities held by the investment company.

4. Written Procedures and Agreements

Paragraph (a)(6) contains four requirements regarding the establishment of written procedures and agreements covering the operation of the program and the maintenance of records related to these procedures and agreements. These conditions and their purposes are described in more detail below. The Commission, however, is sensitive to imposing undue burdens on sponsors of investment advisory programs. Comment is therefore requested whether any of the conditions discussed below would impose an

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[52] The revised proposed rule would not require the client to be the record owner of the securities held in its account. The Division has taken the position that an investment advisory program would not be deemed to be an investment company solely because securities are held in nominee or street name. The Division reasoned that placing securities in nominee or street name is an administrative mechanism used to record and facilitate the transfer of ownership. In addition, requiring securities to be held in the client's name would be inconsistent with Commission policy of encouraging the holding of securities in nominee name to promote the establishment of centralized clearance and settlement systems and the elimination of certificated securities. UMB Bank, n.a. (pub. avail. Jan. 23, 1995) (investment company securities). *See, e.g.,* Manning & Napier Advisors, Inc., *supra* note 36 (non-investment company securities). The recent enforcement action against Clarke Lanzen Skalla Investment Firm, Inc., in which, among other things, securities purchased on behalf of clients were held in nominee name, was not inconsistent with the Division's position in the UMB Bank no-action letter. *See supra* note 11.

[53] The proposed rule would have required that the client maintain the right to ''hypothecate'' securities in its account. That term is not included in the revised proposed rule because it is generally considered to be synonymous with ''pledge.'' *See* **Black's Law Dictionary** 669 (5th ed. 1979).

[54] Any such delegation should be contained in the investment advisory agreement or in another document and retained with the records relating to the program. The procedures for delegation may also be specified in the procedures adopted under the rule.

[55] The procedure for such revocation should be described in the procedures for the program. *See infra* section II.A.4. (Written Procedures and Agreements).

[56] 17 CFR 240.10b–10. If a program is structured so that each client's securities transactions are executed by a registered broker-dealer, rule 10b–10 would govern the delivery of confirmations. If client transactions are executed by an entity that is not subject to rule 10b–10, the revised proposed rule would require the delivery of confirmations in the manner required by rule 10b–10, to the same extent as if the transactions were executed by a registered broker-dealer.

[57] 15 U.S.C. 78a *et seq.*

[58] Proposed paragraph (c)(2).

[59] *See, e.g.,* Westfield Consultants Group, *supra* note; Manning & Napier Advisors, Inc., *supra* note; Jefferies & Company (pub. avail. June 16, 1989).

[60] The Commission has taken the view that, for purposes of complying with rule 10b–10, a broker-dealer may provide a person whose account is managed on a discretionary basis by a fiduciary, such as a client in an investment advisory program, with a periodic statement (delivered no less frequently than quarterly) in lieu of the immediate confirmation for each transaction, if the broker-dealer obtains from the person a written agreement stating that the immediate confirmation will be provided to the fiduciary. The periodic statement the broker-dealer sends to the person must contain the same information that could have been in the immediate confirmation for each transaction. Although the person may waive his or her right to the immediate confirmation, the person may not waive his or her right to the periodic statement. Confirmation of Transactions, Securities Exchange Act Release No. 34962, notes 34–36 and accompanying text (Nov. 10, 1994), 59 FR 59612 (Nov. 17, 1994). By reference to rule 10b–10, the revised proposed rule would incorporate this position.

[61] The Commission recently approved a proposed amendment of a rule of the National Association of Securities Dealers, Inc. to permit beneficial owners of stock to designate a registered investment adviser to receive and vote proxies on their behalf. Self-Regulatory Organizations; Order Approving Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Interpretation of the Board of Governors—Forwarding of Proxy and Other Material Under Article III, Section 1 of the NASD Rules of Fair Practice, Securities Exchange Act Release No. 35681 (May 5, 1995), 60 FR 25749 (May 12, 1995).

[62] *E.g.,* Westfield Consultants Group, *supra* note 3; Manning & Napier Advisors, Inc., *supra* note 36; Jefferies & Company, *supra* note 59; Rauscher Pierce Refsnes, Inc., *supra* note 3.

undue burden on persons relying on the rule, or whether the burden of any condition would outweigh its benefits. Comment is specifically requested whether any of these conditions can be eliminated, consolidated, or otherwise made less burdensome without compromising investor protection.

Paragraph (a)(6)(i) would require the sponsor of the program to establish and effect written policies and procedures that are reasonably designed to ensure that each of the provisions of the rule is implemented. The paragraph also would require that, to the extent that the sponsor designates another person to carry out certain obligations under the rule, the sponsor must obtain from that person an agreement in writing to carry out those obligations. These provisions are designed to require the sponsor to formalize the manner in which it intends to comply with rule 3a–4, and, if the sponsor delegates its responsibilities under the rule, to specifically record the delegation and obtain from the other parties an agreement acknowledging their responsibilities.[63] The requirement that a sponsor establish and effect written procedures detailing compliance with the conditions of rule 3a–4 also is intended to provide the Commission with a readily available source of information regarding the manner in which the rule is being interpreted and applied by the investment advisory industry.

Paragraph (a)(6)(ii)(A) would require the sponsor to maintain and preserve all written policies, procedures and agreements that pertain to the operation of the investment advisory program in its office for as long as it serves as the sponsor of that program.[64] The paragraph also would require the sponsor to maintain and preserve these documents in an easily accessible place for not less than three years after the sponsor ceases to serve as sponsor of the program. Given the importance of these documents, the Commission believes that the documents must be maintained and preserved in the office of the sponsor for as long as the sponsor acts in that capacity, so that they are available for easy reference. These documents also must be retained in an easily accessible place for three years after the sponsor of the program ceases to serve as the sponsor should any questions later arise about the operation of the program.

Paragraph (a)(6)(ii)(B) would require the sponsor or another person designated by the sponsor to maintain and preserve all documents created pursuant to the policies and procedures governing the operation of the program, such as client contracts, client questionnaires, and copies of client statements, in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the document was created. Under this provision, these documents would be required to be maintained and preserved in a manner similar to that required for advisory books and records under paragraph (e)(i) of rule 204–2.[65] Unlike rule 204–2, however, paragraph (a)(6)(ii)(B) would not require the documents to be kept for the first two years in the office of the person creating or receiving the records (i.e., the sponsor). Rather, the paragraph would permit the sponsor to designate another person to maintain and preserve these documents.[66]

Paragraph (a)(6)(iii) would require the sponsor to enter into a written agreement with any person designated to maintain and preserve the books and records pertaining to the program (other than the written policies, procedures and agreements). The paragraph also would require that the agreement include a list of the books and records maintained and preserved by that person and a provision obligating the person maintaining the books and records to provide the sponsor with copies of such books and records within a reasonable time of the sponsor's request.

These requirements are intended to avoid duplicative recordkeeping by allowing the sponsor to designate another person involved in the operation of the investment advisory program to maintain copies of books and records provided that person has a contractual obligation to provide the records to the sponsor upon request. In addition, the requirement that each party's recordkeeping responsibilities be included in the party's agreement with the sponsor would help to ensure that each person is aware of its responsibilities. Finally, since the provision would require that the sponsor be able to request and obtain promptly the books and records maintained by such persons, it effectively would permit the sponsor to monitor more effectively the person's performance of its duties under the contract, and help facilitate Commission examinations.

Paragraph (a)(6)(iv) would require the sponsor to furnish to the Commission upon demand copies of the policies, procedures, all documents created pursuant to the policies and procedures, and the written agreements with other persons involved in the operation of the program. This provision is intended to facilitate Commission examination of investment advisory programs relying on rule 3a–4.

As discussed above, most sponsors of investment advisory programs are required to be registered under the Advisers Act.[67] Thus, these sponsors are already required under section 204 of the Advisers Act to make advisory records available to the Commission upon request.[68] Revised proposed rule 3a–4, however, would be available to all sponsors of investment advisory programs, regardless of their status under the Advisers Act. Accordingly, paragraph (a)(6)(iv) is intended to ensure that the Commission would have access to certain records with respect to investment advisory programs that are sponsored by persons that are not subject to the Advisers Act.

B. Form N–3a4

Paragraph (a)(7) would require any sponsor of an investment advisory program intending to rely on the safe harbor provided in rule 3a–4 to file with the Commission Form N–3a4.[69] Form

[63] In addition, because the procedures would be reasonably designed to ensure that the provisions of the rule are implemented, sponsors may wish to specify in the procedures the persons other than the principal sponsor that are involved in the operation of the program, and each person's duties. The procedures need not, however, specify each individual by name.

[64] Because an adviser may have more than one office, paragraph (a)(6)(ii)(A) would provide that these records should be kept ''in an appropriate office of the sponsor.'' This language is similar to that used in paragraph (e)(i) of rule 204–2 under the Advisers Act (15 CFR 275.204–2), which sets forth the recordkeeping requirements for investment advisers.

[65] See *supra* note 64. Revised proposed rule 3a–4 would not require the creation of any records other than the policies, procedures, and written agreements if the sponsor designates another person to perform obligations under the revised proposed rule or to maintain and preserve certain books and records. Paragraphs (a)(6)(i), (a)(6)(iii). Paragraph (a)(6)(ii)(B), however, would specify how records that are created pursuant to the policies and procedures (whether or not also required by rule 204–2 under the Advisers Act) must be maintained. If records pertaining to the program are required to be created under rule 204–2, but not under the policies or procedures, those records would be required to be maintained in accordance with paragraph (e) of rule 204–2. See National Regulatory Services, Inc., *supra* note (portfolio manager in an investment advisory program must maintain records of brochure delivery at its office, even if sponsor created such records).

[66] However, as discussed below, the sponsor would be required to enter into a written agreement with the designated person that specifies that documents to be maintained by that person and that copies of such documents would be provided to the sponsor upon request.

[67] *See supra* notes 5–8 and accompanying text.

[68] 15 U.S.C. 80b–4.

[69] In addition, in the event that another person had previously served as principal sponsor of, and

Continued

N–3a4 would notify the Commission of investment advisory programs that are intended to be organized and operated in compliance with the rule's requirements.[70] The form would assist the Commission in monitoring the use of rule 3a–4 and facilitate Commission examination of persons involved in investment advisory programs.

C. Advisers Act Issues Raised by Investment Advisory Programs

Wrap fee and other investment advisory programs raise, in addition to the Investment Company Act issues addressed in this release, a number of issues under the Advisers Act. The Commission expects to publish an interpretive release that would address many of these issues.

In particular, the Commission expects that the release will address the suitability obligations of sponsors and portfolio managers to clients of the investment advisory program, including suitability obligations regarding client participation in the program, the selection of portfolio managers, and the selection of investments. The release will discuss how an adviser's obligation to seek best execution applies in the context of wrap fee programs when brokerage commissions are not charged separately for each transaction. In addition, the interpretive release may discuss the application of the restrictions on principal and agency cross transactions in section 206(3) of the Advisers Act to investment advisory programs, including whether these restrictions apply to transactions with a sponsor that is unaffiliated with the portfolio manager recommending the transactions. Finally, the release may address certain issues unique to programs under which client assets are invested in mutual funds, including the disclosure obligations of investment advisers regarding the various fees associated with these programs.[71]

The release will not be issued until after comments have been received on revised proposed rule 3a–4. This timing would allow the interpretive release to reflect, where appropriate, these comments. Such a time schedule will also permit the consideration of comment from members of the investment advisory program industry regarding the issues expected to be addressed in the interpretive release. Commenters are urged to submit such comments on these and any other issues investment advisory programs raise under the Advisers Act. Comment is specifically requested regarding how investment advisers participating in investment advisory programs currently understand and comply with their Advisers Act obligations. Commenters also are urged to suggest specific factual situations that the release should address.

III. Cost/Benefit Analysis

Revised proposed rule 3a–4 under the Investment Company Act would provide a nonexclusive safe harbor from the definition of investment company for investment advisory programs. Programs that are organized and operated in a manner consistent with the rule's conditions would not be required to register under the Investment Company Act or comply with the Act's substantive requirements. The revised proposed rule is intended to provide guidance to persons operating investment advisory programs regarding the status of these programs under the Investment Company Act, and help to ensure that such programs do not operate as investment companies without clients of the programs benefitting from the Act's protections.

Proposed Form N–3a4 would be filed with the Commission by sponsors of programs intending to rely on rule 3a–4. The proposed form would help the Commission in monitoring the use of rule 3a–4 and facilitate Commission examination of persons involved in these programs.

The Commission anticipates that the cost of compliance with revised proposed rule 3a–4 and the proposed form would be small. In addition, the Commission does not believe that compliance with any of the proposed provisions would be unduly burdensome. Comment is requested, however, on the costs and benefits associated with the revised proposed rule and proposed form. Commenters should submit estimates for any costs and benefits perceived, together with any supporting empirical evidence available.

IV. Summary of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis in accordance with 5 U.S.C. 603 regarding revised proposed rule 3a–4 and proposed Form N–3a4. The Analysis notes that the revised proposed rule is intended to provide a nonexclusive safe harbor from the definition of investment company for investment advisory programs organized and operated in compliance with the conditions of the rule, and that the proposed form would be filed with the Commission by sponsors of investment advisory programs intending to rely on the rule. The Analysis explains that the rule is intended to provide guidance regarding the status of investment advisory programs under the Investment Company Act, and that the rule and the form would facilitate Commission examination of persons involved in the operation of a program. The Analysis concludes that the rule would not be overly costly or burdensome to sponsors of investment advisory programs that intend to rely on the safe harbor. A copy of the Initial Regulatory Flexibility Analysis may be obtained from Rochelle Kauffman Plesset, at Mail Stop 10–6, Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549.

V. Statutory Authority

The Commission is publishing for public comment revised proposed rule 3a–4 and Form N–3a4 pursuant to the authority set forth in sections 6(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a–6(c), –37(a)].

Text of Revised Proposed Rule and Proposed Form

List of Subjects in 17 CFR Parts 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, title 17, chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for Part 270 continues to read, in part, as follows:

Authority: 15 U.S.C. 80a–1 *et seq.*, 80a–37, 80a–39 unless otherwise noted;

* * * * *

2. By adding § 270.3a–4 to read as follows:

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submitted Form N–3a4 with respect to, an investment advisory program, the new principal sponsor would be required to submit an amended Form N–3a4 identifying itself as the new sponsor and specifying the name of the prior principal sponsor.

[70] Paragraph (a)(7) also would require sponsors to file with the Commission any amendments to the form. Thus, proposed Form N–3a4 also would be used to change information included in a prior filing, to notify the Commission that the sponsor no longer intends to operate the program in reliance on the safe harbor, or to notify the Commission that a program operating in reliance on the safe harbor will cease operations.

[71] The recently adopted wrap fee disclosure requirements set forth in Schedule H of Form ADV apply only to sponsors of wrap fee programs and not to sponsors of mutual fund wrap programs.

§ 270.3a–4 Status of Investment Advisory Programs.

Note: This section is a nonexclusive safe harbor from the definition of investment company for certain programs that provide investment advisory services to clients. Interests in programs that are organized and operated in compliance with the conditions of § 270.3a–4 also are not required to be registered under section 5 of the Securities Act of 1933 [15 U.S.C. 77e]. The section is not intended, however, to create any presumption about a program that is not organized and operated in compliance with the conditions.

(a) Notwithstanding section 3(a) of the Act [15 U.S.C. 80a–3], any program under which investment advisory services are provided to clients will not be deemed to be an investment company within the meaning of the Act, *provided that:*

(1) Each client's account in the program is managed on the basis of the client's financial situation, investment objectives, and instructions.

(2) (i) At the opening of the account, the sponsor or another person designated by the sponsor obtains information from the client regarding the client's financial situation and investment objectives, and gives the client the opportunity to provide specific instructions concerning the management of the account;

(ii) At least annually, the sponsor or another person designated by the sponsor contacts the client to determine whether there have been any changes in the client's financial situation, investment objectives, or instructions in the preceding year;

(iii) At least quarterly, the sponsor or another person designated by the sponsor notifies the client in writing to contact the sponsor or such other person if there have been any changes in the client's financial situation, investment objectives, or instructions, and provides the client with a means through which such contact is to be made; and

(iv) The sponsor and persons authorized to make investment decisions for the client's account are reasonably available to the client for consultation.

(3) Each client has the ability to impose reasonable restrictions on the management of its account, including the designation of particular securities or types of securities that should not be purchased for the account, or that should be sold if held in the account.

(4) The sponsor or person designated by the sponsor provides each client with a quarterly statement containing a description of all activity in the client's account during the preceding quarter, including all transactions made on behalf of the account, all contributions and withdrawals made by the client, all fees and expenses charged to the account, and the value of the account at the beginning and end of the quarter.

(5) Each client retains indicia of ownership of all securities and funds in the account, including the right to:

(i) Withdraw securities or cash;

(ii) Pledge securities;

(iii) Vote securities, or delegate the authority to vote securities to another person;

(iv) Be provided in a timely manner with confirmations of securities transactions of the type required by § 240.10b–10 of this chapter, and all other documents that would have been provided to the client (or the client's agent) had the client purchased or sold the same securities outside the program; and

(v) Proceed directly as a securityholder against the issuer of any security in the client's account and not be obligated to join any person involved in the operation of the program, or any other client of the program, as a condition precedent to initiating such proceeding.

(6) (i) The sponsor of a program relying on this section must establish and effect written policies and procedures that are reasonably designed to ensure that each of the conditions of this section is met. To the extent that the sponsor designates another person to carry out its obligations under this section, the sponsor must obtain from that person an agreement in writing to carry out those obligations.

(ii) Notwithstanding the requirements of paragraph (e) of § 275.204–2 of this chapter as such requirements would apply to the records set forth in paragraph (a)(6)(ii) of this section:

(A) The sponsor shall maintain and preserve in an appropriate office of the sponsor during the period that it serves as the sponsor of the program, and in an easily accessible place for a period not less than three years after the sponsor ceases to serve in that capacity, all written policies, procedures and agreements required to be established under paragraphs (a)(6)(i) and (a)(6)(iii) of this section; and

(B) The sponsor or another person designated by the sponsor shall maintain and preserve in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the document was created, all documents created pursuant to the policies and procedures (including any client contracts, client questionnaires, and copies of client statements).

(iii) The sponsor shall enter into a written agreement with any person designated by the sponsor to maintain and preserve the books and records pertaining to the program (other than those specified in paragraph (a)(6)(ii)(A) of this section). Such agreement shall include a list of the books and records to be maintained and preserved by that person and a provision that the person will provide the sponsor copies of such books and records within a reasonable time of the sponsor's request.

(iv) The sponsor shall furnish to the Commission upon demand copies of all documents maintained under paragraph (a)(6)(ii) of this section.

(7) The sponsor has filed with the Commission Form N–3a4 [17 CFR 274.222] and any amendments thereto.

(b) As used in this section, the term sponsor refers to any person who receives compensation for sponsoring, organizing or administering the program, or for selecting, or providing advice to clients regarding the selection of, persons responsible for managing the client's account in the program. If a program has more than one sponsor, one person shall be designated the principal sponsor, and such person shall comply with the provisions of this section relating to the duties and responsibilities of the sponsor.

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

3. The authority citation for Part 274 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a–8, 80a–24, and 80a–29 unless otherwise noted.

4. By adding § 274.222 to subpart C to read as follows:

§ 274.222 Form N–3a4, Notification of reliance on rule 3a–4 under the Investment Company Act.

This form shall be filed with the Commission as required by rule 3a–4 (§ 270.3a–4 of this chapter) by sponsors of investment advisory programs that intend to rely on the safe harbor provided by that rule.

Editorial Note: The text of Form N–3a4 appears in the Appendix to this document and will not appear in the Code of Federal Regulations.

Dated: July 27, 1995.

By the Commission.

Margaret L. McFarland,

Deputy Secretary.

Appendix

Note: The following Appendix will not appear in the Code of Federal Regulations.

OMB APPROVAL

OMB Number:
Expires:
Estimated average burden hours per response:

Form N–3a4

U.S. Securities and Exchange Commission

Washington, D.C. 20549

Notification of Intention to Rely on Safe Harbor Pursuant to Rule 3a–4 [17 CFR 270.3a–4]

[ ] Initial Filing [ ] Amendment [ ] Withdrawal

1. Full name of investment advisory program:

_____

2. Full name of principal sponsor (as defined in rule 3a–4) of investment advisory program:

_____

3. Principal sponsor's status under the Investment Advisers Act

[ ] Principal sponsor is registered under that Act; its SEC Investment Advisers Act file number is: 801

[ ] Principal sponsor is not registered under that Act

4. Address of principal sponsor's principal place of business (number, street, city, state, zip code):

_____

5. Telephone number at this location (include area code):

_____

6. If another person had previously served as principal sponsor of, and filed Form N–3a4 with respect to, the investment advisory program identified in Item 1:

a. Full name of previous principal sponsor:

_____

b. Previous principal sponsor's status under the Investment Advisers Act

[ ] Previous principal sponsor is/was registered under that Act; its SEC Investment Advisers Act file number is/was: 801–

[ ] Previous principal sponsor is/was not registered under that Act

7. The undersigned hereby notifies the Securities and Exchange Commission, in its capacity as principal sponsor, that

[ ] it intends to operate the program in reliance on the safe harbor provided in rule 3a–4 under the Investment Company Act of 1940.

[ ] it no longer intends to operate the program in reliance on the safe harbor provided in rule 3a–4 under the Investment Company Act of 1940.

[ ] the program will cease operating as an investment advisory program as of _____ (insert date in blank).

Signed by: _____

(Name of person signing on behalf of principal sponsor)

_____

(title of person)

Date: _____

Instructions

1. This form is to be used to notify the Commission of the intention of the principal sponsor of an investment advisory program to operate the program in reliance on the safe harbor in rule 3a–4 under the Investment Company Act. This form also is to be used to amend a prior filing, to notify the Commission that the sponsor no longer intends to operate the program in reliance on the safe harbor, or to notify the Commission that a program operating in reliance on the safe harbor will cease operations.

2. This form shall be filed in triplicate with the Commission. One copy shall be manually signed; the other copies may have facsimile or typed signatures.

3. Under Item 1, insert name under which the investment advisory program is marketed to clients. If no such name is used, insert a name used to identify the program in internal documents (e.g. contracts) or any other name that would clearly identify the program.

4. The principal sponsor of an investment advisory program shall file this form promptly after becoming principal sponsor of the program. In the event that the previously submitted form becomes inaccurate, the principal sponsor shall amend the form by submitting an amended form, completed in its entirety, with the appropriate box checked at the top of the form. If a previous principal sponsor of the program had filed a Form N–3a4, the new principal sponsor shall submit an amended form, completed in its entirety including the information requested in Item 6.

5. If the principal sponsor no longer intends to operate the program in reliance on rule 3a–4, or the program is ceasing operations, the principal sponsor shall withdraw its notification on Form N–3a4 by submitting another form, completed in its entirety including the information required in Item 7, and checking the appropriate box at the top of the form.

[FR Doc. 95–18891 Filed 8–1–95; 8:45 am]

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