SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 275 and 279

[Release No. IA–1681, File No. S7–28–97]

RIN 3235–AH22

Exemption for Investment Advisers Operating in Multiple States; Revisions to Rules Implementing Amendments to the Investment Advisers Act of 1940

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rules.

SUMMARY: The Commission is publishing for comment under the Investment Advisers Act of 1940 rule amendments to exempt multi-state investment advisers from the prohibition on Commission registration and two alternative amendments to revise the definition of the term ''investment adviser representative.'' The Commission is proposing these amendments to refine the rules implementing the Investment Advisers Supervision Coordination Act.

DATES: Comments must be received on or before January 20, 1998.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Stop 6–9, Washington, D.C. 20549. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–28–97; this file number should be included on the subject line if E-mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549. Electronically submitted comment letters also will be posted on the Commission's Internet web site (http://www.sec.gov).

FOR FURTHER INFORMATION CONTACT: Carolyn-Gail Gilheany, Attorney, or Jennifer S. Choi, Special Counsel, at (202) 942–0716, Task Force on Investment Adviser Regulation, Division of Investment Management, Stop 10–6, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Commission is requesting public comment on proposed amendments to rule 203A–2 [17 CFR 275.203A–2], rule 203A–3 [17 CFR 275.203A–3], rule 206(4)–3 [17 CFR 275.206(4)–3] and Schedule I to Form ADV [17 CFR 279.1] under the Investment Advisers Act of 1940 [15 U.S.C. 80b–1 *et seq.*] (''Advisers Act''). The Commission also is proposing to withdraw rule 203A–5 [17 CFR 275.203A–5] and Form ADV–T [17 CFR 279.3] under the Advisers Act.

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Executive Summary

Section 203A of the Advisers Act generally prohibits an investment adviser from registering with the Commission unless it has more than $25 million of assets under management or is an adviser to a registered investment company. Section 203A also preempts most state regulatory requirements for Commission-registered investment advisers and their supervised persons except for certain ''investment adviser representatives.'' The Commission is proposing an exemption from the prohibition on Commission registration for advisers required to register as an investment adviser in 30 or more states. The Commission also is proposing two alternative amendments to the definition of investment adviser representative. Under the current definition, supervised persons of Commission-registered investment advisers will not be subject to state qualification requirements if no more than ten percent of their clients are natural persons (''ten percent allowance''). The Commission is proposing either (1) to add a provision that would permit supervised persons to have the greater of five natural person clients or the number of natural person clients permitted under the ten percent allowance, or (2) to eliminate the ten percent allowance and permit supervised persons to have an unlimited number of accommodation clients who have certain business or familial relationships with the supervised person or the supervised person's business or institutional clients.

I. Background

Last year, Congress enacted the National Securities Markets Improvement Act of 1996 (''1996 Act''). [1] Title III of the 1996 Act, the Investment Advisers Supervision Coordination Act (''Coordination Act''), amended the Advisers Act by reallocating federal and state responsibilities for regulation of investment advisers. By limiting federal registration and preempting certain state laws, the Coordination Act divided regulatory responsibilities for the approximately 23,350 investment advisers that were registered with the Commission. [2] The Coordination Act became effective on July 8, 1997.

Under new section 203A(a) of the Advisers Act, [3] an investment adviser that is regulated or required to be regulated as an investment adviser in the state in which it maintains its principal office and place of business is prohibited from registering with the Commission unless the investment adviser (i) has at least $25 million of assets under management, or (ii) is an investment adviser to an investment company registered under the Investment Company Act of 1940 (''Investment Company Act''). [4] Section 203A(b) of the Advisers Act generally preempts state law with respect to Commission-registered investment advisers. [5]

On May 15, 1997, the Commission adopted new rules and rule

[1] Pub. L. No. 104–290, 110 Stat. 3416 (1996) (codified in scattered sections of the United States Code).

[2] Other amendments made by the 1996 Act to the Advisers Act include revisions to (i) section 205 [15 U.S.C. 80b–5] to create additional exceptions to the Advisers Act's limitations on performance fee arrangements, (ii) section 222 [15 U.S.C. 80b–18a] to impose certain uniformity requirements on state investment adviser laws, (iii) section 203(e) [15 U.S.C. 80b–3(e)] to permit the Commission to deny or revoke the registration of any person convicted of any felony (or any person associated with such investment adviser), and (iv) section 203(b) [15 U.S.C. 80b–3(b)] to exempt from registration certain advisers to church employee pension plans. *See* sections 210, 304, 305(a), and 508(d) of the 1996 Act.

[3] 15 U.S.C. 80b–3a(a).

[4] The Commission has authority to deny registration to any applicant that does not meet the criteria for Commission registration and to cancel the registration of any adviser that no longer meets the registration criteria. Section 203(c) and (h) of the Advisers Act [15 U.S.C. 80b–3(c) and (h)].

[5] 15 U.S.C. 80b–3a(b). In addition, state law is preempted with respect to advisers that are excepted from the definition of investment adviser under section 202(a)(11) of the Advisers Act [15 U.S.C. 80b–2(a)(11)].

amendments to implement the Coordination Act.[6] These implementing rules included rules that exempt four types of investment advisers from the statutory prohibition on Commission registration and define certain terms used in the Coordination Act.[7] In adopting these rules, the Commission anticipated that experience with the new regulatory scheme might reveal the need for additional rules or further refinement of existing rules. Based on its experience, the Commission is proposing to exempt multi-state investment advisers from the prohibition on Commission registration, to amend the definition of investment adviser representative, and to clarify certain other implementing rules.

II. Discussion

A. Multi-State Investment Adviser Exemption from Prohibition on Registration with the Commission

As discussed above, section 203A of the Advisers Act limits registration with the Commission, in most cases, to investment advisers with at least $25 million of assets under management and preempts state law with respect to these investment advisers.[8] The $25 million threshold was designed to allocate regulatory responsibility to the Commission for larger investment advisers whose activities are likely to affect national markets and to relieve them of the burdens imposed by multiple state regulation.[9] Congress recognized, however, that there may be investment advisers with less than $25 million of assets under management that have national businesses and for which multiple state registration would be burdensome.[10] Therefore, the Commission was given authority in section 203A(c) of the Advisers Act to exempt investment advisers, by rule or order, from the prohibition on Commission registration if the prohibition would be ''unfair, a burden on interstate commerce, or otherwise inconsistent with the purposes'' of section 203A.[11]

Pursuant to its authority, the Commission adopted rule 203A–2, which permits Commission registration for nationally recognized statistical rating organizations and certain pension consultants, affiliated investment advisers, and newly formed investment advisers with reasonable expectations that they would soon become eligible for Commission registration.[12] The Commission also, by order, has granted exemptive relief to investment advisers that do not have $25 million of assets under management but have a national or multi-state practice and conduct advisory activities that require them to register as investment advisers in 30 or more states.[13] The Commission is proposing to amend rule 203A–2 to codify the exemptions provided by individual orders to investment advisers required to be registered in multiple states.

Under the proposed exemption, an investment adviser required to be registered as an investment adviser with 30 or more state securities authorities would be permitted to register with the Commission.[14] The Commission believes that an investment adviser whose activities trigger registration requirements in 30 states is a national firm and that the multiple state registration requirements for such a firm would constitute a burden on interstate commerce. For that reason, the Commission believes that such an investment adviser would be the type of firm for which Congress expected the Commission to exercise its section 203A(c) exemptive authority and, as a result, would have a single, national regulator.[15]

Under the proposed rule amendments, an adviser applying for registration relying on the exemption would be required to submit a representation that the investment adviser has reviewed its obligations under state law and concluded that it is required to register as an investment adviser with the securities authorities of at least 30 states.[16] Once registered with the Commission, the investment adviser would continue to be eligible for the exemption as long as it is annually able to provide a representation that the investment adviser has determined that, but for the exemption, it would be obligated to register in at least 25 states, five fewer states than when it initially registered.[17] The Commission is proposing this five-state difference to prevent an investment adviser registered with the Commission from losing the exemption simply because, for example, it lost a few clients in a small number of states.[18]

Like other exemptions in rule 203A–2, the proposed multi-state exemption

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[6] Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1633 (May 15, 1997) [62 FR 28112 (May 22, 1997)] (''Adopting Release'').

[7] *Id.* The Commission also amended several rules under the Advisers Act to reflect the changes made by the 1996 Act.

[8] Section 203A(a) and (b). Notwithstanding section 203A(b), states retain authority over Commission-registered advisers under state investment adviser statutes to: (1) investigate and bring enforcement actions with respect to fraud or deceit against an investment adviser or a person associated with an investment adviser; (2) require filings, for notice purposes only, of documents filed with the Commission; and (3) require payment of state filing, registration, and licensing fees. Moreover, section 203A(b) specifically preserves state law with respect to investment adviser representatives of Commission-registered advisers who have a place of business in the state. *See infra* section II.B of this Release.

[9] *See* S. Rep. No. 293, 104th Cong., 2d Sess. 3–5 (1996) [hereinafter Senate Report].

[10] *Id.* at 5.

[11] Section 203A(c) [15 U.S.C. 80b–3a(c)].

[12] 17 CFR 275.203A–2.

[13] *See* Arthur Andersen Financial Advisers, Investment Advisers Act Release Nos. 1637 (June 16, 1997), 62 FR 33689 (Notice of Application), 1642 (July 8, 1997), 64 SEC Docket 2417 (Order); Ernst & Young Investment Advisers LLP, Investment Advisers Act Release Nos. 1638 (June 16, 1997), 62 FR 33692 (Notice of Application), and 1641 (July 8, 1997), 64 SEC Docket 2416 (Order); and KPMG Investment Advisors, Investment Advisers Act Release Nos. 1639 (June 17, 1997), 62 FR 33945 (Notice of Application), and 1643 (July 8, 1997), 64 SEC Docket 2418 (Order).

[14] In tallying the number of states in which an adviser is required to register, the investment adviser would be required to exclude those states in which it is not required to register because of applicable state laws or the national de minimis standard of section 222(d) of the Advisers Act. [15 U.S.C. 80b–18a] The Commission believes such an exclusion is appropriate because it is the obligation to register in a state, rather than the business decision to register voluntarily, that demonstrates that the adviser is subject to the type of burden contemplated by the exemption.

[15] *See* Senate Report at 5 (Congress recognized that the ''definition of 'assets under management' * * * may, in some cases, exclude firms with a national or multistate practice from being able to register with the SEC'').

[16] Proposed paragraph (e)(2) of rule 203A–2. At the time of its application for registration with the Commission, the investment adviser would be required to include on Schedule E to Form ADV an undertaking to withdraw from registration with the Commission if it would no longer be required to register in at least 25 states at the time of filing Schedule I. The exemption would require an investment adviser that indicates that it is no longer required to register in at least 25 states to withdraw from Commission registration by filing Form ADV-W within 90 days of filing Schedule I. Proposed paragraph (e)(3) of rule 203A–2.

[17] This representation must be attached to the investment adviser's annual amendment to Form ADV revising Schedule I. Proposed paragraph (e)(2) of rule 203A–2. Under the proposed multi-state exemption, the investment adviser also would be required to maintain a record of the states that the adviser believes it would, but for the exemption, be required to register. Proposed paragraph (e)(4) of rule 203A–2.

[18] This ''five-state difference'' is similar to the ''$5 million window,'' which makes Commission registration optional for an adviser having between $25 and $30 million of assets under management. *See* rule 203A–1(a), (b) [17 CFR 275.203A–1(a), (b)]. The Commission adopted the $5 million window to avoid transient registration problems that could occur because of a small decrease in the value of client assets (as a result of a market decline) or the departure of one or a few clients. *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1601 (Dec. 20, 1996) [61 FR 68480 (Dec. 27, 1996)] (''Proposing Release''). Under the proposed five-state difference, an investment adviser registered with the Commission in reliance upon the multi-state exemption would not be required to de-register and then re-register with the Commission frequently as a result of a change in registration obligation in one or a few states.

could be used by a newly formed investment adviser in conjunction with the ''start-up adviser'' exemption in paragraph (d) of the rule.[19] A newly formed investment adviser not registered in any state could register with the Commission if it reasonably expected that it would be required to register in 30 or more states within 120 days. After the 120-day period, the investment adviser would be required to file an amendment to Form ADV revising Schedule I and attach a representation that, but for the proposed multi-state exemption, the investment adviser would be required to register in at least 25 states.[20]

Comment is requested whether the 30 state threshold should be increased or decreased and whether the five-state difference is sufficient to prevent transient registration problems. Because determining the obligations to register under state law requires a legal analysis, should the Commission require investment advisers to represent that counsel has reviewed the applicable state and federal laws and has concluded that the investment adviser qualifies for the proposed multi-state exemption? Should the Commission prohibit a newly formed investment adviser from using this exemption in conjunction with the reasonable expectation exemption?

B. Definition of Investment Adviser Representative

The Coordination Act preempts most state regulatory requirements for Commission-registered investment advisers and their supervised persons,[21] but permits states to continue to license, register, or otherwise qualify an ''investment adviser representative'' who has a place of business in the state.[22] In rule 203A–3(a), the Commission defined investment adviser representative as a supervised person more than ten percent of whose clients are natural persons other than excepted persons.[23]

1. Accommodation Clients

The ''ten percent allowance'' in the definition of investment adviser representative was designed to permit supervised persons who provide advisory services principally to clients other than natural persons to continue to accept so-called ''accommodation clients'' without being subject to state qualification requirements.[24] In adopting the ten percent allowance, the Commission acknowledged that the allowance may pose a problem for supervised persons with one or a few institutional clients who would not be able to have any accommodation clients.[25] To have one accommodation client, a supervised person would need to have at least ten clients that are not natural persons. Therefore, the Commission directed the staff to work with investment advisers whose supervised persons would be affected by the definition to develop a workable method of addressing this concern and indicated that it may propose revisions to the definition.[26] The Commission staff has consulted with members of the industry for their views and has recommended proposals to the Commission to resolve this issue.

The Commission is now proposing two alternative amendments to the definition of investment adviser representative to allow supervised persons who provide services to one or a few institutional or business client accounts to continue to have accommodation clients without being subject to state qualification requirements. Under the first alternative, the Commission proposes to retain the ten percent allowance and add a provision that would permit supervised persons to have up to five natural person clients. Supervised persons could have under the first alternative the greater of five natural person clients or the number of natural person clients permitted under the ten percent allowance without being subject to state qualification requirements.

The first alternative would allow supervised persons with one or a few institutional or business clients to accept at least five natural person clients and would address the problem with the current rule. Moreover, this alternative would provide a simple, bright-line test for supervised persons to determine when they are subject to state qualification requirements. The disadvantage of this alternative, however, is that the five clients may not necessarily be limited to those clients who the supervised person advises on an accommodation basis; the proposed five natural person minimum could include natural persons who have no relationship to an investment adviser's institutional or business clients. Furthermore, the five natural person minimum would permit supervised persons who have only retail clients (*i.e.,* natural person clients) to avoid state qualification requirements until they obtained their sixth client. The provision, however, likely would have a small effect on the number of supervised persons who would not be subject to state qualification requirements because many states do not require supervised persons to register in the state until they have more than five clients in their respective state.[27]

Under the second alternative, supervised persons who have natural person clients would be excluded from the definition of investment adviser representative if the natural person clients either are ''high net worth'' clients or have a familial or business relationship with the supervised person or his business or institutional clients.[28]

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[19] 17 CFR 275.203A–2(d).

[20] These requirements would be the result of the conditions for the exemptions provided by rule 203A–2(d) and proposed paragraph (e) of rule 203A–2.

[21] The term supervised person is defined in the Advisers Act as any ''partner, officer, director . . . or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser.'' Section 202(a)(25) of the Advisers Act [15 U.S.C. 80b–2(a)(25)].

[22] Section 203A(b).

[23] 17 CFR 275.203A–3(a). The rule defines ''excepted persons'' as natural persons who have $500,000 or more under management with the representative's investment advisory firm immediately after entering into the advisory contract with the firm, or who the advisory firm reasonably believes immediately prior to entering into the advisory contract have a net worth in excess of $1 million (collectively ''high net worth individuals''). Rule 203A–3(a)(3)(i) [17 CFR 275.203A–3(a)(3)(i)]. (The Commission is proposing changes to the criteria for determining high net worth individuals. *See infra* section II.B.2 of this Release.) The Commission also excluded from the term ''investment adviser representative'' those supervised persons who do not on a regular basis solicit, meet with, or otherwise communicate with clients of the investment adviser or who provide only impersonal investment advice. Rule 203A–3(a)(2) [17 CFR 275.203A–3(a)(2)].

[24] Adopting Release, *supra* note 6, at nn.113–117 and accompanying text.

[25] As originally proposed, the ten percent allowance would have been measured either by reference to the assets under management attributable to the supervised person or by reference to clients of the supervised person. The Commission adopted only the client test because there did not appear to be any workable method of attributing client assets to supervised persons. *See* Adopting Release, *supra* note 6, at n.115 and accompanying text.

[26] *Id.*

[27] *See, e.g.,* Unif. Sec. Act section 201(c) (1997); Burns Ind. Code Ann. section 23–2–1–8(c)(3) (1997); Md. Code Ann. section 11–401(b)(3)(ii) (1997); Utah Code Ann. section 61–1–3(3)(c) (1997). The first alternative is narrower than these state exemptions because it would permit supervised persons to have a total of five natural person clients nationwide, rather than five natural person clients per state as permitted by these states.

[28] The Investment Company Institute (''ICI'') suggested that the Commission retain the ten percent allowance *and* exclude from the term natural persons certain clients who are ''affiliated with non-natural person clients.'' *See* Letter from Craig S. Tyle, Vice-President and Senior Counsel, ICI, dated August 12, 1997 (available in File No. S7–28–97). Under the current rule, the ten percent allowance is designed as a proxy for accommodation clients and assumes that a supervised person who has a small number of

Under this alternative, the Commission would eliminate the current ten percent allowance, and a supervised person could have an unrestricted number of clients who are natural persons without being subject to state qualification requirements. These clients would be limited, however, to either (i) high net worth clients (as currently permitted by the rule), or (ii) persons who are (A) partners, officers, or directors of the investment adviser for whom the supervised person works or of a business or institutional client of the investment adviser for whom the supervised person works, (B) relatives, spouses, or relatives of spouses of such partners, officers or directors, or (C) relatives or spouses, or relatives of spouses of the supervised person.

The advantage of this approach is that it extends the provision of the rule for accommodation clients to supervised persons with one or a few clients while more closely tying the accommodation client exception to the purpose for which it was adopted. Instead of presuming that the natural person clients of a supervised person having primarily business clients are accommodation clients, the rule would (with the exception of high net worth clients) require there be the type of relationship between the supervised person and the client that customarily results in the client being considered an accommodation client. This approach, however, could greatly increase or decrease the number of natural person clients supervised persons are permitted to have by the rule before they are subject to state qualification requirements. Moreover, it would make the rule somewhat more complex and, perhaps, the status of a supervised person as an investment adviser representative less transparent to a state securities commissioner seeking to enforce state law. Comment is requested on the scope of the accommodation client exception under this alternative. Are there additional relationships between the investment adviser, supervised person, and client that suggest the client is an accommodation client?

Comment is requested on the advantages and disadvantages of the two approaches. Comment is requested on whether additional approaches could be used to permit a supervised person with one or a few institutional or business clients to accept a small number of natural person clients on an accommodation basis without being subject to state qualification requirements. Commenters suggesting an additional approach should address whether the approach limits the scope of the exception to its original purpose (*i.e.*, to permit accommodation clients), any additional complexity it adds to the rule, and the ease with which supervised persons can determine whether they are subject to state qualification requirements.

2. ''High Net Worth'' Clients

Under the current rule, certain ''high net worth'' individuals are excepted persons for purposes of the definition of investment adviser representative and are not counted towards the ten percent allowance. The criteria for determining high net worth individuals are based on the criteria in rule 205–3 under the Advisers Act for determining those clients with whom investment advisers may enter into a performance fee contract under that exemptive rule.[29] The Commission excluded these high net worth individuals from the definition of investment adviser representative because the Commission presumed that these individuals, who are less dependent on the protections of the performance fee prohibition, do not need the protections of state qualification requirements.[30]

In a companion release, the Commission is proposing to revise the high net worth criteria in rule 205–3 to reflect, among other things, the effects of inflation since the standards were adopted in 1985.[31] The criteria for determining which individuals qualify as high net worth individuals in the definition of investment adviser representative would be revised to reflect the changes being proposed in the companion release. Therefore, the threshold levels for high net worth individuals would increase from $500,000 under management and $1,000,000 net worth to $750,000 and $1,500,000, respectively.

C. Other Amendments

1. Pension Consultants—Determining the Value of Assets of Plans

The Commission adopted rule 203A–2(b) to exempt certain pension consultants from the prohibition on Commission registration. Under the rule, pension consultants that provide investment advice to employee benefit plans with respect to assets having an aggregate value of at least $50 million are required to register with the Commission even if they do not otherwise meet the criteria for Commission registration.[32] Rule 203A–2(b)(3) requires investment advisers relying on the exemption to value plan assets as of the date during the investment adviser's most recent fiscal year that the investment adviser was last employed or retained by contract to provide investment advice to the plan with respect to those assets.[33] Because of the fiscal year requirement, an investment adviser could not rely on the pension consultant exemption when, in fact, it provides investment advice to over $50 million of assets of employee benefit plans if the amount of assets grew to more than $50 million after the end of the investment adviser's fiscal year, but before it filed Schedule I.[34] The Commission, therefore, is proposing to amend the rule to permit investment advisers to determine the aggregate value of plan assets during a 12-month period ending within 90 days before the investment adviser files Schedule I.[35]

2. Rule 206(4)–3—Cash Payments for Client Solicitations

The Coordination Act amended section 203(e) of the Advisers Act by adding new section 203(e)(3), which provided the Commission with the authority to deny or revoke the registration of any investment adviser if the investment adviser (or any person

natural person clients does so on the basis of an accommodation to her institutional clients. The ICI proposal would permit the supervised person to have a defined group of accommodation clients in addition to a group of natural persons (up to ten percent of the supervised person's clients) who are unrelated to her institutional clients without being subject to the state qualification requirements. The Commission is proposing a narrower version of the ICI's recommendation to limit the rule's exception to clients who are or may reasonably be presumed to be accommodation clients.

[29] 17 CFR 275.205–3.

[30] *See* Adopting Release, *supra* note 6, at nn. 110–112 and accompanying text.

[31] *See* Investment Advisers Release No. 1682 (November 13, 1997). In the companion release, the Commission also is proposing to add a third alternative test of sophistication.

[32] *See* rule 203A–2(b) [17 CFR 275.203A–2(b)]; Adopting Release, *supra* note 6, at nn. 58–61 and accompanying text.

[33] 17 CFR 275.203A–2(b)(3).

[34] Conversely, if the value of the assets of plans was above $50 million as of the adviser's last fiscal year, but decreased to below $50 million before Schedule I is filed, under the current rule, the adviser would be eligible to rely on the pension consultant exemption.

[35] An adviser seeking to rely on the pension consultant exemption would be required to aggregate: (i) the value of plan assets for which it provided advisory services at the end of the 12-month period, and (ii) the value of any other plan assets for which it provided advisory services at the end of its employment or contract (if terminated before the end of the 12-month period).

During the interim period before the proposed rule is adopted, the Commission would not object if pension consultants chose to value plan assets under the method being proposed rather than under the method provided by the current rule.

associated with the investment adviser) is convicted of any felony, and redesignating section 203(e)(3) as section 203(e)(4).[36] The Commission proposes to conform a cross-reference in rule 206(4)–3(a)(1)(ii)(D) to the redesignated section.[37]

3. Schedule I to Form ADV

Instructions to Schedule I provide guidance on how an investment adviser should determine the amount of its assets under management for purposes of section 203A of the Advisers Act. The Commission is proposing to amend Instruction 7 to Schedule I to clarify that, in determining the total amount of assets under management, investment advisers may include only those securities portfolios for which they provide continuous and regular supervisory or management services as of the date of filing Schedule I. In valuing these securities portfolios, however, investment advisers may use market values as determined within 90 days prior to the filing of Schedule I. The Commission also is proposing several other miscellaneous conforming amendments to Schedule I.[38]

4. Transition Rule 203A–5 and Form ADV–T

The Commission is proposing to withdraw transition rule 203A–5 and Form ADV–T. The rule and form are unnecessary because the transition under the Coordination Act is now complete.

D. General Request for Comment

Any interested persons wishing to submit written comments on the proposed rule amendments and form changes that are the subject of this Release, to suggest additional changes (including changes to the provisions of the rules that the Commission is not proposing to amend), or to submit comments on other matters that might have an effect on the proposals described above, are requested to do so. Commenters suggesting alternative approaches are encouraged to submit their proposed rule text.

[36] *See* section 305 of the 1996 Act.

[37] Rule 206(4)–3 prohibits cash payments for client solicitation under certain circumstances.

[38] Instruction 5 would be revised to eliminate an unnecessary reference to July 8, 1997, amend the instruction with respect to the pension consultant exemption consistent with the revision proposed in this Release, and add an instruction with respect to the proposed multi-state adviser exemption. In addition, the Commission is proposing to delete Instruction 8 and the unnecessary reference to the date of the valuation of the assets under management in Schedule I, Part II.

III. Cost-Benefit Analysis

As discussed above, the proposed multi-state investment adviser exemption would permit investment advisers required to register with 30 or more states to register with the Commission even though they do not otherwise meet the criteria for Commission registration.[39] The Commission has limited data on the number of investment advisers that would qualify for the proposed multi-state investment adviser exemption.[40] Because investment advisers must be required to register in a large number of states to qualify for the proposed multi-state investment adviser exemption, the Commission expects that only a few investment advisers would be eligible. For Paperwork Reduction Act purposes, the Commission estimates that there may be ten investment advisers that would qualify each year.[41] Comment is requested on whether there may be more than ten investment advisers eligible for this proposed multi-state investment adviser exemption annually. Investment advisers that believe they would qualify for this exemption are requested to notify the Commission.

The proposed multi-state investment adviser exemption would benefit investment advisers by permitting them to save costs they otherwise would incur if they were required to comply with 30 separate sets of state regulations, especially where state regulations may be duplicative or conflicting. These benefits would include cost savings for complying with state registration requirements, which the Commission estimates may be as much as $300,000 annually.[42] Although these annual costs may vary from adviser to adviser, the Commission assumes, for purposes of this analysis, that it would cost each adviser $30,000 to comply with state-law registration requirements.[43] Based on that figure, the Commission estimates that the annual benefit from the proposed multi-state investment adviser exemption, in the form of the foregone costs of state registration, would be approximately $300,000 for all ten investment advisers expected to be eligible for the proposed multi-state investment adviser exemption. Comment is requested on the reasonableness of this cost estimate. Commenters are requested to provide factual support or assumptions underlying any alternative cost estimate.

The benefits also would include savings for investment advisers from the cost of being examined by 30 different state regulators. State regulators would save the expense of examining these investment advisers.[44] The Commission does not have information to estimate the costs of state examinations for investment advisers because the Commission has no data on the frequency with which these investment advisers would be examined by a particular state or the number of states that would examine these investment advisers each year. The Commission requests comment on the state examination costs saved by investment advisers that are regulated only by the Commission. Finally, the proposed multi-state investment adviser exemption would produce certain unquantifiable regulatory benefits in allowing qualifying investment advisers to be regulated by one entity rather than 30 separate state regulators.

The proposed multi-state investment adviser exemption would impose certain costs on investment advisers relying on the proposed exemption. Under the proposed multi-state investment adviser exemption, an investment adviser would be required to attach a representation to Schedule I

[39] *See supra* section II.A of this Release.

[40] Every investment adviser applying for registration with the Commission is required to file Form ADV with the Commission and to file an amended Form ADV when information on the form has changed. Form ADV requires information about the states in which an investment adviser is registered, but does not distinguish between states where the registration is mandatory and where registration is voluntary. Moreover, the Commission no longer receives Form ADV information for state-registered advisers.

[41] According to information obtained from the one-time form, Form ADV–T, there are approximately 21 advisers that are registered with 30 or more states and no longer registered with the Commission. Although approximately 21 investment advisers are registered in more than 30 states, the Commission estimates that only about half of these advisers are required to register in 30 or more states. Therefore, the Commission estimates that there may be ten investment advisers that would qualify for the proposed multi-state exemption each year.

[42] The Coordination Act expressly preserved the authority of the states to require Commission-registered investment advisers to pay state filing, registration, and licensing fees. Section 307(b) of the Coordination Act.

[43] In the Cost-Benefit Analysis of Rules Implementing Amendments to the Investment Advisers Act of 1940, the Commission estimated that the cost for a mid-size adviser to comply with state-law registration requirements could be as much as $20,000. *See* Cost-Benefit Memorandum (available in File No. S7–31–96) (''Implementing Amendments Cost-Benefit Analysis''). The Commission believes that, because advisers eligible for the proposed multi-state exemption would typically be required to register in more states than the average adviser registered with the Commission (*i.e.*, at least 30 states), the cost would be at least $30,000 per adviser. These dollar estimates were based on discussions with law firms that provide these kinds of services to investment advisers.

[44] The Commission requests comment from the states on the costs of investment adviser examinations and the frequency of such examinations.

initially, when registering, and annually, when amending Form ADV, about the number of states in which the investment adviser would be required to register. The investment adviser also would be required to maintain a record of the states in which it believes it would, but for the exemption, be required to register that was the basis of its representation included on the attachment to Schedule I.

The Commission estimates that the total cost to each eligible investment adviser to comply with the requirements of the proposed multi-state investment adviser exemption would be approximately $24,000.[45] Thus, the Commission estimates that the total cost for the ten investment advisers expected to be eligible for the proposed multi-state investment adviser exemption would be approximately $240,000. There also may be incidental costs to the Commission of registering investment advisers that qualify for this proposed multi-state investment adviser exemption and costs associated with examining those investment advisers.

Overall, the Commission believes that the proposed rule amendments would not impose significant additional costs on investment advisers, but rather would result in a net savings when compared with the costs of complying with state registration requirements. Comment is requested concerning the savings for complying with state registration requirements and any benefit to multi-state advisers in having one regulator. Comment is also requested concerning the costs associated with the requirements of the proposed multi-state investment adviser exemption.

As discussed in more detail above, the Commission is proposing two alternative amendments to the definition of investment adviser representative.[46] Although the Commission has never registered investment adviser representatives, the Commission estimates that Commission-registered advisers employ a total of approximately 153,000 investment adviser representatives.[47] The Commission, however, does not have data on the number of representatives who may be affected by the proposed amendments. The Commission, therefore, is unable to quantify the total benefits and costs that may result from these proposed amendments. The Commission believes, nonetheless, that the proposed amendments could provide benefits to Commission-registered investment advisers and their supervised persons because the proposed amendments would reduce their regulatory burdens by permitting supervised persons who provide services to a few institutional clients to have a small number of natural persons as accommodation clients without being subject to state qualification requirements. The Commission requests comment on the percentage of all investment adviser representatives who would be exempt from state qualification requirements under each of the alternatives being proposed.

The first proposed alternative amendment to the definition of investment adviser representative would retain the present ten percent allowance and also permit a supervised person to have up to five natural person clients. The first alternative definition would benefit supervised persons who provide advice to five natural person clients because they would no longer be subject to state qualification requirements even if they are not able to take advantage of the ten percent allowance. Under the current rule, a supervised person would need to have ten institutional clients to have one accommodation client. The first proposed alternative amendment would provide a bright line test that would allow supervised persons and their firms to determine easily when supervised persons must register with the states.

The first alternative would increase the number of supervised persons of Commission-registered advisers who would no longer be subject to state qualification requirements. This proposal would benefit affected supervised persons by permitting them to save the expense associated with investment adviser representative qualification examinations, such as the costs of monitoring state registration requirements and preparing and registering for state exams.[48] The Commission is unable to quantify the total savings because the Commission does not have data on the number of representatives who would be affected by this proposed amendment. Because the Coordination Act preserved the authority of states to require the payment of state filing, registration, and licensing fees, there would be no loss to the states of fees collected.

Costs associated with the first proposed amendment include the foregone fees collected by the National Association of Securities Dealers Regulation (''NASDR'') and the North American Securities Administrators Association, Inc. (''NASAA'') for state examinations for investment adviser representatives.[49] The Commission is unable to quantify the total costs because the Commission does not have data on the number of representatives who would be affected by this proposed amendment. Comment is requested on the effect this provision will have on the costs incurred or avoided by investment advisers and their supervised persons and on the exam fees collected by the NASDR and NASAA.

As detailed above, the second alternative proposed amendment to the definition of investment adviser representative would replace the ten percent allowance and allow supervised persons to have accommodation clients who have a familial or business relationship with the supervised persons or their institutional clients without limitation on the number of accommodation clients. This alternative proposal might have the effect of either increasing or decreasing the number of supervised persons subject to state qualification requirements, and comment is requested on which outcome is more likely.

To the extent that the second alternative increases the number of supervised persons who are no longer subject to state qualification requirements, affected supervised persons would save state examination and examination preparation fees.[50] The costs associated with such an increase would be the foregone fees collected by the NASDR and NASAA for the state examinations.[51]

If the second alternative decreases the number of supervised persons who are not subject to state qualification requirements, the alternative would

[45] The Commission estimated this figure by multiplying the aggregate burden hours required to attach a representation to Schedule I to Form ADV (240 hours) by an average hourly compensation rate of $100. The estimation of the aggregate burden hours for complying with the requirements of the proposed multi-state exemption is based on the Commission's Paperwork Reduction Act Submission. *See infra* section IV of this Release.

[46] *See supra* section II.B of this Release.

[47] This estimate of the number of investment adviser representatives employed by Commission-registered advisers was made for purposes of the Implementing Amendments Cost-Benefit Analysis. *See* Cost-Benefit Memorandum, *supra* note .

[48] In the Implementing Amendments Cost-Benefit Analysis, the Commission estimated the following costs: $96 to take an exam, $850 for exam preparation, and $150 annually per investment adviser representative to monitor state registration requirements. *See* Cost-Benefit Memorandum, *supra* note .

[49] In the Implementing Amendments Cost-Benefit Analysis, the Commission estimated that foregone revenue from the exam fees would $32 per exam. *Id*.

[50] *See supra* note and accompanying text.

[51] *See supra* note and accompanying text. The Commission does not believe that there are any substantial costs to investor protection that would be associated with this proposed amendment.

produce unquantifiable benefits by tying the accommodation client exception more closely to the purpose for which it was adopted. The second alternative would permit supervised persons to accept clients who have a relationship with the supervised person or his institutional clients that would result in the individual client being considered an accommodation client. The costs of the second alternative, if it decreases the number of supervised persons not subject to state qualification requirements, would be the expense associated with state investment adviser representative examinations.[52] Comment is requested on the effect of the second alternative amendment on the costs incurred or avoided by investment advisers and their supervised persons.

The other proposed rule amendments would revise the time period for determining the value of assets of plans for pension consultants, clarify the instructions in Schedule I to Form ADV, and provide an additional instruction in Schedule I to Form ADV. The benefits of these proposed amendments would be to eliminate any confusion that the language of the rules or instructions may have created. The Commission believes that these amendments would not impose any additional costs to investment advisers.

Comment is requested on this cost-benefit analysis. Commenters are requested to provide views and empirical data relating to any costs and benefits associated with the proposed rule amendments.

For purposes of making determinations required by the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission is requesting information regarding the potential effect of the proposed rule amendments on the economy on an annual basis. Commenters should provide data to support their views.

IV. Paperwork Reduction Act

Certain provisions of the proposed rule amendments contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995,[53] and the Commission has submitted them to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for the collections of information are ''Form ADV'' and ''Schedule I to Form ADV,'' both under the Advisers Act. Form ADV and Schedule I to Form ADV, which the Commission is proposing to amend, contain currently approved collections of information under OMB control numbers 3235–0049 and 3235–0490, respectively. The proposed rule amendments are necessary to clarify previously-adopted rules that implemented changes to the Advisers Act. An agency may not sponsor, conduct, or require response to an information collection unless a currently valid OMB control number is displayed.

Form ADV

Form ADV is required by rule 203–1 [17 CFR 275.203–1] to be filed by every adviser that applies for registration with the Commission as an investment adviser. Rule 204–1 [17 CFR 275.204–1] sets forth the circumstances requiring the filing of an amendment to Form ADV. Registrants must file an amended Form ADV when information on the initial Form ADV has changed, either at the end of the fiscal year or promptly for certain material changes. In addition, rule 204–1 also requires an investment adviser to file the cover page of Form ADV (along with a Schedule I) annually within 90 days after the end of the investment adviser's fiscal year regardless of whether other changes have taken place during the year.

After 1997, the Commission estimates approximately 7,300 investment advisers would be registered with the Commission and required to amend Form ADV on an annual basis as required by rule 204–1.[54] The Commission previously estimated that there would be 750 new investment advisers registering with the Commission each year. The Commission estimates that an additional ten investment advisers each year would be eligible for Commission registration under the proposed multi-state exemption. Thus, the annual number of responses for filing an application for investment adviser registration is estimated to be approximately 760. The 760 new advisers each year also will be subject to the annual amendment requirement. The Commission estimates that there would be 8,060 total respondents to this collection of information on an annual basis.

The Commission estimates that each of the 7,300 investment advisers registered with the Commission will amend Form ADV, as required by rule 204–1, an average of 1.5 times annually. Of the 760 new advisers each year, 660 will amend Form ADV an average of once annually. The estimated 100 newly-formed investment advisers that will rely on rule 203A–2(d) will amend Form ADV an average of twice annually. Thus, the annual number of responses for completing amended Form ADV is estimated to be approximately 11,810.

The total number of annual responses for Form ADV (initial registration and amendments) is estimated to be 760 responses for new advisers (including ten responses for new advisers relying on the proposed multi-state exemption) and 11,810 responses for annual amendments. The average burden hours for completing Form ADV for initial registration is 9.0063 hours for each respondent (unchanged from previous estimate). The average burden hours for completing Form ADV as an annual amendment is 1.0672 hours (unchanged from previous estimate). The total burden hours imposed by Form ADV is estimated to be 19,448.42.

The collection of information required by Form ADV is mandatory, and responses are not kept confidential.

Schedule I

Schedule I requires an investment adviser to declare whether it is eligible for Commission registration. Schedule I, as part of Form ADV, is required to be filed with an investment adviser's initial application on Form ADV. The rules imposing this collection of information are found at 17 CFR 275.203–1 and 17 CFR 279.1. Rule 204–1 [17 CFR 275.204–1] sets forth the circumstances requiring the filing of an amended Form ADV. Rule 204–1 requires an investment adviser registered with the Commission to file an amended Schedule I to Form ADV annually within 90 days after the end of the investment adviser's fiscal year.

The Commission estimates that 7,300 investment advisers registered with the Commission would respond to the information collection requirements of Schedule I to Form ADV an average of once a year. In addition, the Commission estimates that approximately 760 new advisers each year will file Schedule I of Form ADV. Of the 760 advisers, 660 will file Schedule I to Form ADV an average of once each year, and the remaining 100 that rely on the exemption provided by

[52] *See supra* note and accompanying text.

[53] 44 U.S.C. 3501 *et seq.*

[54] Under rule 203A–5 of the Advisers Act, all investment advisers registered with the Commission were required to file a completed Form ADV–T with the Commission by July 8, 1997, indicating whether they remain eligible for Commission registration. Of the 23,350 Commission-registered investment advisers, approximately 7,200 advisers indicated that they remain eligible for Commission registration, 10,600 advisers withdrew their registrations, and 5,800 advisers did not file their Form ADV–T. The Commission believes that most of the investment advisers that did not file Form ADV–T are either no longer in the advisory business or no longer eligible to register with the Commission. The Commission expects to cancel the registrations of most of these investment advisers.

rule 203A–2(d) will file Schedule I to Form ADV an average of twice each year. It is estimated that the total number of responses would be 8,160.

For the 765 investment advisers that must calculate assets under management for the purpose of completing Schedule I (9.5% of respondents—excluding the ten investment advisers expected to rely on the proposed multi-state exemption), compliance with the requirement to file an amended Schedule I would impose a total annual burden for each investment adviser of approximately 2 hours (unchanged from previous estimate). For the 7,285 investment advisers that either do not need to calculate assets under management to complete Schedule I or calculate assets under management as part of their normal business operations (90.5% of respondents—excluding the ten investment advisers expected to rely on the proposed multi-state exemption) this burden would be 0.75 of an hour (unchanged from previous estimate).

The Commission estimates that an additional ten investment advisers would be eligible for the proposed multi-state exemption. For the ten investment advisers that would rely on the proposed multi-state exemption, the Commission estimates compliance with the requirement to file an amended Schedule I attaching a representation that the investment adviser is required to register as an investment adviser in 30 or more states would impose a total annual burden for each investment adviser of approximately 240 hours.[55]

The total burden hours imposed by Schedule I to Form ADV is estimated to be 9,480.313.

The collection of information required by Schedule I is mandatory, and responses are not kept confidential.

The Commission estimates that these collections of Form ADV and Schedule I together would impose a total hourly burden of 28,928.73 hours.

The total burdens associated with Form ADV and Schedule I to Form ADV would change from the filing of the last Paperwork Reduction Act Submission because of the proposed multi-state exemption and the tabulation of Form ADV–Ts.[56] The current total Form ADV burden is 18,127.88 hours. The new total Form ADV burden would be 19,448.42 hours. The total change in burden hours for Form ADV would be 1,320.54 hours. The current total burden for Schedule I is 6,418.94 hours. The new total burden for Schedule I would be 9,480.313 hours. The total change in burden for Schedule I of Form ADV would be 3,061.373 hours.

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to (i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (ii) evaluate the accuracy of the agency's estimate of the burden of the proposed collections of information; (iii) enhance the quality, utility, and clarity of the information to be collected; and (iv) minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons desiring to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, D.C. 20503, and should also send a copy of their comments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Stop 6–9, Washington, D.C. 20549 with reference to File No. S7–28–97. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, so that a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

V. Summary of Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (''IRFA'') in accordance with 5 U.S.C. 603 regarding amendments to rules 203A–2, 203A–3, 206(4)–3 and Schedule I to Form ADV, and the withdrawal of rule 203A–5 and Form ADV–T under the Advisers Act. The following summarizes the IRFA.

As set forth in greater detail in the IRFA, the Coordination Act, which became effective on July 8, 1997, amended the Advisers Act by reallocating federal and state responsibilities for regulation of investment advisers. On May 15, 1997, the Commission adopted new rules and rule amendments to implement the Coordination Act.[57] The Commission proposes to revise some of these implementing rules. The IRFA states that the proposed rule amendments would exempt multi-state investment advisers from the prohibition on Commission registration, amend the definition of investment adviser representative, and clarify certain other implementing rules.

The IRFA sets forth the statutory authority for the proposed rule amendments. The IRFA also discusses the effect of the proposed rule amendments on small entities. For purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is a small entity (i) if it manages assets of $50 million or less, in discretionary or nondiscretionary accounts, as of the end of its most recent fiscal year or (ii) if it renders other advisory services, has $50,000 or less in assets related to its advisory business.[58]

The proposed multi-state exemption for investment advisers would be available to any investment adviser that is prohibited from registering with the Commission and is required to register in 30 or more states. The Commission estimates that there may be ten such investment advisers that would be eligible for the proposed multi-state exemption each year.[59] Therefore, the Commission believes that there would be a few small entities that would be affected by the proposed rule.

The proposed rule amendments minimize regulatory burdens on small-entity investment advisers that are eligible for the proposed multi-state exemption by permitting the investment adviser, once registered with the

[55] Investment advisers also would be required to maintain a record of the states in which they believe they would, but for the exemption, be required to register that was the basis of their representation included on the attachment to Schedule I. The Commission believes that the requirement that the investment advisers maintain a record would impose a nominal burden on investment advisers because the information would have to be gathered for purposes of making the representation.

[56] The total hourly burdens for Form ADV and Schedule I would change because (1) the proposed multi-state exemption would permit a small number of additional advisers to register with the Commission, and (2) the tabulation of information from the completed Forms ADV–T has provided the Commission with a more accurate number of advisers it regulates after the July 8, 1997 division of regulatory responsibilities between the federal and state governments.

[57] *See* Adopting Release, supra note 6.

[58] Rule 275.0–7 [17 CFR 275.0–7]. In January 1997, the Commission proposed to revise this definition of ''small entity.'' *See* Definitions of ''Small Business'' or ''Small Organization'' Under the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Exchange Act of 1934, and the Securities Act of 1933, Release Nos. 33–7383, 34–38190, IC–22478, and IA–1609 (Jan. 22, 1997) [62 FR 4106 (Jan. 28, 1997)]. The Commission expects to adopt a revised definition of small investment adviser for Regulatory Flexibility Act purposes to reflect the Coordination Act.

[59] *See supra* note 41.

Commission, to continue to be eligible for the proposed multi-state exemption until it is obligated to register in less than 25 states. This five-state difference prevents an investment adviser from being required to register and then de-register frequently with the Commission as a result of a change in its registration obligation in one state or few states.

The proposed amendments to the definition of investment adviser representative would permit supervised persons of Commission-registered investment advisers who only have a few business or institutional clients to accept accommodation clients. The Commission does not have information from which to estimate the number of Commission-registered investment advisers managing assets of $50 million or less or having less than $50,000 in assets relating to its advisory business whose supervised persons would be exempt from the definition of investment adviser representative under the proposed amendments.

The other proposed rule amendments affect only Commission-registered investment advisers. For purposes of these amendments, the Commission estimates that approximately 850 investment advisers are small entities.[60] These proposed amendments clarify the implementing rules and do not impose any additional burden on investment advisers. Therefore, the Commission believes that it is reasonable to estimate that these clarifying amendments would not have a significant economic effect on small entities. Comment is requested on the number of small entities that would be affected by these proposed amendments.

The proposed withdrawal of rule 203A–5 and Form ADV–T would have no effect on small entities because no investment advisers currently should be filing Form ADV–T.

The proposed rule amendments would impose certain new reporting and recordkeeping requirements and eliminate certain other requirements. Investment advisers relying on the proposed multi-state exemption would be required at initial registration to attach a representation to Schedule I that the investment adviser has determined that it must register in at least 30 states and a representation on Schedule E to Form ADV that it will withdraw from Commission registration when it is no longer required to register in at least 25 states.[61] Thereafter, in the annual amendment to Form ADV revising Schedule I, the investment adviser would be required to submit a representation that it has concluded that, but for the proposed multi-state exemption, it would be required to register in at least 25 states. If the amended Schedule I indicated that the investment adviser was no longer eligible for Commission registration, the proposed amendment would require the investment adviser to file a Form ADV–W within 90 days to withdraw its registration with the Commission.

The Commission estimates that it will take approximately 240 hours, annually on average, to comply with these requirements. This burden on investment advisers that use this proposed rule would be outweighed by the cost savings and benefits to the multi-state investment advisers relying on the proposed multi-state exemption.

The proposed withdrawal of Form ADV–T and rule 203A–5 would eliminate any incidental burden that may continue to be imposed by the transition rule. The proposed rule amendments to rule 206(4)–3 and Form ADV would not impose any new reporting, recordkeeping or other compliance requirements.

The Commission believes that there are no rules that duplicate, overlap, or conflict with, the proposed rule amendments.

The IRFA discusses the various alternatives considered by the Commission in connection with the proposed rule amendments that might minimize the effect on small entities, including (a) the establishment of differing compliance or reporting requirements or timetables that take into account resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the rule, or any part thereof, for small entities.

As stated in the IRFA, after taking into account the resources available to small entities and the potential burden that could be placed on investment advisers that may no longer qualify for the proposed multi-state exemption because of a change in the registration obligations in a few states, the Commission proposes to permit an investment adviser, once registered with the Commission, to continue to be eligible for the proposed multi-state exemption as long as it would be obligated to register in at least 25 states, five fewer states than when it initially registered. Moreover, the burdens associated with complying with the requirements of the rule would affect only a very small number of investment advisers each year.

With respect to the other proposed rule amendments, the Commission believes that the establishment of different compliance or reporting requirements for small entities is neither necessary nor practicable. The information required by Form ADV and Schedule I is necessary for the Commission to determine whether the investment advisers are eligible for Commission registration. The proposed rule amendments will not change significantly any compliance costs. Further clarification, consolidation or simplification of the requirements for small entities does not seem feasible. The Commission believes that the rule amendments, as proposed, will not adversely affect small entities and, instead, include regulatory alternatives that minimize the effect on small entities.

The IRFA includes information concerning the solicitation of comments with respect to the IRFA generally, and in particular, the number of small entities that would be affected by the proposed rule amendments. A copy of the IRFA may be obtained by contacting Carolyn-Gail Gilheany, Securities and Exchange Commission, 450 5th Street, N.W., Mail Stop 10–6, Washington, D.C. 20549.

VI. Statutory Authority

The Commission is proposing amendments to rule 203A–2 pursuant to the authority set forth in section 203A(c) of the Investment Advisers Act of 1940 [15 U.S.C. 80b–3a(c)].

The Commission is proposing amendments to rule 203A–3 pursuant to the authority set forth in sections 202(a)(17) and 211(a) of the Investment Advisers Act of 1940 [15 U.S.C. 80b–2(a)(17), 80b–11(a)].

The Commission is proposing amendments to rule 206(4)–3 pursuant to the authority set forth in sections 204,

[60] This estimate of the number of small entities was made for purposes of the Final Regulatory Flexibility Analysis for the rules implementing the Coordination Act. *See* Adopting Release, *supra* note 6, at nn. 189–190 and accompanying text. Of the 23,350 Commission-registered investment advisers, 5,800 advisers have not filed their Form ADV–T, indicating their eligibility to remain registered with the Commission. *See supra* note 54. The Commission also expects to adopt a revised definition of small entity for purposes of the Regulatory Flexibility Act. *See supra* note 58. Therefore, the Commission plans to revise its estimate of the number of Commission-registered advisers that are small entities after the transition is complete so that the Commission would have more accurate information to estimate the number of small entities under the new definition of that term.

[61] The proposed multi-state investment adviser exemption also would require investment advisers to maintain a record of the states in which they would, but for the exemption, be required to register.

206, and 211 of the Investment Advisers Act of 1940 [15 U.S.C. 80b–4, 80b–6, 80b–11].

The Commission is proposing to withdraw rule 203A–5 pursuant to the authority set forth in sections 204 and 211(a) of the Investment Advisers Act of 1940 [15 U.S.C. 80b–4, 80b–11(a)].

The Commission is proposing amendments to Schedule I to Form ADV pursuant to the authority set forth in sections 203(c)(1) and 204 of the Investment Advisers Act of 1940 [15 U.S.C. 80b–3(c)(1) and 80b–4].

The Commission is proposing to remove and reserve rule 279.3 and proposing to remove Form ADV–T pursuant to the authority set forth in sections 204 and 211(a) of the Investment Advisers Act of 1940 [15 U.S.C. 80b–4, 80b–11(a)].

List of Subjects in 17 CFR Parts 275 and 279

Reporting and recordkeeping requirements, Securities.

Text of Proposed Rule and Form Amendments

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 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1. The authority citation for Part 275 is revised to read as follows:

Authority: 15 U.S.C. 80b–2(a)(17), 80b–3, 80b–4, 80b–6(4), 80b–6a, 80b–11, unless otherwise noted.

Section 275.203A–1 is also issued under 15 U.S.C. 80b–3a.

Section 275.203A–2 is also issued under 15 U.S.C. 80b–3a.

Section 275.204–2 is also issued under 15 U.S.C. 80b–6.

Section 275.205–3 is also issued under 15 U.S.C. 80b–5(e).

2. Section 275.203A–2 is amended by revising the introductory text of § 275.203A–2 and paragraph (b)(3) and adding paragraph (e) to read as follows:

§ 275.203A–2 Exemptions from prohibition on Commission registration.

The prohibition of section 203A(a) of the Act (15 U.S.C. 80b–3a(a)) shall not apply to:

* * * * *

(b) * * *

(3) In determining the aggregate value of assets of plans, include only that portion of a plan's assets for which the investment adviser provided investment advice (including any advice with respect to the selection of an investment adviser to manage such assets). Determine the aggregate value of assets by cumulating the value of assets of plans with respect to which the investment adviser was last employed or retained by contract to provide investment advice during the 12-month period ended within 90 days of filing Schedule I to Form ADV (17 CFR 279.1).

* * * * *

(e) *Multi-State Investment Advisers.* An investment adviser that:

(1) Upon submission of its application for registration with the Commission, is required by the laws of 30 or more States to register as an investment adviser with securities commissioners (or any agencies or officers performing like functions) in the respective States, and thereafter would, but for this section, be required by the laws of at least 25 States to register as an investment adviser with securities commissioners (or any agencies or officers performing like functions) in the respective States;

(2) Attaches a representation to Schedule I to Form ADV (17 CFR 279.1) that the investment adviser has reviewed the applicable State and federal laws and has concluded that, in the case of an application for registration with the Commission, it is required by the laws of 30 or more States to register as an investment adviser with the securities commissioners (or any agencies or officers performing like functions) in the respective States and, in the case of an amendment to Form ADV revising Schedule I to Form ADV, it would be required by the laws of at least 25 States to register with the securities commissioners (or any agencies or officers performing like functions) in the respective States within 90 days prior to the date of filing Schedule I;

(3) Includes on Schedule E to its Form ADV (17 CFR 279.1), an undertaking to withdraw from registration with the Commission if an amendment to Form ADV revising Schedule I to Form ADV indicates that the investment adviser would be required by the laws of fewer than 25 States to register as an investment adviser with the securities commissioners (or any agencies or officers performing like functions) in the respective States, and, within 90 days after filing Schedule I to Form ADV, files a completed Form ADV–W (17 CFR 279.2) whereby the investment adviser withdraws from registration with the Commission if the amendment to Form ADV revising Schedule I indicates that the investment adviser would be prohibited by section 203A of the Act (15 U.S.C. 80b–3a) from registering with the Commission; and

(4) Maintains in an easily accessible place a record of the States that the investment adviser has determined it would, but for the exemption, be required to register for a period of not less than five years from the filing of a Schedule I to Form ADV that includes a representation that is based on such record.

3. In § 275.203A–3 the introductory text and paragraph (a) are revised to read as follows:

Proposal I

§ 275.203A–3 Definitions.

For purposes of section 203A of the Act (15 U.S.C. 80b–3a) and the rules thereunder:

(a)(1) *Investment Adviser Representative. Investment adviser representative* of an investment adviser means a supervised person of the investment adviser:

(i) Who has more than five clients who are natural persons other than excepted persons described in paragraph (a)(3)(i) of this section; or

(ii) More than ten percent of whose clients are natural persons other than excepted persons described in paragraph (a)(3)(i) of this section.

(2) Notwithstanding paragraph (a)(1) of this section, a supervised person is not an investment adviser representative if the supervised person:

(i) Does not on a regular basis solicit, meet with, or otherwise communicate with clients of the investment adviser; or

(ii) Provides only impersonal investment advice.

(3) For purposes of this section:

(i) *Excepted person* means a natural person who is a qualified client as defined in § 275.205–3(d)(1).

(ii) *Impersonal investment advice* means investment advisory services provided by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts.

(4) Supervised persons may rely on the definition of *client* in § 275.203(b)(3)–1 to identify clients for purposes of paragraph (a)(1) of this section, except that supervised persons need not count clients that are not residents of the United States.

Proposal II

§ 275.203A–3 Definitions.

For purposes of section 203A of the Act (15 U.S.C. 80b–3a) and the rules thereunder:

(a)(1) *Investment Adviser Representative. Investment adviser representative* of an investment adviser means a supervised person of the

investment adviser whose clients are natural persons other than excepted persons described in paragraph (a)(3)(i) of this section.

(2) Notwithstanding paragraph (a)(1) of this section, a supervised person is not an investment adviser representative if the supervised person:

(i) Does not on a regular basis solicit, meet with, or otherwise communicate with clients of the investment adviser; or

(ii) Provides only impersonal investment advice.

(3) For purposes of this section:

(i) *Excepted person* means a natural person who is a:

(A) Qualified client as defined in § 275.205–3(d)(1);

(B) Partner, officer, director, (or other person occupying a similar status or performing similar functions), of the investment adviser for whom the supervised person works or of a client that is not a natural person of the investment adviser for whom the supervised person works;

(C) Relative, spouse, or relative of spouse of such partner, officer or director; or

(D) Relative, spouse or relative of spouse of the supervised person.

(ii) *Impersonal investment advice* means investment advisory services provided by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts.

(4) Supervised persons may rely on the definition of *client* in § 275.203(b)(3)–1 to identify clients for purposes of paragraph (a)(1) of this section, except that supervised persons need not count clients that are not residents of the United States.

§ 275.203A–5 [Removed and Reserved]

4. Section 275.203A–5 is removed and reserved.

§ 275.206(4)–3 [Amended]

5. In § 275.206(4)–3, paragraph (a)(1)(ii)(D) is amended by revising the cite ''203(e)(3)'' to read ''203(e)(4)''.

§§ 275.203A–1 and 275.203A–2 [Amended]

6. In 17 CFR part 275 remove ''[15 U.S.C. 80b–3A(a)]'' and add, in its place, ''(15 U.S.C. 80b–3a(a))'' in the following places:

a. Section 275.203A–1 (b)(2), (c), and (d); and

b. Section 275.203A–2 (d)(2) and (d)(3).

PART 279—FORMS PRESCRIBED UNDER THE INVESTMENT ADVISERS ACT OF 1940

7. The authority citation for Part 279 continues to read as follows:

Authority: The Investment Advisers Act of 1940, 15 U.S.C. 80b–1, *et seq.*

8. By revising Schedule I to Form ADV (referenced in § 279.1) to read as follows:

Note: The text of Schedule I to Form ADV (§ 279.1) does not and the amendments will not appear in the Code of Federal Regulation. Schedule I is attached as Appendix A.

§ 279.3 [Removed and Reserved]

9. Section 279.3 is removed and reserved.

10. Form ADV–T is removed.

Note: Form ADV–T does not appear in the Code of Federal Regulation.

Dated: November 13, 1997.

By the Commission.

Jonathan G. Katz,

Secretary.

BILLING CODE 8010–01–P

APPENDIX A [NOTE: The text of Schedule I does not appear in the Code of Federal Regulations.]

SCHEDULE I

Schedule for Declaring Eligibility for SEC Registration

OMB APPROVAL
OMB Number: 3235-0490
Expires:
Estimated average burden
hours per response: 1.1618 minutes

Applicant:	SEC File No. 801-	Date: MM/DD/YY

Part I Eligibility for SEC Registration

Section 203(h) of the Investment Advisers Act of 1940 ("Advisers Act") authorizes the Commission to cancel or deny the registration of any investment adviser that does not meet the criteria for SEC registration set forth in section 203A of the Advisers Act. This Part I requires applicant to declare whether it is eligible, or continues to be eligible, for Commission registration.

Check either (a) or (b):

(a) ☐ Applicant is eligible (or will remain eligible) for SEC registration.

For an applicant to be eligible (or remain eligible) for SEC registration, applicant must respond affirmatively (by checking the appropriate box or boxes) to at least one of the items (i) through (x) below:

Applicant:

(i) ☐ has assets under management of $25 million (in U.S. dollars) or more;

Report assets under management in Part II if "assets under management" is the sole basis of applicant's eligibility for SEC registration (i.e., this item (i) is checked, and none of items (ii) through (x) below are checked).

(ii) ☐ has its principal office and place of business in Colorado, Iowa, Ohio, or Wyoming (*See Instruction 3*);

(iii) ☐ has its principal office and place of business outside the United States (*See Instruction 3*);

(iv) ☐ is an investment adviser to an investment company registered under the Investment Company Act of 1940 (*See Instruction 4*);

(v) ☐ is a nationally recognized statistical rating organization;

(vi) ☐ is a pension consultant that qualifies for the exemption in rule 203A-2(b) (*See Instruction 5(a)*);

(vii) ☐ is an investment adviser that controls, is controlled by, or is under common control with, an investment adviser eligible to maintain its registration with the Commission, and whose principal office and place of business is the same as the eligible investment adviser (*See Instruction 5(b)*);

(viii) ☐ is a newly formed investment adviser relying on rule 203A-2(d) (*See Instruction 5(c)*);

(ix) ☐ is a multi-state investment adviser relying on rule 203A-2(e) (*See Instruction 5(d)*);

(x) ☐ has received an order of the Commission exempting applicant from the prohibition on registration with the Commission.

Application number: 803- _____

Date of Commission's order: _____

(b) ☐ Registrant is no longer eligible for SEC registration. (*See Instruction 6*)

Applicant:	SEC File No. 801-	Date: MM/DD/YY

Part II Assets Under Management

Report assets under management if required by Part I (*i.e.*, if item I(a)(i) is checked yes "(x)" and is the sole basis for applicant's eligibility for SEC registration).

State the amount of applicant's assets under management (in U.S. dollars): (*See Instruction 7*)

$_____.00 (in U.S. dollars)

Applicants are reminded that it is a violation of section 207 of the Advisers Act to make any untrue statement of a material fact in any report filed with the Commission, or willfully to omit to state in any such report any material fact that is required to be stated therein.

BILLING CODE 8010–01–C

Schedule Instructions

Instruction 1. General Instructions

(a) SEC's Collection of Information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Sections 203(c)(1) and 204 of the Advisers Act authorize the Commission to collect the information on this Schedule from applicants. *See* 15 U.S.C. §§ 80b–3(c)(1) and 80b–4. Filing of this Schedule is mandatory. The principal purpose of this collection of information is to enable the Commission to determine which investment advisers are eligible to maintain their registration with the Commission and to provide for the withdrawal from Commission registration for advisers that are no longer eligible. The Commission will maintain files of the information on this Schedule and will make the information publicly available. Any member of the public may direct to the Commission any comments concerning the accuracy of the burden estimate on page one of this Schedule, and any suggestions for reducing this burden. This collection of information has been reviewed by the Office of Management and Budget in accordance with the clearance requirements of 44 U.S.C. § 3507. The applicable Privacy Act system of records is SEC–2, and the routine use of the records are set forth at 40 Federal Register 39255 (Aug. 27, 1975) and 41 FR 5318 (Feb. 5, 1976).

(b) For Further Information: Additional information about the rules referred to in this Schedule is found in the Commission's adopting release, Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Rel. No. 1633 (May 15, 1997).

Instruction 2. Principal Place of Business

Applicant's principal place of business reported in Form ADV, Part I, Item 2.A. is the applicant's principal office and place of business, *i.e.*, the executive office from which the officers, partners, or managers of the applicant direct, control, and coordinate applicant's activities. *See* rule 203A–3(c).

Instruction 3. Advisers in Colorado, Iowa, Ohio, or Wyoming; Foreign Advisors

Under the Advisers Act, an applicant whose principal office and place of business (see Instruction 2) is in a State that does not register investment advisers is required to register with the Commission, even if none of the criteria for SEC registration (e.g., $25 million of assets under management) is met. Currently these States are Colorado, Iowa, Ohio, and Wyoming. Applicants that have their principal office and place of business in one of these States should check the box in item (a)(ii) of Part I.

An applicant whose principal office and place of business is located in a country other than the United States (*i.e.*, not in the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States) also is required to register with the Commission. Such an applicant should check the box in item (a)(iii) of Part I.

Instruction 4. Advisers to Investment Companies

An applicant should not check item (a)(iv) of Part I unless applicant currently provides advisory services pursuant to an investment advisory contract to an investment company registered under the Investment Company Act of 1940. The investment company must be operational, i.e., have assets and shareholders (other than just the organizing shareholders).

Instruction 5. Exemptions

(a) Pension Consultants. An applicant that provides investment advice to employee benefit plans with respect to assets having an aggregate value of more than $50 million during the 12-month period ended within 90 days of filing this Schedule may register with the Commission. An investment adviser seeking to rely on the pension consultant exemption must aggregate: (i) the value of assets for which it provided advisory services at the end of the 12-month period, and (ii) the value of any other assets for which it provided advisory services at the end of its employment or contract (if terminated before the end of the 12-month period). See rule 203A–2(b).

(b) Affiliated Advisers. An applicant that controls, is controlled by, or is under common control with, an investment adviser that is eligible to maintain its registration with the Commission (''eligible adviser'') is itself eligible to maintain its registration with the Commission if the principal office and place of business of the applicant is the same as that of the eligible adviser. See rule 203A–2(c).

(c) Newly Formed Advisers. A newly formed investment adviser may register with the Commission at the time of its formation if the adviser has a reasonable expectation that within 120 days of registration it will become eligible for Commission registration. At the end of the 120-day period, the adviser is required to file an amended Schedule I. If the investment adviser indicates on the amended Schedule I that it has not become eligible to register with the Commission, the adviser is required to file a Form ADV–W concurrently with the Schedule I, thereby withdrawing from registration with the Commission. An applicant registering with the Commission in reliance on this exemption must include on Schedule E of Form ADV an undertaking to withdraw from registration if, at the end of the 120-day period, the investment adviser would be prohibited from Commission registration. See rule 203A–2(d).

(d) Multi-State Advisers. An investment adviser may register with the Commission if it is required to register as an investment adviser with the securities authorities of 30 or more states. To take advantage of this exemption, an applicant must (i) attach to this Schedule a representation that it has reviewed the state and federal laws and has concluded that it must register with the securities authorities of at least 30 states within 90 days prior to the date of filing this Schedule, and (ii) include on Schedule E to Form ADV an undertaking to withdraw from registration if it would no longer be required to register in at least 25 states when it files its annual amendment to Form ADV revising this Schedule. Each year (and for so long as the investment adviser continues to rely on the multi-state investment adviser exemption), when the adviser updates its Schedule I, it must attach a new representation that it has concluded that, but for the exemption, it would be required to register with the securities authorities of at least 25 states within 90 days prior to the date of filing Schedule I. Additionally, each time the adviser makes such a representation, the adviser must create and maintain a list of the states that, but for the exemption, it would be required to register. This list must be maintained in an easily accessible place for a period of not less than five years from the date each representation is filed as an attachment to this Schedule. See rule 203A–2(e).

Instruction 6. Part I, Item (b)

If item (b) of Part I is checked, registrant's investment registration with the SEC must be withdrawn within 90 days after the date this Schedule I was required by rule 204–1(a) to have been filed with the Commission. Thus, registrant's registration must be withdrawn no later than 180 days after the end of its fiscal year. If registrant's

registration is not withdrawn within this time period, registrant will be subject to having its registration cancelled pursuant to section 203(h) of the Advisers Act. See rule 203A–1(c).

Instruction 7. Determining Assets Under Management

Not all applicants are required to provide the amount of their assets under management. An applicant must report its assets under management in Part II only if item I(a)(i) is check yes ''(x)'' and the amount of assets applicant has under management is the sole basis for applicant's eligibility for SEC registration (i.e., applicant has not checked any of items I(a)(ii) through (x)).

In determining the assets applicant has under management, include the ''securities portfolios'' (or portions thereof) for which applicant provides ''continuous and regular supervisory or management services'' as of the date of filing this Schedule.

(a) Securities Portfolios. An account is a securities portfolio if at least 50% of the total value of the account consists of securities. For purpose of this 50% test, applicant may treat cash and cash equivalents (i.e., bank deposits, certificates of deposit, bankers acceptances, and similar bank instruments) as securities.

Applicants may include securities portfolios that are: (i) Family or proprietary accounts of the applicant (unless applicant is a sole proprietor, in which case the personal assets of the sole proprietor must be excluded); (ii) accounts for which applicant receives no compensation for its services; and (iii) accounts of clients who are not U.S. residents.

(b) Value of Portfolio. Include the entire value of each securities portfolio (or portion thereof) for which applicant provides ''continuous and regular supervisory or management services.'' If applicant provides continuous and regular supervisory or management services for only a portion of a securities portfolio, include as assets under management only the portion of the securities portfolio that receives such services. Exclude, for example, a portion of an account:

(1) under management by another person; or

(2) that consists of real estate or businesses the operations of which are ''managed'' on behalf of a client but not as an investment.

No deduction is required for securities purchased on margin.

(c) Continuous and Regular Supervisory or Management Services. General Criteria. An applicant provides continuous and regular supervisory or management services with respect to a securities portfolio if the applicant either—

(1) has discretionary authority over and provides ongoing supervisory or management services with respect to the account; or

(2) does not have discretionary authority over the account, but has an ongoing responsibility to select or make recommendations, based upon the needs of the client, as to specific securities or other investments the account may purchase or sell and, if such recommendations are accepted by the client, is responsible for arranging or effecting the purchase or sale.

Factors. Applicants should consider the following factors in evaluating whether continuous and regular supervisory or management services are being provided.

(1) Terms of the advisory contract. A provision in an advisory contract by which the applicant agrees to provide ongoing management services suggests that the account receives such services. Other provisions in the contract, or the actual management of the applicant, however, may rebut such a suggestion.

(2) Form of compensation. A form of compensation based on the average value of assets under management over a specified period of time would suggest that the applicant provides continuous and regular supervisory or management services. On the other hand, a form of compensation based upon time the applicant spends with a client during a client visit would suggest otherwise. A retainer based upon a percentage of assets covered by a financial plan would not suggest that the applicant provides continuous and regular supervisory or management services.

(3) The management practice of the applicant. The extent to which the applicant is actively managing the assets or providing advice bears on whether the services are continuous and regular supervisory or management services. However, infrequent trades (e.g., based on a ''buy and hold'' strategy) should not alone form the basis for a determination that the services are not provided on a continuous and regular basis.

Examples. To assist applicants, the Commission is providing examples of accounts that may receive continuous and regular supervisory or management services, based upon the criteria and factors discussed above. These examples are not exclusive.

Accounts that may receive continuous and regular supervisory or management services:

(1) Accounts for which the applicant allocates assets of a client among mutual funds (even if it does so without a grant of discretionary authority, but only if the general criteria for non-discretionary accounts is satisfied and the factors suggest that the account receives continuous and regular supervisory or management services); and

(2) Accounts for which the applicant allocates assets among other managers—but *only* under a grant of discretionary authority by which it may hire and fire managers and reallocate assets among them.

Accounts that do not receive continuous and regular supervisory or management services:

(1) Accounts for which the applicant provides market timing recommendations (to buy or sell) but has no ongoing management responsibilities;

(2) Accounts for which the applicant provides only impersonal advice, e.g., market newsletters;

(3) Accounts for which the applicant provides an initial asset allocation, without continuous and regular monitoring and reallocation; and

(4) Accounts for which the applicant provides advice only on an intermittent or periodic basis, upon the request of the client, or in response to some market event, e.g., an account that is reviewed and adjusted on a quarterly basis.

(d) Value of Assets Under Management. Calculate the total amount of applicant's assets under management by including the value, as determined within 90 days prior to the date of filing this Schedule, of securities portfolios (or portions thereof) for which applicant provides continuous and regular supervisory or management services as of the date of filing this Schedule. Current market value should be determined using the same method as that used to determine the account value reported to clients or fees for investment advisory services.

(e) Example. To assist applicants, the Commission is providing an example of the method of determining whether a client account may be included as ''assets under management.''

Example

A client's portfolio consists of the following:

$6,000,000	stocks and bonds
$1,000,000	cash and cash equivalents
$3,000,000	non-securities (collectibles, commodities, real estate, etc.)

$10,000,000	Total Assets

First, is the account a ''securities portfolio?'' The account is a securities portfolio because securities as well as cash and cash equivalents (which the applicant has chosen to include as securities) ($6,000,000+$1,000,000=$7,000,000) comprise at least 50% of the value of the account (here, 70%). (See Instruction 7(a))

Second, does the account receive ''continuous and regular supervisory or management services?'' The entire account is managed on a discretionary basis and is provided ongoing supervisory and management services, and therefore receives continuous and regular supervisory or management services. (See Instruction 7(c))

Third, what is the entire value of the account? The entire value of the account ($10,000,000) is included in the calculation of the investment adviser's total assets under management.

[FR Doc. 97–30296 Filed 11–18–97; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

[Release No. IA–1682, File No. S7–29–97]

RIN 3235–AH25

Exemption To Allow Investment Advisers To Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Commission is proposing amendments to the rule under the Investment Advisers Act of 1940 that permits investment advisers to charge certain clients performance or incentive fees. The amendments would modify the rule's criteria for clients eligible to enter into a contract under which a performance fee is charged and eliminate provisions specifying required contract terms and disclosures. The amendments would provide investment advisers greater flexibility in structuring performance fee arrangements with clients who are financially sophisticated or have the resources to obtain sophisticated financial advice regarding the terms of these arrangements.

DATES: Comments must be received on or before January 20, 1998.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Stop 6–9, Washington, D.C. 20549. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–29–97; this file number should be included on the subject line if E-mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549. Electronically submitted comment letters also will be posted on the Commission's Internet web site (http://www.sec.gov).

FOR FURTHER INFORMATION CONTACT: Kathy D. Ireland, Attorney, or Jennifer S. Choi, Special Counsel, at (202) 942–0716, Task Force on Investment Adviser Regulation, Division of Investment Management, Stop 10–6, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Commission is requesting public comment on proposed amendments to rule 205–3 [17 CFR 275.205–3] under the Investment Advisers Act of 1940 [15 U.S.C. 80b–1 *et seq.*] (''Advisers Act'').

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Executive Summary

Rule 205–3 under the Advisers Act permits investment advisers to charge performance fees to clients with at least $500,000 under the adviser's management or with a net worth of more than $1,000,000. The rule requires certain terms to be included in contracts providing for performance fees and specific disclosures to be made to clients entering into these contracts. The Commission is proposing to eliminate the provisions of the rule that prescribe contractual terms and require specific disclosures. In addition, the Commission is proposing to revise the threshold levels for determining client eligibility to reflect the effects of inflation on the levels set in 1985 when the rule was adopted and to add a third criterion for eligibility. Under the proposed amendments, eligible clients must have assets under management with the adviser of at least $750,000, net worth of more than $1,500,000, or be ''qualified purchasers'' under section 2(a)(51)(A) of the Investment Company Act of 1940 (''Investment Company Act'').[1]

I. Background

Section 205(a)(1) of the Advisers Act generally prohibits an investment adviser from entering into, extending, renewing, or performing any investment advisory contract that provides for compensation to the adviser based on a share of capital gains on, or capital appreciation of, the funds or any portion of the funds of the client.[2] Congress enacted the prohibition against performance fees in 1940 to protect advisory clients from compensation arrangements that it believed might encourage advisers to take undue risks with client funds to increase advisory fees.[3]

In 1970, Congress provided an exception from the prohibition in section 205(a)(1) for advisory contracts relating to the investment of assets in excess of $1,000,000,[4] so long as an appropriate ''fulcrum fee'' is used.[5] This

[1] 15 U.S.C. 80a–2(a)(51)(A).

[2] 15 U.S.C. 80b–5(a)(1).

[3] H.R. Rep. No. 2639, 76th Cong., 3d Sess. 29 (1940). Performance fees were characterized as ''heads I win, tails you lose'' arrangements in which the adviser had everything to gain if successful and little, if anything, to lose if not. S. **Rep. No.** 1775, 76th Cong., 3d Sess. 22 (1940). *See also* SEC, **Investment Trusts and Investment Companies,** H.R. Doc. No. 477, 76th Cong., 3d Sess. 30 (1939). Congress, however, recognized that performance fees may not be harmful in every context and initially excluded from the prohibition contracts between investment advisers and investment companies. Investment Advisers Act of 1940, ch. 686, § 205(1), 54 Stat. 847, 852 (1940) (amended 1970).

[4] Trusts, governmental plans, collective trust funds, and separate accounts referred to in section 3(c)(11) of the Investment Company Act [15 U.S.C. 80a–3(c)(11)] are not eligible for this exception from the performance fee prohibition under section 205(b)(2)(B) of the Advisers Act [15 U.S.C. 80b–5(b)(2)(B)].

[5] 15 U.S.C. 80b–5(b). A fulcrum fee generally involves averaging the adviser's fee over a specified period and increasing and decreasing the fee proportionately with the investment performance of the company or fund in relation to the investment record of an appropriate index of securities prices. *See* Adoption of Rule 205–2 Under the Investment Advisers Act of 1940, as Amended, Defining ''Specified Period'' Over Which the Asset Value of the Company or Fund Under Management is Averaged, Investment Advisers Act Release No. 347 (Nov. 10, 1972) (37 FR 24895 (Nov. 23, 1972)); Adoption of Rule 205–1 Under the Investment Advisers Act of 1940 Defining ''Investment Performance'' of an Investment Company and