

## IAPD Launched ... ADV Part II Delayed


In late September, the SEC launched the Investment Adviser Public Disclosure website (IAPD), which may be found at [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov).

This new Internet site, maintained by the NASD, contains the vast majority of the Form ADV Part I information. With the site's launch, this information is readily accessible to potential advisory clients (and everyone else) for the first time. The IAPD is the second step in the Investment Adviser Registration Depository (IARD) program, the Internet-based electronic regulatory filing system for investment advisers. Use of the IARD for filing Part I of Form ADV by SEC registered advisers became mandatory at the beginning of this year.

In early September, Paul Roye, Director of the SEC's Division of Investment Management, said that after the IAPD launch, the next phase of IARD will be

*At Lord, Bissell & Brook, our heartfelt sympathies and prayers are with the nation and, especially, those most directly impacted by the events of September 11.*

the addition of the state investment adviser representative licensing system. Just as the electronic filing of Form ADV Part I is generally acknowledged to be a more efficient process than the former paper filing process, the adviser representative licensing phase of IARD will likely lead to efficiencies. As always, however, there will certainly be a number of issues to work through with individual states. The initial implementation of this phase will likely require additional time and effort of advisers with representatives in multiple states.

Mr. Roye also confirmed that the Form ADV Part II will be the final phase of IARD implementation. After significant comments and questions were raised last year, the initial staff proposal on Part II was withdrawn. The staff's view of the comments suggests that the next proposal (like the first) will include a completely narrative form of brochure, but that the updating and delivery requirements of the initial proposal may be revisited. Based on the priorities set forth in Mr. Roye's speech, it appears that adoption and implementation of the new Part II before the latter half of next year is unlikely. 

## ICAA Suggests Amendments to Advertising Rule

At the end of August, the Investment Counsel Association of America (ICAA) submitted a letter to the Division of Investment Management of the SEC explaining its view that

Rule 206(4)-1 under the Investment Advisers Act of 1940 should be revised. Rule 206(4)-1 contains restrictions on advertising by registered investment advisers.

### Fall 2001

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ICAA Suggests  
Amendments to  
Advertising Rule

Legislation May  
Create Opportunities  
Under ERISA

SEC Denies  
Rulemaking Petition  
on Portfolio  
Investment Programs

SEC Acts Quickly in  
Wake of Disaster

Proposal for  
Amending the  
Depository Rule

Brief Notes

[www.lordbissell.com](http://www.lordbissell.com)

*continued on page 2*


The ICAA asserts in its letter that the amendments would update, simplify and conform the Rule to the original intent of the Advisers Act. The ICAA's principal recommendations are:

- Eliminate the four specific prohibitions of the current rule (testimonials, past specific recommendations, standalone graphs/charts/formulae, and statements regarding furnishing items without charge);
- Introduce a standard similar to Rule 10b-5 to address fraudulent, deceptive or manipulative acts;
- Distinguish between materials prepared for sophisticated, institutional-type clients and those prepared for retail clients, with more specific baseline standards for retail clients; and

- Issue an interpretive release clarifying and consolidating no-action letters and other advice in connection with investment adviser advertising.

Generally, the ICAA's proposed amendments would make it a violation of the Advisers Act if an advertisement:

- ▶ Contains any untrue statement of a material fact; or
- ▶ Omits to state a material fact necessary in order to make a statement made, in the light of the circumstances of its use, not misleading.


The ICAA's letter may very well influence action taken with respect to Rule 206(4)-1, as the SEC has acknowledged that it is considering revisions to the advertising regulations applicable to advisers. 

## Legislation May Create Opportunities Under ERISA

This summer the U.S. House of Representatives has been working on the Retirement Security Advice Act. The legislation appears to have bipartisan support and is working its way through two House committees.

The Act would amend the Employee Retirement Income Security Act (ERISA) to create new prohibited transaction exemptions. Prohibited transaction exemptions are safe harbors that provide an outline for dealing with retirement plans in a manner which will not violate the broad proscriptions against fraud and potential conflicts of interest set forth in ERISA. If it becomes law, this legislation would allow employers to hire investment advisers to provide individualized advice to employees regarding investing in their

401(k) and other retirement plans. At this time, employers may not contract with an adviser to provide this service.

As proposed, investment advisers (including state registered advisers), broker-dealers, insurance companies and banks would all be allowed to provide advice. As with all ERISA clients, advisers engaged pursuant to the Act would be subject to fiduciary liability under ERISA. Additionally, potential conflicts of interest and fees must be disclosed to employees. Finally, the advice given must be non-discretionary -- employees will retain the ultimate power to decide whether to implement the advice. 

## SEC Denies Rulemaking Petition on Portfolio Investment Programs

Recently, the SEC denied a rulemaking petition by the Investment Company Institute (ICI) to regulate portfolio investment programs as investment companies.

Earlier this year, the ICI requested that the SEC adopt rules which would interpret the definition of "investment company" in the Investment Company Act of 1940 to include portfolio investment programs. Portfolio investment programs are a relatively new product sponsored by a small number of broker-dealers and investment advisers via the Internet. One such sponsor of these programs which was a focus of the petition is FOLIOfn Investments, Inc. Other

companies are said to be preparing similar offerings.

Portfolio investment programs offer pre-selected portfolios of securities which may be purchased in a single transaction. Generally, the pre-selected portfolios are designed to fit a particular style box used in the rating of mutual funds (eg. the "Small-Cap Growth" portfolio). Most programs provide that the particular securities within the portfolio may be altered by the individual investor.

The portfolio is weighted among the various securities in the portfolio, so that the investor purchases individ-

ual stocks as a percentage of the portfolio purchased, instead of purchasing a particular number of shares of each individual security. This results in a portfolio which almost always contains odd lots and fractional shares. The sponsors of these programs typically provide, for a fixed fee, odd lot and fractional share trading services.

Finally, the sponsors update their pre-selected portfolios on a periodic basis (though they typically have no obligation to do so) in order to keep the portfolio in line with its style box designation. FOLIOfn, for example, periodically updates its “Ready-to-go” portfolios and offers the ability for an existing investor to update his or her portfolio to reflect changes in the pre-selected portfolio of securities by the click of a mouse. The result of the mouse click is a number of trades in individual securities until the portfolio is “re-balanced” to match the updated “Ready-to-go” portfolio.

The argument made by the ICI for regulating these programs as investment companies relies primarily on defining the programs themselves as “securities” (because an investment company must be an “issuer” of securities). To determine whether a program is a “security,” the ICI discusses the definition of an “investment contract” as provided in the Supreme Court’s decision in *SEC v W.J. Howey, Ca.* The Howey case defines an investment contract to be a “contract, transaction, or scheme whereby a person invests his [or her] money in a common enterprise and is led to expect profits ... from the efforts of [others]...”. There can be little dispute that there is an investment and expectation of profit in connection with the programs.

The question, then, turns on whether there is a common enterprise and whether the profits are expected from the efforts of others. The ICI’s principal arguments are that:


- Investment by a number of people in the same pre-selected portfolio constitutes a “common enterprise;”
- Investors rely on the efforts of the sponsor to manage their investments by periodic “updates” of the pre-selected portfolios; and
- Investors rely on the efforts of the sponsor to arrange or provide odd lot and fractional share trading services.

The ICI also argues that portfolio investment programs present the same risks to investors and the same potential for conflicts of interest presented by investment companies. These reasons, the ICI asserts, justify regulating these programs as investment companies.


The ICI’s rulemaking petition received opposition not only from sponsors of portfolio investment programs, but also from the Securities Industry Association (SIA). The SIA submitted a letter to the SEC this summer formally setting forth its opposition.

It must be acknowledged that the ICI makes some well supported legal and policy arguments in support of its petition. However, the SEC was not persuaded.

The SEC cited reasons including limited resources and the following substantive justifications in denying the petition:

- Unlike investment companies, portfolio investment programs provide investors with an opportunity to make their own investment decisions based on the individual needs and objectives of an investor.
- Unlike investment companies, each investor in a program is the direct beneficial owner of his or her specific individual securities which make up the portfolio.
- Unlike investment companies, each investor has all the rights of ownership with respect to each individual security, including the right to vote, receive dividends and pledge the securities.
- Finally, the Advisers Act (with respect to adviser sponsors) and the Securities Exchange Act of 1934 (with respect to broker-dealer sponsors) provide a regulatory scheme applicable to the sponsors of these programs. 

## SEC Acts Quickly in Wake of Disaster

The SEC acted swiftly following the tragic events of September 11 to issue a number of orders which allowed investment companies to deviate from certain regulation under the Investment Company Act. These actions provided necessary relief to a number of funds following the market closings. Generally, for a limited time, the SEC relaxed requirements and restrictions relating to in-person meetings of fund boards and borrowing by open-end funds. 

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## Proposal for Amending the Depository Rule

The SEC has recently authorized the proposal of amendments to the depository rule, Rule 17f-4, under the Investment Company Act. This rule identifies the categories of permissible securities depositories and sets forth the essential terms of depository arrangements for registered investment companies. The proposal would eliminate the

requirement that fund boards formally approve custodial arrangements under the rule -- though boards would continue to be responsible for monitoring the arrangements. Additionally, the proposal would expand the rule's application beyond management investment companies to include unit investment trusts. 

## Brief Notes

At the urging of the fund industry, the SEC has delayed the compliance date for **after-tax return disclosures** until December 1.

Robert Plaze and Jennifer Sawin of the SEC's Division of Investment Management recently released a report titled "**Regulation of Investment Advisers by the Securities and Exchange Commission.**"

In a September speech, Paul Roye stated his belief that the NASDR's proposal on **analyst disclosure** may impact investment advisers, especially if they have representatives holding a Series 7 license or if their employees are otherwise associated persons of a broker-dealer.

In early September, the SEC approved new New York Stock Exchange rules requiring members of the NYSE to maintain **error accounts**.

The National Credit Union Association this summer approved the expansion of the "incidental powers" of **credit unions** to include offering investment advice, selling insurance and brokering securities.

Earlier this year, the NASD issued Notice to Members 01-22 regarding **best execution**. This summer the Association for Investment Management & Research issued a report titled "Best Execution and Portfolio Performance."

Following is a list of **Internet sites** that may be useful to investment advisers, fund managers and private investment companies:

Securities and Exchange Commission:  
<http://www.sec.gov>

Investment Counsel Association of America:  
<http://www.icaa.org>

Association for Investment Management & Research:  
<http://www.aimr.com>

Investment Company Institute:  
<http://www.ici.org>

Securities Industry Association:  
<http://www.sia.com>

NASD Regulation, Inc.:  
<http://www.nasdr.com>