Investment Management Regulatory Update

May 2, 2000

SEC Proposes Sweeping Changes to Form ADV

As previously reported in a Special Regulatory Update, the SEC has proposed sweeping changes to Form ADV. The proposed changes have three major themes. First, future Form ADV filings would be made electronically through the Investment Adviser Registration Depository ("IARD") system, which would be administered by NASD Regulation, Inc., and would allow for public access through the SEC's website. Second, the format and substance of Form ADV would be significantly altered by requiring narrative disclosures in "plain English" and adding additional disclosure items. Third, an adviser would be required to increase the frequency of information provided to clients. The proposals call for changes to be phased in through four stages beginning in late 2000 and continuing through 2001. See *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV*, Advisers Act Release No. 1862 (Apr. 5, 2000)

The proposed new and amended rules and the SEC's explanatory release are voluminous and describe many new substantive and procedural requirements in detail. However, the following five aspects of the proposals seem most significant.

Davis Polk & Wardwell produces this publication as a service to our clients to update them on new developments in the investment management field. While reasonable care has been taken to assure the accuracy of this Update as of its publication date, we do not warrant or represent that it is accurate and we undertake no duty to update it; it is not a substitute for primary sources or legal research.

1. **Redrafting Existing Form ADVs in "Plain English."** Advisers would need to (a) redraft their entire Form ADV to comply with additional disclosure requirements and (b) write Part 2 in narrative form, similar to a Schedule H for wrap fee programs, and in "plain English."

2. **Drafting and Delivering New "Brochure Supplements."** Advisers would also be required to draft "brochure supplements" containing the following information about *every* person who communicates with, provides investment advice to, or makes discretionary decisions for, clients (*i.e.*, a "supervised person"): (a) formal education; (b) business background; (c) disciplinary background; (d) supervisor's name, title and telephone number; (e) any involvement in past bankruptcies and (f) the receipt of any transaction-based compensation. An applicable brochure supplement must be delivered to each client every time a new supervised person begins servicing the client. In essence, advisers would need to (a) customize the brochure supplement delivery for each client or group of similarly advised clients; (b) carefully monitor changes to the supplements and (c) ensure proper delivery to clients. (Note that, as proposed, brochure supplements would not be filed as part of the IARD.)

3. **Re-Delivering Form ADV on a One-Time Basis.** After an adviser initially redrafts its Form ADV to comply with the proposals, it would need to make a one-time redelivery of Part 2 to all its existing clients.

4. Adhering to Same Paper-Based Delivery System. Advisers must continue to deliver Part 2 of the form to clients at the beginning of the advisory relationship, along with an appropriate brochure supplement. The proposals do not permit an adviser to satisfy the delivery requirement by reference to the IARD or through a client representation that the client has read the adviser's Form ADV on the Internet. Although an adviser may electronically deliver its Form ADV in accordance with prior SEC interpretive guidelines, as a practical matter, advisers would be required to continue delivering the form in hard copy.

5. Delivering to Clients an Update for Every Material Change. Currently, advisers only need to submit material changes promptly to the SEC. Under the proposals, adviser would be required to deliver to the SEC *and every client* an updated Form ADV (or an appropriate sticker) promptly after each material change to the form (including changes to the brochure supplements).

Comments on the proposals are due by June 13, 2000. Davis Polk & Wardwell anticipates submitting a comment letter to communicate the concerns of our clients.

Paul Roye Outlines Advisers Act Priorities

On April 6, Paul Roye, Director of the Division of Investment Management, gave a speech to the Investment Counsel Association of America in which he outlined the Division's Advisers Act priorities. These priorities and the Division's anticipated actions are summarized below (other than the revised Form ADV proposals).

1. The Broker Dealer Exclusion. The SEC has proposed Rule 202(a)(11)-1, which would exclude from the definition of an "investment adviser" broker-dealers who charge clients an asset-based fee (as opposed to a commission-based fee), so long as certain conditions are met. The Division is continuing to focus on comments received on the proposal and, at a minimum, will likely require more specific disclosure in advertisements and contracts to clarify that any accounts established in reliance on the rule are not subject to the Advisers Act.

2. Other "Investment Adviser" Exclusions. The Division is also reviewing the publishers' exclusion and its application to the Internet and other activities. The Division believes that the exclusion is not available when a publisher's advice is not disinterested, particularly when the publisher is paid for touting stocks or the publisher engages in scalping. In addition, the Division is reviewing the accountants' exclusion to emphasize its view that the exclusion is only available where advice is solely incidental to providing professional accounting services.

3. Principal Transaction Relief. The Division recognizes that developments in the securities market have led to greater liquidity in certain types of securities and more transparency in certain types of transactions. These developments have created a need for the SEC to reconsider Section 206(3) and "crafting relief in this area is one of [the Division's] top priorities."

4. Pay-to-Play. The SEC intends to adopt some sort of pay-to-play rule. However, the final rule may have some significant changes from the version as proposed. The Division is reconsidering whether MSRB rule G-37 is a workable model for the advisory business or whether some other regulatory approach would work better. Mere after-the-fact disclosure, however, will not suffice. In addition, the Division has acknowledged industry concerns with the proposal, including: (a) creation of unnecessary administrative burdens, (b) its impact on advisory employees' ability to make legitimate campaign contributions and (c) potential for penalizing firms disproportionately for inadvertent violations.

5. Advertising and Performance Reporting. The Division may look to revise Rule 206(4)-1, the rule regulating advertising, to mirror a general antifraud standard like that set forth in Rule 156 under the Securities Act, governing investment company advertising. The revised rule could provide general guidance on the factors and types of information and statements that may make an advertisement false and misleading. The intention of a rule revision in this area would be to eliminate inconsistent regulatory treatment of advertising practices by advisers as compared to other providers of financial services. The Division may also consider whether there is a need to standardize the calculation of performance by advisers.

6. Additional Priorities

A. Books and Records. The Division has acknowledged that Rule 204-2, the rule regulating an adviser's maintenance of books and records, is in need of modernization to reflect an electronic environment. Although this project is "a priority," no timetable has been suggested.

B. The Custody Rule. The Division may consider substantially revising Rule 206(4)-2, the custody rule, to: (1) simplify it, (2) clearly define when an adviser is deemed to have custody and (3) set forth workable standards that provide meaningful protections for advisory clients.

C. The Proposed Suitability Rule. In 1994, the SEC proposed Rule 206(4)-5, which would have established required undertakings relating to satisfying an adviser's suitability obligation. The SEC has not taken further action and is now considering whether to adopt or rescind the proposal.

D. Codes of Ethics. In light of recent changes to Rule 17j-1 under the Investment Company Act, the Division may explore "whether requiring all advisers to adopt a code of ethics would be a substantial investor protection improvement in adviser regulation."

SEC Sanctions Former President of Adviser and Others for Misuse of Client Brokerage Commissions

On April 13, the SEC settled three related administrative proceedings in connection with an investment adviser's fraudulent use of $1.8 million of its advisory clients' commissions to pay certain broker-dealers for client referrals. In an earlier proceeding, the SEC found that the investment adviser failed to disclose that it directed client transactions to certain brokers on the basis of their ability to refer clients to the adviser, in violation of numerous provisions of the Advisers Act. See *Fleet Investment Advisers*, Advisers Act Release No. 1821 (Sept. 9, 1999). In these proceedings, the SEC found that the adviser's former president aided and abetted the violations by (1) supporting the direction of commissions to brokers selected on the basis of client referrals notwithstanding Form ADV disclosures to the contrary and (2) signing four amendments to Form ADV that omitted adequate disclosure concerning brokerage practices. The SEC also found that the adviser's former CIO, who was responsible for overseeing relevant compliance procedures, approved the undisclosed direction of commissions to brokers, knowing or having reason to know that the primary purpose was to compensate the brokers for client referrals. Finally, the SEC found that the former owner of a brokerage firm involved failed reasonably to supervise a registered representative of the firm who participated in the commissions-for-referrals arrangement. See *In the Matter of Michael J. Rothmeier et al.*, Advisers Act Release Nos. 1865, 1866 and 1867 (Apr. 13, 2000).

SEC Finds Advisory Firm Used Fraudulent Advertising

The SEC recently found that an advisory firm and its principal misrepresented the firm's investment performance in an advertising circular. Specifically the SEC found that the adviser had claimed (1) a one-year annualized return of 54.6% when actual returns were between 15% and 30%; (2) assets under management of $278 million when it only had $30 million and (3) 522 clients when it had only approximately 100 clients. The SEC also found that the circular misrepresented the principal's experience as an investment adviser and his educational qualifications, as well as the qualifications and experience of the firm's "professional staff." See *Gold Asset Management, Inc. and Mark Gold,* Advisers Act Release No. 1868 (Apr. 14, 2000).

SEC Charges Adviser With Fraudulent Scheme to Divert Funds

On April 3, the SEC charged an investment adviser with a fraudulent scheme to divert $20 million from client accounts. The adviser allegedly gained possession of at least $20 million in client funds, diverting more than $4 million to pay operating expenses and living expenses and to compensate other clients who had been defrauded earlier in the scheme. According to the complaint, the adviser stole money by diverting checks issued from his clients' individual accounts and endorsing them himself. To conceal the alleged diversion of funds, the adviser paid complaining clients with funds diverted from other clients. In addition, the adviser allegedly: (1) misrepresented to clients that their money had been invested in securities transactions or "private placements" that never took place; (2) provided false order tickets and portfolio statements; (3) stated falsely that client assets were held in "trust" or "escrow" accounts and (4) caused clients to invest in high-risk securities issued by a company with little operating history, despite a host of undisclosed conflicts of interests, including a personal stake in the company's stock and warrants. Finally, the complaint alleges that the adviser repeatedly made false statements to the SEC staff during a recent examination, withheld required books and records and provided falsified documents to the staff. Along with the SEC's complaint, the US Attorney for the Southern District of New York simultaneously unsealed a criminal complaint containing similar charges. See *SEC v. Dana C. Giachetto and The Cassandra Group, Inc.*, SEC Litigation Release No. 16499 (Apr. 3, 2000).

SEC Charges Operator of Website with Securities Fraud

On March 20, the SEC filed and settled civil fraud charges against the operator of an Internet website that provided "real-time, daytrading" stock recommendations on a subscription basis. The SEC found that the operator and his company (of which he was the sole member and employee) violated the general antifraud provisions of the federal securities laws by posting false and misleading statements on the website, including (1) misrepresenting that clients could see the real-time actual trades of a successful daytrader and thus be able to profit by mimicking his trades; (2) posting recommendations that he represented were actual trades that his company's "head trader" had just completed or was about to execute and (3) communicating with subscribers on an individual basis and giving personalized investment advice. In addition, the SEC found that as a result of these activities the operator and his company should have been, but were not, registered as an investment adviser. See *SEC v. DynamicDaytrader.com L.L.C. and David A. Rudnick*, SEC Litigation Release No. 16475 (Civil Action No. 00-85-PC) (D. Me.) (Mar. 20, 2000).

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