

## **SUPPORTING STATEMENT RULE 3a-4**

### **A. JUSTIFICATION**

#### **1. Necessity for the Information Collection**

Rule 3a-4 (17 CFR 270.3a-4) under the Investment Company Act of 1940 (15 U.S.C. 80a) ("Investment Company Act" or "Act") provides a nonexclusive safe harbor from the definition of investment company under the Act for certain investment advisory programs. These programs, which include "wrap fee" and "mutual fund wrap" programs, generally are designed to provide professional portfolio management services to clients who are investing less than the minimum usually required by portfolio managers but more than the minimum account size of most mutual funds. Under wrap fee and similar programs, a client's account is typically managed on a discretionary basis according to pre-selected investment objectives. Clients with similar investment objectives often receive the same investment advice and may hold the same or substantially the same securities in their accounts. Some of these investment advisory programs may meet the definition of investment company under the Act because of the similarity of account management.

In 1997, the Commission adopted rule 3a-4, which clarifies that programs organized and operated in a manner consistent with the conditions of rule 3a-4 are not required to register under the Investment Company Act or comply with the Act's

requirements.<sup>1</sup> These programs differ from investment companies because, among other things, they provide individualized investment advice to the client. The rule's provisions have the effect of ensuring that clients in a program relying on the rule receive advice tailored to the client's needs.

For a program to be eligible for the rule's safe harbor, each client's account must be managed on the basis of the client's financial situation and investment objectives and consistent with any reasonable restrictions the client imposes on managing the account. When an account is opened, the sponsor<sup>2</sup> (or its designee) must obtain information from each client regarding the client's financial situation and investment objectives, and must allow the client an opportunity to impose reasonable restrictions on managing the account.<sup>3</sup> In addition, the sponsor (or its designee) annually must contact the client to determine whether the client's financial situation or investment objectives have changed and whether the client wishes to impose any reasonable restrictions on the management of the account or reasonably modify existing restrictions. The sponsor (or its designee) also must notify the client quarterly, in writing, to contact the sponsor (or the designee)

---

<sup>1</sup> Status of Investment Advisory Programs Under the Investment Company Act of 1940, Investment Company Act Release No. 22579 (Mar. 24, 1997) (62 FR 15098 (Mar. 31, 1997)) ("Adopting Release"). In addition, there are no registration requirements under section 5 of the Securities Act of 1933 for these programs. See 17 CFR 270.3a-4, introductory note.

<sup>2</sup> For purposes of rule 3a-4, the term "sponsor" refers to any person who receives compensation for sponsoring, organizing or administering the program, or for selecting, or providing advice to clients regarding the selection of, persons responsible for managing the client's account in the program.

<sup>3</sup> Clients specifically must be allowed to designate securities that should not be purchased for the account or that should be sold if held in the account. The rule does not require that a client be able to require particular securities be purchased for the account.

regarding changes to the client's financial situation, investment objectives, or restrictions on the account's management.<sup>4</sup>

The program must provide each client with a quarterly statement describing all activity in the client's account during the previous quarter. The sponsor and personnel of the client's account manager who know about the client's account and its management must be reasonably available to consult with the client. Each client also must retain certain indicia of ownership of all securities and funds in the account.

Rule 3a-4 is intended primarily to provide guidance regarding the status of investment advisory programs under the Investment Company Act. The rule is not intended to create a presumption about a program that is not operated according to the rule's guidelines.

## **2. Purpose of the Information Collection**

The requirement that the sponsor (or its designee) obtain information about the client's financial situation and investment objectives when the account is opened is designed to ensure that the investment adviser has sufficient information regarding the client's unique needs and goals to enable the portfolio manager to provide individualized investment advice. The sponsor is required to contact clients annually and provide them with quarterly notices to ensure that the sponsor has current information about the client's financial status, investment objectives, and restrictions on management of the account. Maintaining current information enables the

---

<sup>4</sup>

<sup>?</sup> The sponsor also must provide a means by which clients can contact the sponsor (or its designee).

portfolio manager to evaluate the client's portfolio in light of the client's changing needs and circumstances. The requirement that clients be provided with quarterly statements of account activity is designed to ensure the client receives an individualized report, which the Commission believes is a key element of individualized advisory services.

### **3. Role of Improved Information Technology**

Rule 31a-2(f) under the Act permits investment companies to maintain many types of records (and produce them for the Commission's examination as necessary) on magnetic tape, disk, or other computer storage media. Quarterly statements to clients are generally in paper form and are mailed to clients, and quarterly notices must be written. However, rule 3a-4 gives sponsors flexibility in the manner in which they comply with the requirements for annual client contact. The Adopting Release specifically notes that client contact may be made "in person, by telephone, or by letter or electronic mail that includes a questionnaire requesting the client to provide or update relevant information."<sup>5</sup>

### **4. Efforts to Identify Duplication**

The Commission periodically evaluates rule-based reporting and recordkeeping requirements for duplication, and reevaluates them whenever it proposes a rule or a change in a rule. Rule 3a-4 does not require duplicative reporting or recordkeeping.

### **5. Effect on Small Entities**

The Commission does not believe that compliance with rule 3a-4 is

---

<sup>5</sup> See Adopting Release, *supra* note 1, at text following n.36.

unduly burdensome for large or small entities. The rule's requirements are consistent with providing individualized investment advice.<sup>6</sup> Moreover, sponsors that find the requirements of the rule to be overly burdensome are not required to operate their investment advisory programs in reliance on the safe harbor. Failure to operate an investment adviser program in accordance with rule 3a-4 does not necessarily indicate that the program is an investment company.

## **6. Consequences of Less Frequent Collection**

Rule 3a-4's requirement for sponsors to obtain information as to the client's financial situation and investment goals when the account is opened, is not a recurring obligation. The requirements for annual and quarterly client contact reflect the view that without regular contact with clients, portfolio managers are unlikely to have current information regarding each client's financial situation and investment objectives, which the managers need in order to provide individualized investment advice. The requirement for quarterly account activity statements also enables the portfolio manager to be familiar with the client's account and its management. This requirement also provides current information to clients about their accounts, which might prompt them to update the sponsor regarding changing financial situations or goals.

## **7. Inconsistencies with Guidelines in 5 CFR 1320.5(d)(2)**

---

<sup>6</sup> Rule 3a-4 is also consistent with a series of no-action letters the Commission issued from 1982 until the rule's adoption in March 1997. Compliance with the rule generally should not be burdensome to those sponsors that operated their programs in a manner consistent with these previously issued no-action positions. In addition, many sponsors already provide quarterly statements to clients, and the burden of the quarterly activity report is likely to be less for those sponsors.

None.

## **8. Consultation Outside the Agency**

The Commission proposed rule 3a-4 for public comment before its adoption (Investment Company Act Release No. 20260 (July 27, 1995), 60 FR 39574 (Aug. 2, 1995)) and made rule changes based on the comments it received from the public (see Adopting Release, *supra* note 1). The Commission requested public comment on the collection of information requirements in rule 3a-4 before it submitted this request for extension and approval to OMB. The Commission received no comments in response to this request.

The Commission and staff of the Division of Investment Management also participate in an ongoing dialogue with representatives of the investment company industry through public conferences, meetings, and informal exchanges. These forums provide the Commission and the staff useful means to identify and address paperwork burdens that may confront the industry.

## **9. Payment or Gift to Respondents**

Not applicable.

## **10. Assurance of Confidentiality**

Not applicable.

## 11. Sensitive Questions

Not applicable.

## 12. Estimate of Hour Burden

The Commission staff estimates that approximately 64 wrap fee and mutual fund wrap programs administered by 56 program sponsors use the procedures under rule 3a-4.<sup>7</sup> Although it is impossible to determine the exact number of clients that participate in investment advisory programs, an estimate can be made by dividing total assets by the industry average account size (\$345.5 billion<sup>8</sup> divided by \$126,202),<sup>9</sup> for a total of 2,737,675 clients. The Commission estimates that each year under the rule, the 56 program sponsors collectively make approximately (i) 5 responses to each of 457,204 new clients<sup>10</sup> and (ii) 5 responses to each of 2,280,471 continuing clients,<sup>11</sup> for a total of 13,688,375 responses. The estimated responses include:

---

<sup>7</sup> These estimates are based on statistical information on wrap fee and mutual fund wrap programs provided by Cerulli Associates in 2003. We request comment on whether the number of wrap programs and program sponsors has changed.

<sup>8</sup> See Cerulli Associates, *The Cerulli Edge: Managed Accounts Edition*, Advisors Issue 10 (3d quarter 2006).

<sup>9</sup> *Id.* at 13.

<sup>10</sup> The requirement for initial client contact and evaluation is not a recurring obligation, but only occurs when the account is opened. The estimated annual hourly burden is based on the average number of new accounts opened each year. Although it is impossible to determine the exact number of new accounts opened each year, an average number can be estimated by dividing the average annual increase in account assets in 2003 through 2006, by the average account size (\$57.7 billion divided by \$126,202), for an average annual number of new accounts of 457,204.

<sup>11</sup> The estimated number of continuing clients is the difference between the estimated number of total clients (2,737,675) and the estimated number of new clients (457,204). See *supra* note 10 for an estimate of the average annual number of new clients.

- 1 response to prepare, conduct and/or review initial interviews with new clients, with each response requiring:
  - 1.25 hours: 45 minutes of professional time;
  - 30 minutes of staff time.
- 1 response to prepare, conduct and/or review annual interviews with continuing clients, with each response requiring:
  - 30 minutes: 24 minutes of professional time;
  - 6 minutes of staff time.
- 4 responses to prepare and mail quarterly client account statements, including the notice to update information, with each response requiring:
  - 15 minutes: 15 minutes of staff time.<sup>12</sup>

These estimates are based upon data from an outside source and the staff's knowledge of recordkeeping practices in the securities industry.

The Commission estimates, therefore, that each year each of the 56 program sponsors expends a total of approximately 2.25 hours per new client and 1.5 hours per continuing client complying with the requirements of rule 3a-4. Of this annual time burden, 0.75 hours per new client and 0.4 hours per continuing client consist of professional time at \$127 per hour<sup>13</sup> and 1.5 hours per new client and 1.1 hours per continuing client consist of support staff time at \$38 per hour.<sup>14</sup> Thus, the Commission estimates that the total annual hour burden of the rule's paperwork requirement is 4,449,415.5 hours at an annual total cost of \$69,304,128 for new clients<sup>15</sup> and \$212,186,465 for

<sup>12</sup> The staff bases this estimate on the fact that, by business necessity, computer records already will be available that contain the information in the quarterly reports.

<sup>13</sup> ? This estimate is from the SIA Report on Office Salaries in the Securities Industry 2005, modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

<sup>14</sup> This estimate is from the SIA Report on Office Salaries in the Securities Industry 2005, modified to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

<sup>15</sup> ? The estimated annual cost for new clients includes the costs of the initial client



continuing clients.

These estimates represent a decrease of 2,063,087 hours from the prior estimate of 6,512,502.5 hours. The decrease results from a change in the method of computation for the number of clients that participate in these investment advisory programs. Previously, we have computed the number of clients based on the minimum account requirement for participation in these programs. For this estimate we computed the number of clients based on the industry average account size in these programs resulting in a decrease in the estimated number of clients in these investment advisory programs.

The estimate of average burden hours is made solely for the purposes of the Paperwork Reduction Act. The estimate is not derived from a comprehensive or even a representative survey or study of Commission rules.

### **13. Estimate of Total Annual Cost Burden**

Rule 3a-4 does not impose any paperwork related cost burden not discussed in item 12 above.

### **14. Estimate of Cost to the Federal Government**

The rule imposes no costs on the federal government.

### **15. Explanation of Changes in Burden**

The reasons for the changes in burden hours are explained in item 12 above.

### **16. Information Collection Planned for Statistical Purposes**

Not applicable.

---

interview, quarterly contact, and quarterly statements.

**17. Approval to not Display Expiration Date**

Not applicable.

**18. Exception to Certification Statement**

Not applicable.

**B. COLLECTIONS OF INFORMATION EMPLOYING STATISTICAL**

**METHODS**

Not applicable.