InteractiveBrokers

SPOTLIGHT ON

Rule 3a-4 under the Investment Company Act: The functional line between investment company and personal advisory services

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Background

During the 1990s, broker-dealers, investment advisers, and banks constrained by law from issuing and underwriting securities offered investors a variety of programs of professional discretionary portfolio management services. Many of these programs resemble mass-produced accounts or shares in investment companies.[1] They seek to provide discretionary investment management services to a large volume of clients who typically have less capital to invest in individual accounts but have more than the minimum amount required of investing in most mutual funds.[2] Typically, many of these investment advisory programs are organized by a sponsor, the party responsible for providing or arranging the "provision of asset allocation advice and administrative services." [3] In other instances, the sponsor may assist with the selection and recommendation of a portfolio manager and serve as the client's primary point of contact.

The Securities and Exchange Commission (the "SEC") adopted Rule 3a-4 in 1997 to clarify the status of these programs and thereby create a nonexclusive safe harbor for programs operating in accordance with the conditions of the Rule. This Spotlight will walk through conditions of the Safe Harbor and examples of its applications, featuring specialty programs like model portfolios and wrap-fee programs in which the investor pays one fee for all services rendered in connection with the investor's account.

Investment Companies and the Rule 3a-4 Safe Harbor

An investment company usually pools investors' funds and invests those funds in securities or other assets. The investors lose a measure of control over their investments to the investment company. Still, they then share in the profits and losses in proportion to the amount contributed by each individual investor. Investment companies are typically one of three types, including mutual funds, closed-end funds, and unit investment trusts. These types of investment companies are subject to full disclosure with respect to the financial condition, investment objectives and policies,

[1] Frankel, Laby and Schwing, *Regulation of Money Managers: Mutual Funds and Advisers*, §5.01 (3rd Ed, 2020-2 Supp.).

[2] Federal Register, Vol. 62, No. 61 (March 31, 1997), available at https://www.govinfo.gov/content/pkg/FR-1997-03-31/pdf/97-8075.pdf#page=12

[3] Id.

company structure and operations.[4] Aside from having to meet the disclosure requirements of the Act, companies that are inadvertently classified as an investment company but have failed to register as such may face legal sanctions and enforcement actions brought by the SEC.

Rule 3a-4 strikes a balance between pooled services that may constitute securities and individual services—offered by investment advisers or broker-dealers that do not constitute securities, under which investors retain control over their investments.[5] The safe harbor imposes a number of conditions to ensure that clients receive individualized treatment:

1. Individual Management. A sponsor must manage each client's account based on the client's financial situation and investment objectives, and in accordance with any reasonable investment restrictions imposed by the client;

2. Collection of Client Information. At the opening of an account, a sponsor must obtain information from a client about his or her financial situation and investment objectives, and provide the client with an opportunity to impose reasonable investment restrictions on the management of the account;

3. Annual Client Contact. A sponsor must at least annually contact each client to determine whether any changes have occurred with respect to the client's financial situation or investment objectives and whether the client wants to change or impose new investment restrictions on the management of the account;

4. Quarterly Notices. A sponsor must at least quarterly send to each client a written notice instructing the client to contact the sponsor if there have been any changes to the client's financial situation or investment objectives, or if the client wants to change or impose new investment restrictions on the management of the account, and provide a means for contacting the sponsor;

5. Sponsor and Portfolio Manager Availability. A sponsor and personnel of the manager of each client's account who is knowledgeable about the client's account must be reasonably available to consult with the client;

6. Reasonable Investment Restrictions. A sponsor must provide each client with the ability to impose reasonable restrictions on the management of his or her account, which must include the ability to designate particular securities or types of securities that may not be purchased for the account;

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[4] SEC, *Laws and Rules*, available at https://www.sec.gov/investment/laws-and-rules

[5] Frankel, Laby and Schwing, *Regulation of Money Managers: Mutual Funds and Advisers*, §5.01 (3rd Ed, 2020-2 Supp.).

7. Quarterly Account Statements. A sponsor must provide each client with at least a quarterly account statement that describes all activity in the client's account for the preceding quarter; and

8. Securities Ownership. A sponsor must ensure that, with respect to all securities and funds held in a client's account, each client retains certain specified indicia of ownership, including the right to withdraw securities or cash, vote securities, receive securities-related documents (such as proxy statements), receive trade confirmations and exercise legal rights associated with securities ownership.[6]

Quarterly and Annual Requirements Breakdown[7]

The provisions of the Rule set forth quarterly and annual requirements designed to ensure that advisers are making individualized decisions regarding the management of the client's account and are updating strategies according to the client's goals and financial situation. The quarterly due diligence required of the designated person or sponsor includes notifying the client in writing to have the client provide updates to the designated person or sponsor regarding the client's situation. In addition, the designated person or sponsor is to provide quarterly statements to clients detailing all transactions that occurred in the account. While the Rule does not specify the exact form of the statements, they are meant to provide transparency with respect to the client's account(s).

The annual due diligence required of the designated person or sponsor includes reaching out to the client to acquire about any changes to the client's goals or situation. These quarterly and annual provisions are set, so the designated person or sponsor is performing its due diligence on an ongoing basis. The SEC noted that if the sponsor is not provided with updated client information, the sponsor will not be able to relay the proper guidance to the portfolio manager, making it difficult for the portfolio manager to manage the client's account with tailored advice.

While the quarterly requirement provision contemplates only that notice be given to a client in order to have the client provide updates to the designated person or sponsor regarding changes in the client's situation, the annual contact provision contemplates that the sponsor (or the designated person) actively attempt to contact the client to obtain information in order to be covered by the rule.

Safe Harbor Applications

While investment advisers will provide tailored advice to a client, ensuring that the securities chosen for the client's portfolio are in line with the financial situation and investment objectives of the client, the investment manager of an investment company does not have an obligation to

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[6] 17 CFR §270.3a-4 – Status of investment advisory programs.

[7] Federal Register, Vol. 62, No. 61 (March 31, 1997), available at https://www.govinfo.gov/content/pkg/FR-1997-03-31/pdf/97-8075.pdf#page=12

ensure that the securities chosen for the portfolio are in line with the investment philosophy of every investor invested into the company. The key difference is attention to individualized treatment.

Clarke Lanzen Skalla Investment Firm[8]

Clarke Lanzen opened 360 accounts under what is referred to as a "managed asset allocation program." Under the program, clients chose among six investment strategies, such as aggressive, balanced, and conservative, each with its own predetermined investment formula. After a customer chose a strategy, the customer's funds were invested in various mutual funds, with the funds of all customers choosing a particular strategy invested in the same funds. Customers gave the firm discretionary authority, so they had no contractual right to instruct the firm to refrain from investing in a particular fund. All the customers' investments in a particular mutual fund were carried into a single omnibus account in the custodian's name. The firm charged a set-up fee and an annual fee based on assets under management.

Clark Lanzen fell outside of the Safe Harbor and was deemed an investment company. First, customers did not receive <u>individualized management</u>. While customers could still change their strategy at any time, their investments followed the same strategy and were placed into the same exact mutual funds. Second, customers could not place <u>reasonable restrictions</u> on the investments because they had no contractual right to instruct the firm. Third, customers did not retain sufficient indicia of rights traditionally associated with <u>individual ownership</u> of the securities purchased for their account. Clark Lanzen held the investments of its customers in a single account under the custodian's name and charged a set-up fee and an annual asset-based fee that it did not differentiate between the customers.

Folio Investing[9]

In 2000, Folio Investing ("Folio"), an SEC-registered broker-dealer, offered investors a program that provided investors with a fixed set of portfolios and software. Investors could then choose their portfolios and either adopt them or change their composition initially and periodically. Investors were provided with periodic portfolio updating features and a connected share trading service. Folio aggregated the securities that investors wished to trade, to benefit them from lower transaction costs. Folio's software also assisted investors in determining the composition of the portfolios that fitted their needs.

Folio fell under the Safe Harbor and was not deemed an investment company. This program was a typical wrap-fee program sponsored by a broker-dealer. Folio's advice, in this case, was <u>not discretionary and individualized</u>. Even if investors selected one of these prepackaged model

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[8] *In the Matter of Clark lanzen Skalla Inv. Firm*, Inc., IC-21140 (June 16,1995).
[9] Letter to Jonathan G. Katz, SEC Rulemaking (Mar. 28, 2001), available at http://www.ici.org/policy/comments/01_SEC_WEB_PORT_LTR (last visited June 11, 2015); Frankel, Laby and Schwing, *Regulation of Money Managers: Mutual Funds and Advisers*, §5.01 (3rd Ed, 2020-2 Supp.).

portfolios initially, they were free to change composition periodically with the software's assistance, based on each investor's individual needs and objectives. In addition, each investor was the beneficial owner of the securities in his or her portfolio and had all ownership rights. The SEC further noted that Folio had already been subject to broker-dealer regulations and other federal securities laws, which would give investors adequate protection.

***Impact on Robo Advisers*[10]**

Robo advisers generally manage client assets on a discretionary basis through separately managed accounts and wrap programs. In a typical robo program, investors establish individual brokerage accounts to custody their assets, and the robo adviser selects and manages a portfolio of ETFs based on an asset allocation recommended by the adviser and selected by the client. While many robo advisers give clients the flexibility to change their asset allocation frequently through a website or phone application, robo advisers retain the authority to manage accounts based on the asset allocation parameters designated by clients. Robo advisory programs would fall under the Safe Harbor so long as they comply with the Rule 3a-4 conditions designed to ensure that clients receive individualized treatment and that there is no pooling of assets.

Critics, however, argue that the Safe Harbor does not extend to robo advisers because they do not meet two key provisions of the Safe Harbor. One is that "each client's account in the program is managed on the basis of the client's financial situation and investment objectives and in accordance with any reasonable restrictions imposed by the client on the management of the account."[11] The other is that the "sponsor and personnel of the manager of the client's account who are knowledgeable about the account and its management are reasonably available to the client for consultation."[12] These critics appear to take a narrow view of the Safe Harbor conditions.

First, the provision relating to individualized treatment is not a suitability standard that requires robo advisers to collect a specific set of information from each client, nor does the rule dictate the quantity of information that must be collected. The intent of this provision is to negate the inference that the discretionary managed account program is operating as a pooled investment company. In most cases, robo advisers offer far more customization than simply giving clients model portfolios to choose from. For example, some robo advisers offer features and tools including financial planning, sophisticated, technology-driven portfolio rebalancing based on market changes, cash inflows and outflows, risk parameters, or asset placement, and tax-loss harvesting services. The result is that clients are more informed of their financial situation and receive investment advice that is truly customized to their particular investment goals and needs.

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[10] Jennifer L. Klass and Eric Perelman, *The Evolution of Advice: Digital Investment Advisers as Fiduciaries*, (October 5, 2016), available at https://www.morganlewis.com/~/media/files/publication/report/im-the-evolution-of-advice-digital-investment-advisers-as-fiduciaries-october-2016.ashx?la=en.

[11] 17 C.F.R §270.3a-4(a)(1).

[12] 17 C.F.R §270.3a-4(a)(2)(iv).

Second, robo advisers tend to be more available than traditional advisers. Although the Safe Harbor does not dictate the availability of an adviser, robo advisers typically provide their clients with 24/7 access to a great deal of interactive real-time information about the holdings, performance and attributes of their accounts. Moreover, many robo advisers supplement their online programs with around-the-clock telephone or chat features and regular publications of their investment philosophy and approach through email or social media posts. As a result, robo advisers arguably distinguish themselves from traditional advisers with an emphasis on transparency. By contrast, an investor of a mutual fund offered by a registered investment company would have extremely little access to the portfolio manager of the mutual fund. Robo advisers possess unique advantages that strengthen the fiduciary relationship and promote the delivery of individualized, sophisticated and consistent advice.

Conclusion

Advancements in modern-day technology have provided a framework that allows for certain investment advisor programs to operate outside of the Company Act. Where traditionally, a registered investment adviser provides individualized investment advice to its clients, a registered investment company engages in investing, reinvesting, and trading securities by pooling and collectively managing investors' funds. The difference between providing investment advice and providing investment services is blurred when technology allows for investment advisor programs to formulate standard model portfolios and invariably implement uniform strategies for its clients.

The increase in the types of investment advisor programs available in today's wealth management industry presents new areas of inquiry regarding the regulatory environment. Some of these investment advisor programs rely on the Rule as a safe harbor from registering as an investment company. As a result, these programs are not strictly regulated by Federal law, leaving less protection for investors that participate in them. These investment advisor programs need to pay particular attention to the Rule's individualization requirements to fall under the Safe Harbor.