STATE OF CONNECTICUT

DEPARTMENT OF BANKING

44 Capitol Avenue, Hartford, CT 06106

HOWARD B. BROWN
COMMISSIONER

SECURITIES AND BUSINESS INVESTMENTS DIVISION
BULLETIN

FEBRUARY 1987
VOLUME II NO. 4

TABLE OF CONTENTS

CALEB L. NICHOLS
DIVISION DIRECTOR
(203) 566-4560

RALPH A. LAMBIASE
DIRECTOR OF ENFORCEMENT
(203) 566-4560

ERIC J. WILDER
ASSISTANT DIRECTOR
(203) 566-4560

CYNTHIA ANTANAITIS
SENIOR ASSISTANT COUNSEL
(203) 566-4560

BANKING COMMISSIONER'S COMMENTS

This issue of the Securities and Business Investments Division Bulletin is devoted primarily to a discussion of the initiatives taken by this department to facilitate the capital formation process of small businesses.

During the 1986 calendar year, significant steps were taken at the administrative level to ease the compliance requirements for businesses seeking to raise relatively small amounts of capital. The department has promulgated an exemption from registration for transactions made under Rule 504 of Regulation D. Rule 504 is designed to streamline the capital formation process for small businesses in Connecticut.

I am very conscious of the vital role that small businesses play in bolstering our local, state, and national economy. I want to be certain that the regulatory framework within which small businesses operate, will facilitate, rather than impede the capital formation process. To this end, the Department of Banking sponsored the second in a series of Guest Lectures on September 25, 1986. The program was designed to address some of the regulatory concerns of investment advisers, managers of venture capital funds, issuers relying on federal and state private placement exemptions and entrepreneurs in the capital formation process. Presentations were given by representatives from the Securities and Exchange Commission, the Connecticut Department of Economic Development, the investment banking community and members of the Connecticut Bar Association. Pertinent excerpts of these lectures are contained in this issue of the bulletin.

On July 8, 1986, the department issued an Order permitting accelerated effectiveness for securities issued by investment trusts. The Order coordinates state and federal registration effectiveness for this type of securities offering. The Order also permits the omission of certain information and documents from the registration statement if they are substantially similar to those previously filed for a prior series and informs the registrant precisely what has to be filed. Finally, the Order permits effectiveness in accordance with the designation of effectiveness made pursuant to federal Rule 487 and speeds up effectiveness at the state level by waiving the fifteen day waiting period contained in Section 36-486(c) of the Connecticut General Statutes.

Finally, this agency has recently demonstrated its ability to exercise some degree of control over professionals who represent individuals dealing in the securities business. Under the terms of an administrative settlement, a Certified Public Accountant was recently barred from practicing before this department because the financial statements that he prepared and that were relied upon by investors were not only incorrect, but grossly misleading and not prepared in accordance with generally accepted accounting principles. The department will continue to closely review information, including financial statements, that is furnished to investors in connection with an offering of securities to ensure that such information is accurate, complete, and not misleading.

I continue to look forward to your comments and suggestions concerning the contents of this and prospective editions of the Bulletin.

H B Brown

Howard B. Brown
Banking Commissioner

ANNOUNCEMENTS

Staff Changes

John P. Walsh was promoted to Securities Examiner 3 on July 18, 1986.

Naomi Church was promoted to Securities Examiner I on January 2, 1987.

Lisa Barone commenced employment with the Department of Banking as a Connecticut Careers Trainee on October 31, 1986.

Jean Foto was promoted to Pre-Professional Trainee on November 21, 1986.

Vera Garrison was promoted to Senior Clerk on November 21, 1986.

Pamela Sailor commenced employment with the Department of Banking, Securities and Business Investments Division, as a Clerk Typist on May 23, 1986.

Kristine Fonte, formerly of the Connecticut Department of Children and Youth Services in Danbury, joined the staff in the Securities Registration Section as a Clerk Typist on December 19, 1986.

Kevin Atkins resigned as clerk typist to accept a position with the New England Telephone Company.

Staff Awards

Ralph A. Lambiase was awarded a plaque by the North American Securities Administrator's Association, Inc. in recognition of his work in the area of training and broker-dealer examinations.

Conferences

The Department of Banking participated in a conference sponsored by the American Law Institute/American Bar Association involving a course of study on New England Securities Regulation which was held in Hartford on October 23-25, 1986.

TASK FORCE ESTABLISHED BY THE SECRETARY OF THE STATE

The Department of Banking is participating in a Task Force established by the Secretary of the State, Julia H. Tashjian. The purpose of the Task Force is to review the statutes, policies and procedures administered by the Board of Accountancy, an agency that has been recently placed under the jurisdiction of the Office of the Secretary of the State.

Serving on the Task Force with the Department of Banking are representatives from the Office of the State Auditors of Public Accounts, the Connecticut Society of Certified Public Accountants, the Connecticut Association of Public Accountants and the academic community.

The department is paying closer attention to those professionals who practice before this agency. The Securities and Exchange Commission has by statute disciplined accountants and attorneys who practice before it but few states have done likewise.

RULE 504 OF REGULATION D

On October 30, 1986, Commissioner Howard B. Brown promulgated amendments to Section 36-500-22(b)(9) of the Regulations under the Connecticut Uniform Securities Act. The amendments provide exempt status for offerings made pursuant to Rule 504 of federal Regulation D and are designed to facilitate the capital formation process for small businesses seeking to raise capital in an amount not exceeding $500,000. The amendments should have a favorable impact on the small business community, the venture capital industry, start-ups and incubators such as the Science Park Development Corporation of New Haven.

Prior to their adoption, the amendments were circulated to the Connecticut Securities Bar and other interested persons for comment and subsequently approved by the Office of the Attorney General and by the Legislative Regulation Review Committee. The Advisory Committee to the Banking Commissioner provided invaluable advice and counsel concerning the formulation of the amendments. The Advisory Committee is comprised of representatives from various sectors of the business community including the Connecticut Bar Association, investment banking community, the insurance industry and the academic community, namely:

William H. Cuddy, Esq. (Day, Berry & Howard of Hartford);
Jody J. Cranmore, Esq. (Cranmore & Fitzgerald of Hartford);
Harold B. Finn, Esq. (Cummings & Lockwood of Stamford);
George N. Gingold, Esq. (Aetna Life & Casualty of Hartford);
Robert Googins, Esq. (Executive Vice-President, Connecticut Mutual Life Insurance of Hartford);
Joel M. Hartstone, Esq. (Hartstone and Dickstein, Inc. of Hartford);
Dane Kostin, Esq. (Tarlow Levy Mandell & Kostin, P.C. of Farmington);
Lee G. Kuckro, Esq. (Advest, Inc. of Hartford);
Frank J. Marco, Esq. (Shipman & Goodwin of Hartford);
Willard F. Pinney, Esq. (Murtha, Cullina, Richter & Pinney of Hartford);
Richard L. Rose, Esq. (Cummings & Lockwood of Stamford);
Stephen H. Solomson, Esq. (Danaher O'Connell, Attmore, Tedford & Flaherty, P.C. of Hartford);
Robert B. Titus, Esq., Chairman (Professor, Western New England School of Law, Springfield, Massachusetts);
Nicholas Wolfson, Esq. (Professor, University of Connecticut School of Law, Hartford); and
Barry Waxman, Esq. (Cohen and Wolf, P.C. of Bridgeport). (Not a member of the Advisory Committee. Chairman of Securities Law Subcommittee of the Connecticut Bar Association's Executive Committee, Section on Corporation and Other Business Organizations).

CONNECTICUT IMPLEMENTS MODIFIED RULE 504 OFFERING EXEMPTION

By Willard F. Pinney, Jr., Esq.*

Connecticut has adopted a modified version of Rule 504 pursuant to a regulation promulgated by the Banking Commissioner effective October 30, 1986. This new offering exemption is intended to simplify and lessen the cost of smaller offerings in Connecticut, but qualified issuers must take care to comply with the filing, disclosure and other requirements of the regulation which differ significantly from Rule 504 in several respects. Rule 504 is one of a series of six rules within Regulation D promulgated under the Securities Act of 1933 (the "Securities Act"). Previously, Connecticut had only recognized exemptions contained in Rules 505 and 506 of Regulation D. (See "Status of Rule 504 Offerings in Connecticut", Connecticut Securities and Business Investments Division Bulletin, November 1984, CCH Blue Sky Law Reports ¶ 14,515.) Now, in addition to the exemptions contained in Rules 505 and 506, Connecticut also recognizes a modified version of the exemption for smaller offerings contained in Rule 504 subject to filing, disclosure and other requirements set out in Section 36-500-22(b)(9) of the Regulations of Connecticut State Agencies (the "Connecticut Regulations") adopted under Section 36-500 of the Connecticut Uniform Securities Act (the "Connecticut Act").

Apart from the modifications noted below, Rule 504 and related provisions of Regulation D under the Securities Act may now be relied upon in Connecticut in connection with offerings not over $500,000 by issuers, other than investment companies, which are not subject to the reporting requirements of Sections 13 or 15(d) of the Securities Exchange Act of 1934. Other applicable provisions of Regulation D include definitions contained in Rule 501, such as the definition of "accredited investor", and the procedural requirements of Rule 502. The notice requirements of Rule 503 are also applicable subject to variations in the timing, frequency and content of notices filed on Form D pursuant to the Connecticut Regulations.

The principal modifications to Rule 504 as adopted by Connecticut are (a) a requirement that the number of non-accredited investors in Connecticut not exceed thirty-five and (b) a requirement that each offeree in Connecticut receive a written disclosure statement (the "Disclosure Statement") containing specified information.

*Mr. Pinney is a partner in the Hartford law firm of Murtha, Cullina, Richter and Pinney and a member of the Banking Commissioner's Advisory Committee on Securities.

The Disclosure Statement which Connecticut requires in connection with a Rule 504 offering must contain: (1) the name, address and state of organization of the issuer and the names and residence addresses of the issuer's officers, directors, general partners or other principals, however designated, 2) a brief description of the offering, including the security being offered and the intended application of the proceeds of the offering; 3) the issuer's balance sheet dated within 120 days of the start of the offering and a profit and loss statement for the issuer's most recent fiscal year and for any period between the close of the last fiscal year and the date of the balance sheet, which financial statements need not be audited, 4) a discussion of the principal factors that make the offering speculative or one of high risk, and 5) such additional information as the commissioner may require in the public interest." The Connecticut Regulation also requires that the Disclosure Statement carry a legend "set forth boldly on the outside cover" as follows:

> THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE BANKING COMMISSIONER OF THE STATE OF CONNECTICUT NOR HAS THE COMMISSIONER PASSED UPON THE ACCURACY OR ADEQUACY OF THIS OFFERING. ANY REPRESENTATION TO THE CONTRARY IS UNLAWFUL.

While the required content of the Disclosure Statement is far less than would be required to qualify the securities for sale in Connecticut under Section 36-487 of the Connecticut Act, careful attention must be given to its preparation, particularly with respect to the statement of risk factors. Typically, risk factors are presented in the context of a broader disclosure document containing more information concerning the issuer and its business than is required in the Disclosure Statement. Therefore, it may be appropriate for some issuers to include as risk factors certain statements, such as statements concerning their business or the industry in which they operate, which normally would be found in other parts of a prospectus or other disclosure document. Furthermore, issuers are free to make additional disclosures not specifically required by the Connecticut Regulation and should keep in mind the applicability of the antifraud provisions of the Act and the necessity that any statements contained in the Disclosure Statement not be materially false or misleading.

Compliance with the Disclosure Statement requirements of the Connecticut Regulation would not constitute compliance with the registration by qualification requirements of Section 36-487 of the Connecticut Act so that the provisions limiting the manner of sale of, and ability to resell, the securities being sold set out in Rule 502(c) and (d) would continue to apply notwithstanding the provisions of Rule 504(b)(1). These limitations proscribe any general solicitation or advertising in connection with a Rule 504 offering and require reasonable care to assure that purchasers are not statutory underwriters. "Reasonable care" includes certain specific actions set out in both Rule 502(d) and in the Connecticut Regulation such as 1) written disclosure to the effect that the securities being sold have not been registered under either the Securities Act or the Connecticut Act and may not be resold without such registration or an available exemption from registration and 2) a legend to the same effect on the certificate or other document evidencing the security. Issuers relying on the Connecticut Regulation should consider including this disclosure in the Disclosure Statement.

Reliance on Rule 504 in Connecticut also requires the filing of a Form D, including a special undertaking to provide certain additional information, such as the Disclosure Statement, upon the request of the Banking Commissioner.

The Connecticut Regulation is the result of a cooperative effort between the Banking Commissioner and his staff and members of the Connecticut Bar who saw the need for a small offering exemption in Connecticut benefiting non-reporting companies. While it should prove to be a considerable benefit to qualifying issuers, reliance on this exemption will require careful adherence to its unique requirements.

ORDER GOVERNING THE REGISTRATION BY COORDINATION
OF SECURITIES ISSUED BY CERTAIN UNIT INVESTMENT TRUSTS

1. The Banking Commissioner (the "Commissioner") is charged with the administration of Chapter 662 of the Connecticut General Statutes, the Connecticut Uniform Securities Act (the "Act").

2. The Commissioner is also charged with the administration of Section 36-500-1 et seq. of the Regulations of Connecticut State Agencies promulgated under the Act.

3. Section 36-500(a) of the Act provides, in part, that:

> The Commissioner may from time to time make, amend and rescind such ... forms and orders as are necessary to carry out the provisions of this chapter, including ... forms and orders governing registration statements, applications, and reports, and defining any terms, whether or not used in this chapter, insofar as the definitions are not inconsistent with the provisions of this chapter. For the purpose of ... forms and orders, the commissioner may classify securities, persons and matters within his jurisdiction and prescribe different requirements for different classes.

4. The Commissioner finds that the issuance of this order is necessary or appropriate in the public interest or for the protection of investors and consistent with the purposes fairly intended by the policy and provisions of the Act.

5. Section 36-488(d) of the Act provides, in part, that "[a]ny document filed under this chapter ... within five years preceding the filing of a registration statement may be incorporated by reference in the registration statement to the extent that the document is currently accurate."

6. Section 36-488(e) of the Act provides, in part, that "[t]he commissioner may ... permit the omission of any item of information or document from any registration statement."

7. Section 36-500-32(a)(6) of the Regulations states that "[t]he commissioner may exempt a person, security or transaction from a specific provision of these Regulations."

8. Pursuant to the authority granted to him under Sections 36-488 and 36-500 of the Act and Section 36-500-32(a)(6) of the Regulations, the Commissioner therefore orders as follows:

(a) A unit investment trust that satisfies the eligibility requirements of Rule 487, 17 C.F.R. §230.487, promulgated by the Securities and Exchange Commission under the Securities Act of 1933, and which seeks to designate the date and time when the federal registration of securities of a series of such unit investment trust, other than the first series, shall become effective under Rule 487, may register such securities under Section 36-486 of the Act in accordance with the following procedure.

(1) Pursuant to subsections (d) and (e) of Section 36-488 of the Act and Section 36-500-32(a)(6) of the Regulations, the following may be omitted from the registration statement filed under Section 36-486(b) of the Act if the registrant represents to the Commissioner in writing that the omitted information does not differ in any material respect from that contained in a registration for a prior series that became effective under Section 36-486 of the Act, but not pursuant to this order, within the previous two years and for which federal effectiveness was determined by the Securities and Exchange Commission:

(A) One copy of the latest form of prospectus filed under the Securities Act of 1933, as required by Section 36-486(b)(1) of the Act and Section 36-500-17-1(b)(2) of the Regulations.

(B) The organizational instruments required by Section 36-486(b)(2) of the Act and Sections 36-500-17-1(b)(3) and 36-500-17-1(b)(4) of the Regulations.

(C) The copy of any agreements with or among underwriters required by Section 36-486(b)(2) of the Act and Section 36-500-17-1(b)(5) of the Regulations.

(D) The copy of any indenture or other instrument governing the issuance of the securities to be registered, as required by Section 36-486(b)(2) of the Act.

(E) The specimen or copy of the security required by Section 36-486(b)(2) of the Act.

(F) If applicable, the advisory, custodian and business management agreements required by Sections 36-500-17-1(b)(6), 36-500-17-1(b)(7) and 36-500-17-1(b)(9) of the Regulations.

(G) The form of application to purchase securities required by Section 36-500-17-1(b)(8) of the Regulations.

(H) The sales literature required by Section 36-491 of the Act and Section 36-500-23(a) of the Regulations.

(I) An undertaking to forward all pre-effective amendments to the federal prospectus, other than an undertaking that merely delays the effective date of the registration statement, as required by Section 36-486(b)(4) of the Act.

(J) A copy of any pre-effective amendment to the federal registration statement, as required by Section 36-500-17-1(e) of the Regulations, and a copy of any pre-effective amendment to the prospectus, as required by Section 36-500-19(d)(1) of the Regulations.

(b) Prior to the date of federal effectiveness, a unit investment trust described in paragraph 8(a) of this order shall submit the following in connection with the registration by coordination of its securities:

(1) A separate nonrefundable filing fee of $300 for each series as required by Section 36-488(a) of the Act and Section 36-500-19(b) of the Regulations.

(2) A separate registration (Form U-1) for each series, as required by Section 36-500-17-1(a) of the Regulations.

(3) The amount of securities to be offered, as required by Section 36-488(c)(1) of the Act.

(4) The states in which a registration statement or similar document in connection with the offering has been or is to be filed, as required by Section 36-488(c)(2) of the Act.

(5) The name of any broker-dealer or agent of issuer registered to do business under the Act who may offer the securities in Connecticut, as required by Section 36-488(c)(3) of the Act.

(6) Information on any adverse order, judgment, decree or permanent or temporary injunction entered in connection with 1) the offering, 2) other securities of the issuer, or 3) the person seeking the registration, by the regulatory authorities in each state, by any self-regulatory organization or by any court or the Securities and Exchange Commission, as required by Section 36-488(c)(4) of the Act and subparagraphs (B) and (E) of subdivision (2) of subsection (d) of Section 36-500-19 of the Regulations.

(7) An undertaking to forward all post-effective amendments to the federal prospectus, as required by Section 36-486(b)(4) of the Act and Section 36-500-19(d)(1) of the Regulations.

(8) Any request by the issuer or person seeking the registration to withdraw an application pending before a state or federal agency to register the same security he or she seeks to register under the Act, as required by Section 36-500-19(d)(2)(C) of the Regulations.

(9) Final notice from any state or federal administrative agency that the security or any information or document filed with that agency relating to such security fails to meet the agency's requirements, as required by Section 36-500-19(d)(2)(D) of the Regulations.

(10) If required by Section 36-502(g) of the Act, a Consent to Service of Process.

(11) Written notice of the date and time of federal effectiveness designated under Rule 487 and the one or more previous series of the trust for which the Securities and Exchange Commission and the Commissioner have determined the effectiveness date.

(12) A copy of the written opinion of counsel, if any, provided pursuant to subsection (b)(6) of Rule 487, stating that the federal registration statement or pre-effective amendment does not contain disclosures that would render the registration statement ineligible to become effective in accordance with Rule 487.

(c) A registration of unit investment trust securities shall become effective in accordance with the designation of effectiveness made pursuant to federal Rule 487 if the conditions precedent to state effectiveness under Section 36-486(c) of the Act are satisfied, except that:

(1) The condition contained in Section 36-486(c)(2) of the Act that the registration statement be on file with the Commissioner for at least 15 days shall be waived under Section 36-486 of the Act; and

(2) The condition contained in Section 36-486(c)(3) of the Act requiring that a written or telegraphic statement of the maximum and minimum proposed offering prices and the maximum underwriting discounts and commissions be on file with the Commissioner for two full business days shall be waived.

(d) Nothing in this order shall relieve a registrant of unit investment trust securities of its obligation to 1) provide notice of the content of the price amendment, a confirmation of federal effectiveness and the post-effective amendment required under Section 36-486(c) of the Act within the time prescribed by that section and 2) make any other post-effective filings required by the Act or the Regulations.

(e) Nothing in this order shall relieve a registrant of unit investment trust securities of its obligation under Section 36-488(j) of the Act and Section 36-500-19(j) of the Regulations to file a correcting amendment with the Commissioner should the information or documents contained in the registration statement become inaccurate or incomplete in any material respect.

(f) Should the Securities and Exchange Commission suspend the ability of the unit investment trust to designate the date and time of federal effectiveness of a series of such trust, the registrant shall notify the Commissioner in writing of such fact within one business day after the registrant receives notice thereof, and, if a request for a hearing is made, the registrant shall promptly notify the Commissioner of the results of any hearing held by the Securities and Exchange Commission.

So ordered, this 8th day of July 1986.

Howard B. Brown
Banking Commissioner

ORDER PURSUANT TO SECTION 36-500 OF CHAPTER 662
OF THE CONNECTICUT GENERAL STATUTES, THE CONNECTICUT
UNIFORM SECURITIES ACT (THE "ACT") AND
SECTION 36-500-32(a)(6) OF THE REGULATIONS
OF CONNECTICUT STATE AGENCIES

1) The Banking Commissioner (the "Commissioner") is charged with the administration of the Act.

2) The Commissioner is also charged with the administration of Sections 36-500-1, et seq. of the Regulations of Connecticut State Agencies promulgated under the Act.

3) Section 36-500(a) of the Act provides that:

> The commissioner may from time to time make, amend and rescind such regulations, forms and orders as are necessary to carry out the provisions of this chapter, including regulations, forms and orders governing registration statements, applications and reports, and defining any terms, whether or not used in this chapter, insofar as the definitions are not inconsistent with the provisions of this chapter. For the purpose of regulations, forms and orders, the commissioner may classify securities, persons and matters within his jurisdiction and prescribe different requirements for different classes.

4) Section 36-500(b) of the Act, provides, in part, that "[i]n prescribing regulations, forms and orders the commissioner may cooperate with the securities administrators of the other states and the Securities and Exchange Commission with a view to effectuating the policy of this chapter to achieve maximum uniformity in the form and content of registration statements, applications and reports wherever practicable."

5) Section 36-500-22(b)(9)(C)(v) of the Regulations requires that, in an offering made pursuant to Rules 504, 505 or 506 of federal Regulation D, 17 C.F.R. §§ 230.501 through 230.506, the issuer must file with the commissioner a notice on Form D at the following times: prior to the first sale of securities in this state and no later than 15 days after the last sale of securities in this state.

(6) On October 2, 1986, the Securities and Exchange Commission adopted various revisions to Form D and Regulation D under the Securities Act of 1933 designed to make Form D a uniform notification form that could be filed with the Securities and Exchange Commission and with the states. Among other things, the revisions eliminated the requirement that Form D be updated every six months until the offering is completed and the requirement that a final filing be made within 30 days of the final sale or the completion of the offering.

7) Section 36-500-32(a)(6) of the Regulations provides that "[t]he commissioner may exempt a person, security or transaction from a specified provision of these Regulations."

8) The Commissioner finds that the issuance of this order is necessary and appropriate in the public interest and for the protection of investors and consistent with the purposes fairly intended by the policy and provisions of the Act.

9) Pursuant to the authority granted to him by Section 36-500 of the Act and Section 36-500-32(a) of the Regulations, the commissioner therefore orders that the requirement in Section 36-500-32(b)(9)(C)(v)(bb) of the Regulations mandating that a notice on Form D be filed no later than 15 days after the last sale of securities in this state be waived.

10) The Commissioner further orders that, for purposes of compliance with Section 36-500-22(b)(9)(C)(vii)(aa) of the Regulations, which requires the issuer to file an undertaking to furnish information provided under Rule 502(b)(2) of Regulation D and Section 36-500-22(b)(9)(C)(iii) of the Regulations, he will accept an executed Part E of Form D which contains an undertaking by the issuer to furnish state administrators, upon their written request, with information furnished by the issuer to offerees.

11) Nothing in this order shall excuse an issuer from amending its Form D to disclose material changes in the information submitted or to ensure that such information is accurate and complete.

So ordered this 28th day
of January 1987

H B Brown

Howard B. Brown
Banking Commissioner

<ins>INVESTOR ALERT: PYRAMID SCHEME FRAUDS*</ins>

<ins>PYRAMID SCHEME FRAUDS</ins>

The <ins>pyramid scheme</ins>, in which promoters lure the unwary by extravagant promises of profit which are tied to an ever-expanding circle of new participants, is back on the American scene. State securities regulators and the Council of Better Business Bureaus warn that this classic get-rich-quick con game has returned in <ins>new and sometimes more sophisticated guises leaving thousands of defrauded investors in its wake.</ins>

The recent renewed national interest in entrepreneurship has provided the cover for a new generation of unscrupulous pyramid scheme operators who combine a money-making variation of the age-old chain letter game with modern high pressure sales techniques. While the new pyramids often employ the use of a "product" to enhance the appearance of legitimacy, the bottom line is that <ins>the profits always come out of the next investor's pocket.</ins>

A recent survey by the North American Securities Administrators Association (NASAA) and the Council of Better Business Bureaus (CBBB) revealed a myriad of pyramids operating throughout the U.S. and Canada:

> Over twenty states have issued Cease and Desist Orders against the principals of a company which used a pyramid sales scheme to promote sales of "lactic activator" kits. The kits contained a substance which purchasers would combine with milk to produce a type of mold culture which an affiliated company would allegedly repurchase for use in the manufacture of a new cosmetic product. The company selling the kits has filed for bankruptcy, claiming 27,000 creditors. Investors throughout the U.S. lost $6 million. Investigators discovered that the vast majority of cultures were simply being ground up and recycled into new activator kits and that each kit's value was a fraction of the price being charged to investors.

*The Investor Alert is a quarterly release produced jointly by the Council of Better Business Bureaus (CBBB) and the North American Securities Administrators Association (NASAA), a national organization comprised of securities administrators from the fifty states and the Canadian provinces. The Investor Alert exposes investment frauds to the public and provides useful information on how to avoid the often sophisticated and unlawful schemes that are perpetrated on investors.

in both civil and criminal actions against operators in Canada and Oklahoma. The latest schemes combine alleged new uses for the same old mold with a religious approach to investors.

In a number of states, the latest fad is the pyramid party, in which the product is dispensed with altogether. A player puts up $1,000 to enter the bottom of the pyramid and then must recruit two more players to recoup his or her original investment. Heavy peer group pressure is employed in hopes that each new player will recruit enough others to produce a 64 person pyramid that puts the original player on top with $16,000. An operator running a similar scheme in Illinois was ordered to repay thousands of losers after the pyramid's inevitable collapse.

At least twelve states including Tennessee, Texas and Minnesota have acted to halt sales of a pyramid scheme disguised as a "self-motivation" program. Participants, who pay up to $6,000 each to attend self-improvement and nutritional seminars, are then motivated to recoup their investment by introducing the program to new investors and receiving a commission on the fee. State actions followed numerous complaints that the seminars were difficult to sell and that the materials were not worth the price charged.

The U.S. Postal Service obtained a consent order in late 1985 from an Arizona company it had alleged was falsely advertising large earnings from a multi-level credit card sales scheme in which participants could supposedly build up huge credit lines and never have to pay balances due. The State of New Mexico also obtained a consent agreement with the company after charging it with violating the state Pyramid Sales law.

Other questionable schemes that have come to the attention of securities regulators and Better Business Bureaus in recent months have included plans for multi-level sales of investment newsletters. One such program promises to provide new subscribers with part ownership in investment portfolios if they recruit new subscribers. Another offers commissions for new subscriber sales in the form of silver bullion, as well as cash.

WHAT IS A PYRAMID SALES SCHEME?

In its purest form, a pyramid sales scheme involves the collection of money from individuals on the bottom to pay other individuals further up the pyramid. The program appeals simply to the greed of individuals and their willingness to take the risk that the pyramid will last until they get to the top.

Many pyramids attempt to prove their legitimacy by the use of a product. The reason is that most state laws prohibit a program where the profit potential comes not primarily from the sales of products to consumers, but from the inducement of other investors to join the scheme. The Federal Trade Commission states that such pyramids display two essential elements: the payment of money for the right to sell the product and the payment for the right to recruit others into the program for rewards that are unrelated to sales of the product to ultimate users.

The classic model for such pyramid scams originated in the late 1960's with Koscot Interplanetary, Inc., Glen Turner and Dare to be Great. Investors purchased individual distributorships for up to $5,000 which enabled them to sell mink oil cosmetics to the public or to participate in a self-motivation course. At revival-type meetings, investors were dazzled by Turner's quasi-religious pitch and promises of enormous wealth.

However, the company provided limited advertising and product distribution, thus encouraging most investors to try to recoup their losses by selling distributorships to new investors. The scheme ultimately collapsed after thousands of people lost over forty million dollars. Turner was prosecuted and sued by investors, but the model was set and other schemes quickly followed.

In contrast, a legitimate multi-level marketing business emphasizes a solid product or service. Success is based on two factors, product quality and hard work based on the ability to sell the product. Recruiting new distributors is secondary.

FRAUDULENT TECHNIQUES--NO ROOM AT THE TOP

Unlike most economic activity, no new money is created in a pyramid sales scheme; those who get in on the ground floor take money from those who come later. Thus, for everyone who makes money, some other person must lose money.

Programs always produce promoters at the top of the pyramid who wave in front of prospects checks for thousands of dollars they claim to have received from pyramid payments. As more people come in, new levels of pyramid are created with the initial promoter and a few early participants on the top levels. Latter recruits are on the bottom with little chance of getting the riches promised by the promoters.

Pyramid schemes are doomed from their inception. Like insatiable monsters, they demand more and more players to stay alive. A successful pyramid would eventually involve more people than live in North America. This is why pyramid schemes always collapse.

Furthermore, program operators often target closely-knit groups to increase peer-group pressure to participate. Such groups may be as diverse as religious and social organizations, football team, and college students. A prospect is led to believe that if a program does not use the mails or is being promoted by a religious group, it must be legitimate and safe.

HOW TO AVOID BEING SWINDLED

The one sure way to avoid losing money in a pyramid is not to play the game. Pyramids are illegal and are thus not registered by any federal or state agency. However, in addition to securities laws many states do have business opportunity laws which may apply to any given promotional scheme. Prospective participants would check with their state securities regulator to see what kind of laws may apply to their situation. Here are some basic rules to follow in steering clear of pyramid schemes:

> Watch out if the start-up cost for the investment is substantial. Pyramid schemes pressure you to pay a large amount to become a "distributor." Profits are thus based on the signing up of new recruits. Beware of promises of quick, easy and unreasonable high profits.
>
> Must you buy a product in order to become a distributor? Find out if the company will buy back inventory.....you could get stuck with unsold products. Remember that legitimate companies should offer and stick to inventory buybacks for at least 80 to 90 percent of what you paid.
>
> What is the consumer market for the products? If the promoters seem to be making most of their money through sale of distributorships or through volume sales to new recruits, stay away.
>
> If the distributorship is providing a product for use in making a final product, make sure that whatever you are required to produce under the investment program is actually reaching the final manufacturer.
>
> Get all the facts about the company, its officers, and its products. Get written copies of the company's marketing plan, sales literature, etc. Avoid promoters who fail to provide clear and detailed explanations of their plans.
>
> Resist the temptation to invest just because the person selling you the program is a friend or is part of your religious or social organization. Remember, that person may have been misled into believing he/she can make large amounts of money in a short time. Also remember that your participation in such a cash pyramid scheme may result in closer IRS scrutiny of your tax return.

FOR MORE INFORMATION

The securities administrator in your state, province, or territory is responsible for the protection of investors insuring that complete information is available for many types of investments. If you have questions about possible pyramid sales schemes, contact the securities administrator listed in this alert. Your prompt action could save you money.

The Council of Better Business Bureaus and the Better Business Bureaus (BBB) of the U.S. and Canada answer inquiries on companies located in areas they serve. Before putting your money in an investment plan, it is a good idea to contact your local BBB for a reliability report on the company you intend to deal with. For more information, contact the BBB listed in this Alert.

The quarterly Investor Alerts expose investment frauds to the public and provide useful information on how to avoid the often sophisticated and unlawful schemes that prey on investors.

Letters of Credit Issued in Connection with Governmental Bond Offerings

The Department of Banking has been receiving a number of requests for advisory interpretations on the exempt status of letters of credit issued in connection with governmental bond offerings. Where an irrevocable letter of credit supports the payment of principal and interest on governmental bonds, the letter of credit would be tantamount to a "guarantee" and hence a separate security under Section 36-471(m) of Chapter 662 of the Connecticut General Statutes the Connecticut Uniform Securities Act. It has been the position of the department, however, that if the letter of credit is issued by a domestic financial institution, the letter of credit would be exempt from securities registration under Section 36-490(a)(3) or Section 36-490(a)(4) of the Act. Where the letter of credit is issued by a domestic branch or agency of a foreign bank, the department has taken a no-enforcement action position as long as the domestic branch or agency of the foreign bank remains subject to domestic supervision, thus bringing the letter of credit within the spirit of Section 36-490(a)(3) of the Act.

The department is issuing this statement to outline its position on the exempt status of letters of credit issued in connection with governmental offerings. The department's position on tender option bonds has been set forth in the CCH Blue Sky Law Reporter at para. 14,526. Due to the large volume of requests for advisory interpretations concerning the exempt status of governmental bond offerings, guarantees, letters of credit and tender options issued in connection with such offerings, the department will no longer issue written advisory interpretations on these issues unless the particular offering presents novel or unresolved questions of law. A Consent to Service of Process (Form U-2) would, of course, still have to be filed where required by Section 36-502(g) of the Act.

ENFORCEMENT

ADMINISTRATIVE ORDERS

HMK Management Corporation/David Kearney

Following an administrative hearing, David J. Kearney of Bantam, Connecticut was found to have sold unregistered securities of HMK Management Corporation ("HMK") and to have made fraudulent statements to investors. It was further found that Mr. Kearney solicited funds on behalf of HMK from at least six investors during the period from 1982 to 1984 and raised at least $120,000.

On January 28, 1985, Mr. Kearney was ordered to Cease and Desist from offering and selling unregistered securities in the form of promissory notes. Based on the evidence received during the administrative hearing, the Cease and Desist Order was sustained.

Cusack, Light and Company, Inc.

On July 31, 1986, Commissioner Brown cancelled the broker-dealer registration of Cusack, Light and Company, Inc. of West Orange, New Jersey. The firm was found to be insolvent and inactive and has ceased to do business in Connecticut.

Waterhouse Securities, Inc.,

Commissioner Brown has sanctioned a New York-based discount brokerage firm for conducting securities business in Connecticut while it was unregistered.

Following an investigation conducted by the Securities and Business Investments Division of the Department of Banking, it was alleged that the firm was not authorized to conduct securities business in Connecticut from January 1985 through July 1986. Without admitting or denying these allegations, Waterhouse Securities, Inc. entered into a stipulation with the

Waterhouse Securities, Inc.,(Continued)

Department of Banking whereby it agreed to pay a fine of $10,000, to receive a letter of censure and to revise its compliance manual so as to detect and prevent the occurrence of future violations of the state securities laws.

The firm is presently registered as a broker-dealer in Connecticut and has approximately 20 agents registered to do business in this state. The investigation by this office was commenced in July of 1986 as a result of a routine public inquiry.

ISC Mail Room, a Division of
Interstate Services Corporation

On September 22, 1986, Commissioner Brown, through the Securities and Business Investments Division of the Department of Banking, ordered ISC Mail Room, a division of Interstate Services Corporation of Las Vegas, Nevada, to Cease and Desist from offering and selling business opportunities in the State of Connecticut.

Based on the division's investigation, it was alleged that the Respondents offered and sold unregistered business opportunities and failed to provide purchaser-investors with a disclosure statement. It was further alleged that the Respondents violated the anti-fraud provisions of the Connecticut Business Opportunity Investment Act because they failed to provide purchaser-investors with statements of the financial condition for Interstate Services Corporation and its subsidiaries, affiliates or divisions; failed to provide a description of risk factors relating to the business opportunity and to disclose that the business opportunity was unregistered; and failed to inform purchaser-investors of adverse orders, judgments, decrees and pending litigation in each state.

Paris Match, Ltd.

On October 29, 1986, Commissioner Brown ordered Paris Match, Ltd. of New York City to Cease and Desist from the offer or sale of business opportunities in Connecticut. As a result of an investigation by the Securities and Business Investments Division of the Department of Banking, it was alleged that the Respondents offered and sold unregistered business opportunities. It was also alleged that the Respondents failed to disclose to purchaser-investors certain information including: (a) statements of financial condition for Paris Match, Ltd.; (b) statements of risk factors relating to the business opportunities; (c) statements concerning the unregistered status of the business opportunities; and (d) statements concerning any adverse orders, judgments or decrees, or pending litigation in each state.

Investors International Securities, Inc./Robert Chapman

On October 30, 1986, Commissioner Brown ordered Investors International Securities, Inc. and its officer Robert Chapman of Westlake Village and Agoura Hills, California, respectively, to Cease and Desist from the further sale of securities in Connecticut. The respondents allegedly sold and purchased securities in Connecticut from April 1984 through August 1985 without effecting a broker-dealer or agent registration. The Cease and Desist Order provided the respondents with the opportunity to request a hearing on the allegations contained in the Order if the request were made within fourteen (14) days following the respondents' receipt of the Order.

Homerica, Inc.

On November 21, 1986, Commissioner Brown ordered Homerica, Inc. located in Mount Penn, and Wyomissing, Pennsylvania, and East Haven, New Haven, and Wallingford, Connecticut to Cease and Desist from further violations of the Connecticut Business Opportunity Investment Act.

An investigation conducted by the Securities and Business Investments Division of the Department of Banking disclosed that the Respondents sold unregistered business opportunities and failed to disclose to purchaser-investors certain relevant investment information including: (a) statements of financial condition for Homerica, Inc. and the other Respondents; (b) statements of risk factors relating to the business opportunities; (c) statements concerning the unregistered status of the business opportunities; and (d) statements concerning any adverse orders, judgments or decrees, or pending litigation in each state.

Raphael Cosmetics, Inc.

On November 21, 1986, Commissioner Brown ordered Raphael Cosmetics, Inc. of 8200 Brook River Drive, Suite 106, Dallas, Texas, to Cease and Desist from further violations of the Connecticut Business Opportunity Investment Act.

An investigation conducted by the Securities and Business Investments Division of the Department of Banking disclosed that the Respondents sold unregistered business opportunities and failed to disclose to purchaser-investors certain relevant investment information including: (a) statements of financial condition for Raphael Cosmetics, Inc. and the other Respondents; (b) statements of risk factors relating to the business opportunities; (c) statements concerning the unregistered status of the business opportunities; and (d) statements concerning any adverse orders, judgments or decrees, or pending litigation in each state.

Photo Concepts International, Inc.

On December 23, 1986, Commissioner Brown ordered Photo Concepts International, Inc. and its principal officer, Darrell Piercy of Costa Mesa, California, to Cease and Desist from the offer and sale of business opportunities in Connecticut.

An investigation conducted by the Securities and Business Investments Division disclosed that the firm offered and sold unregistered business opportunities and failed to disclose to purchaser-investors certain material investment information including: (a) statements of financial condition for Photo Concepts International, Inc.; (b) statements of risk factors relating to the business opportunities; (c) statements concerning the unregistered status of the business opportunities; and (d) statements concerning any adverse orders, judgments or decrees, or pending litigation in each state.

First Meridian Planning Corporation

On December 22, 1986, Commissioner Brown ordered a New York financial planning company and its officers to cease and desist from offering or selling securities in Connecticut and notified them of his intent to revoke the firm's registration as an investment adviser.

The action was brought against First Meridian Planning Corporation of Albany and its president, Roger V. Sala and vice president, John W. Donovan, for violations of the Connecticut Uniform Securities Act.

An investigation conducted by the Securities and Business Investments Division found that First Meridian offered and sold unregistered securities and employed certain personnel who were not registered as investment adviser agents. In addition, the firm and its employees provided investors with untrue or misleading information pertaining to their investments.

The agency's investigation was part of an ongoing investigation initiated by state prosecutors in New York who last month charged First Meridian with defrauding hundreds of investors in four states out of millions of dollars. First Meridian allegedly had a total of 950 clients from New York, New Hampshire, Massachusetts and Connecticut who were induced to invest more than $55 million. As part of its financial planning advice, the company would recommend that clients invest primarily in three products -- condominiums, numismatic coins and art -- and would then make arrangements for the purchase.

The investigation also revealed that at least 80 Connecticut residents invested more than $6 million in First Meridian products. Investments in condominiums, many of which were located in Florida, amounted to $4.2 million while coin investments totalled $1.6 million and $463,000 was invested in works of art. After a review of company documents and from testimony obtained from former sales employees, the department determined that First Meridian's sale of coin portfolios and art constituted transactions in securities and that the offerings should have been registered with the Department.

First Meridian has been registered with the Department of Banking as an investment adviser since September, 1984 and at one time maintained an office in this state.

CIVIL REFERRALS

Microbyx Corporation

On August 15, 1986, Judge Aronsen of the Hartford Superior Court granted a motion of the Attorney General to dismiss a Petition of Appeal made by John Andresen, a principal of Microbyx Corporation, a research and development company incorporated in Delaware.

The petition of appeal was made as a result of an administrative hearing before the Department of Banking on a preliminary Cease and Desist Order issued against the Andresens in March of 1984 that became final in March of 1985. It was established that Mr. and Mrs. Andresen: (1) sold unregistered securities of Microbyx stock in violation of state securities laws and (2) failed to disclose to investors certain material information relating to Microbyx stock, including the basis upon which the stock was valued; the fact that the exclusive assets of the company were the subject of litigation; and information concerning the financial condition of the company.

The motion was granted on the basis that Mr. Andresen failed to serve the appeal petition on the Banking Commissioner within the statutory period required by Section 4-183(b) of the Connecticut General Statutes which provides that copies of an appeal petition shall be served upon all parties of record within 30 days after the mailing of the final decision of the agency. Mr. Andresen's failure to serve the appeal petition in a timely manner removed the appeal from the subject matter jurisdiction of the court.

Mountain Capital Corporation

The Department of Banking requested Attorney General Joseph I. Lieberman to seek the appointment of a receiver over the assets of Mountain Capital Corporation.

The Attorney General's Office closed its case against Mountain Capital Corporation after a petition for involuntary bankruptcy was filed in bankruptcy court in Bridgeport. Attorney Richard Belford was named trustee. The Attorney General's Office and the Securities and Business Investments Division of the Department of Banking are referring any inquiries on Mountain Capital Corporation to the trustee.

Kennedy InterVest Funds Limited

The Office of the Attorney General has been informed that 106 people who invested in Groton-based Kennedy Intervest Fund Ltd., most of them residents of southeastern Connecticut, have received their full investment through the liquidation of the fund. The public fund was liquidated in two installments at the urging of the Department of Banking and the Office of the Attorney General. On January 28, 1986, Commissioner Brown requested the Attorney General to seek an injunction, the appointment of a receiver and an accounting of investor funds that were managed by Lyle H. Kennedy of Groton, Connecticut through the Kennedy Intervest Public Fund and the Kennedy Intervest Private Fund.

ADMINISTRATIVE SETTLEMENTS

Petition Filed With The State
Board Of Accountancy/Glenn G. Gardner, C.P.A.

On November 13, 1986, Commissioner Brown filed a petition with the State Board of Accountancy. The petition requested that the Department of Banking be allowed to intervene and participate in a hearing involving the suspension and revocation of the accounting license of Glenn G. Gardner, C.P.A. Gardner prepared certain financial statements for the Kennedy Intervest Fund Limited which were filed with the department. As a result of a review of the financial statements by the staff of the Securities and Business Investments Division, several discrepancies were identified which caused the statements to be false and misleading. These financial statements were furnished to investors in the fund who relied upon the financial statements in deciding whether to maintain their investment with the fund. It was the department's position that the discrepancies in the financial statements adversely affected the investors in the fund.

These deficiencies were referred to the Board of Accountancy for its review, namely: 1) the value of real estate held by the Fund was not based on generally acceptable auditing standards; 2) the opinion rendered in connection with the financial statements dated December 31, 1984 should have noted several areas of material departures from generally accepted auditing standards and therefore should have been a "subject to" qualified opinion rather than a clean opinion; 3) there was insufficient testing in the amounts represented on the statement of assets and liabilities; 4) the auditor's opinion concerning pending litigation and unasserted claims and assessments was insufficient; 5) the financial statement dated December 31, 1984 failed to disclose material related party transactions; 6) there were no quality control policies or procedures used in the acceptance of the Fund as a client; and 7) the scope of examination of the Fund was restricted and deviated from the scope of review contemplated in the engagement letter.

The department, therefore, recommended that the Board of Accountancy take the following action with respect to the Respondent's license:

1) If the Board of Accountancy found that the Respondent's acts constituted a violation of subsections (f), (g) or (h) of Section 20-280-15c of the Regulations of Connecticut State Agencies, it should revoke the Respondent's license pursuant to Section 4 of P.A. 85-504.

(2) If the Board of Accountancy found that the revocation of Respondent's license was not an appropriate sanction, it should prohibit the Respondent from practicing accounting before the Department of Banking for a period of three (3) years. Section 4(c) of P.A. 85-504 states, in part, that "[t]he board may, upon a finding of any cause specified in subsection (d) of this section [concerning the violation of an applicable statute or regulation] ... limit [the practitioner's] practice to areas prescribed by the board...." In addition, the department requested that the Board of Accountancy, in accordance with Section 11 of P.A. 85-504, censure the Respondent by requiring that he retract the opinion in question and provide the reasons for such retraction to all investors in the Fund.

On December 11, 1986, the Board of Accountancy concluded a Settlement Agreement with Glenn G. Gardner, C.P.A. who resides in Gales Ferry, Connecticut. Under the terms of the Settlement Agreement, Mr. Gardner's license was suspended for one year, which suspension was stayed and he was placed on a probationary status for a period of two years. Mr. Gardner was further required to retract the opinion that he provided to those who invested in the limited partnership. He is required to make this retraction known to all investors. He is further required to take certain remedial educational courses including accounting and professional ethics. Significantly, he is barred from practicing accounting before the Department of Banking for a period of three years.

The department views this action as a precedent-setting case from the standpoint of exercising some degree of accountability over those who practice before this agency.

July, 1986

INVESTMENT ADVISERS, FINANCIAL PLANNERS, AND OTHERS —
AN OVERVIEW OF THE INVESTMENT ADVISERS ACT OF 1940 */

I. INTRODUCTION

A. Legislative Background

The Investment Advisers Act of 1940 ("Act") is the last in a series of federal statutes intended to eliminate abuses in the securities industry that Congress believed contributed to the stock market crash of 1929 and the depression of the 1930's. The Act is based on a congressionally mandated study of investment trusts and investment companies, including consideration of investment counsel and investment advisory services, carried out by the Securities and Exchange Commission ("SEC" or "Commission") during the 1930's. 1/ The Commission's report traces the history and growth of investment advisers and reflects the attitude that investment advisers could not properly perform their function unless all conflicts between them and their clients were removed. The report stressed that a significant problem in

---

*/ This outline was prepared by Thomas P. Lemke and Thomas S. Harman of the Division of Investment Management, Securities and Exchange Commission, with assistance from Forrest R. Foss, Jay B. Gould, Mary Joan Hoene, John Komoroske, Gerald T. Lins, Stephanie M. Monaco, Mary S. Podesta, and Elizabeth T. Tsai. The Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. Thus, the views expressed herein are those of the authors and do not necessarily reflect the views of the Commission or its staff.

1/ See Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, on Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services, H.R. Doc. No. 477, 76th Cong., 2d Sess. (1939).

the industry was the existence, either consciously or, more likely, subconsciously, of a prejudice by advisers in favor of their own financial interests.

The SEC report culminated in the introduction of a bill that, with some changes, became the Act. 2/ Although the original bill contained a section attributing specific abuses to the investment advisory profession, this provision was eliminated from the final version, apparently at the urging of investment advisers concerned with the irreparable harm a public and general indictment might cause their fledgling profession. Nonetheless, the fundamental purpose of the Act remained the same, and the Act, as adopted, reflects Congressional recognition of the "delicate" fiduciary nature of the advisory relationship, as well as Congress' desire to eliminate, or at least expose, all conflicts of interest which might cause advisers, either consciously or unconsciously, to render advice which was not disinterested. Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-192 (1963).

B. Organization of this Outline

This outline will discuss four questions under the Act:

1. WHO is an investment adviser under the Act's definition? (see Part II, infra)

2. WHICH investment advisers must register under the Act? (see Part III, infra)

3. HOW does an investment adviser register? (see Part IV, infra)

4. WHAT requirements apply to a registered investment adviser? (see Part V, infra)

Part VI discusses current events.

2/ The Act is codified in 15 U.S.C. §80b-1 et seq.

II. WHO is an Investment Adviser Under the Act's Definition?

A. Definition of "Investment Adviser"

The term "investment adviser" is defined in Section 202(a)(11) of the Act as any person who

— for compensation

— is engaged in the business

— of providing advice to others, or issues reports or analyses, regarding securities.

To be an investment adviser under the Section 202(a)(11) definition, a person must satisfy all three of its elements.

The most frequent questions under the definition of an investment adviser typically relate to individuals known as "financial planners." Investment Advisers Act Rel. No. 770 (Aug. 13, 1981) ("Release 770") is the seminal interpretive release regarding financial planners. Published by the Commission in 1981, Release 770 represents the views of the staff of the SEC's Division of Investment Management — which is primarily responsible for administering the Act — regarding the applicability of the Act to financial planners, pension consultants, and other persons who, as an integral part of other financially related services, provide investment advisory services to others. Under Release 770, as discussed more fully below, most financial planners are investment advisers under the Act, and would therefore have to comply with it unless they can rely on any of the Act's exemptions or exceptions, which are discussed infra. The staff generally no longer issues no-action letters concerning the applicability of the Act to financial planners (see Mary E. Rogers, pub. avail. May 20, 1982).

The elements of the statutory definition are discussed individually below, particularly those aspects relevant to financial planners.

1. "Compensation"

The term "compensation" in the definition has been broadly construed. Thus, the receipt of any economic benefit, whether in the form of an advisory fee, some other fee relating to the total services rendered, a commission, or some combination thereof, satisfies this element.

In addition , the staff has stated that:

- — a separate fee for advisory services is not necessary (e.g., FINESCO, pub. avail. Dec. 11, 1979) — this element is satisfied if a single fee is charged for a number of services, including advisory services; and

- — compensation need not be received directly from the client (e.g., Warren M. Livingston, pub. avail. March 8, 1980) — this element is satisfied, for example, if a person receives a commission or other fee from an insurance company based on the client's purchase of an insurance product

2. The "Business" Standard

A person must be in the "business" of providing investment advice for compensation to be within the definition of an investment adviser. This need not be the person's sole or principal business, but it must be a business. There is no hard and fast standard in applying this element. The staff views three criteria as relevant to determining whether a person meets this element:

i. Is the person giving investment advice solely incidental to his non-advisory business?

- — if so, the person more likely is not an adviser. If not, the opposite more likely is true (Release 770, supra)

ii. How specific is the advice?

- — the more specific the advice, the more likely a person is in the advisory business (Id.)

iii. Does the person receive compensation, whether directly or indirectly?

— if the person receives compensation for providing investment advice, the business element more likely is satisfied (Id.)

A recurring question is how to distinguish a person in the business of providing advice from one who provides advice incidental to another business. In the financial planner context, Release 770 offers the following guidance:

— a person who holds himself out to the public as an investment adviser or as one who provides investment advice is in the business of providing investment advice

— if a financial planner's principal business is not providing investment advice, then he generally is not in the advisory business if he merely discusses in general terms the advisability of investing in securities in the context, for example, of a discussion of general economic matters or the role of investments generally in a client's overall financial plan

— a financial planner is in the business of providing investment advice if, on anything other than rare and isolated instances, he discusses the advisability of investing in specific securities or types of securities, and

— financial planners who provide market timing services are in the business of providing investment advice

3. "Advice about securities"

Obviously, a person meets the third element of the statutory definition if he provides advice about, or issues reports concerning, specific securities. The more difficult questions arise with less specific advice. The staff has stated in this regard:

- advice about market trends is advice about securities (Dow Theory Forecasts, Inc., pub. avail. Feb. 2, 1978)

- advice in the form of statistical or historical data generally is advice about securities unless the advice is no more than an objective report of facts on a non-selective basis (Bridge Data Co., pub. avail. May 31, 1975)

- a financial planner who advises clients about the selection of an investment manager may meet the third element (FPC Securities Corp., pub. avail. Dec. 1, 1974; Release 770, supra)

- a financial planner who advises clients concerning the advantages of investing in securities versus other types of investments (e.g., real estate, coins, stamps) is providing advice about securities (Id.), and

- a person who provides clients with a selective list of securities provides advice about securities even though he does not make specific recommendations from the list

B. Exceptions from the Investment Adviser Definition

Paragraphs (A)-(F) of Section 202(a)(11) except six categories of persons who otherwise presumably (or at least arguably) satisfy all three elements of the definition, but for whom Congress determined that regulation under the Act was unnecessary. If a person falls within any of the exceptions, he is not subject to any provisions of the Act (in contrast with the treatment given a person who only is exempted from the registration, but not the antifraud provision of the Act, as discussed in Part III, infra). A person relying on an exception must meet all the requirements of the exception. The availability of any exception necessarily depends on the particular facts and circumstances involved. The exceptions, and relevant interpretive statements, are summarized below:

1. Any Bank or Bank Holding Company

Section 202(a)(2) defines the term "bank" as:

i. any banking institution organized under the laws of the United States,

ii. any member bank of the Federal Reserve System,

iii. any other banking institution or trust company meeting the following four requirements:

a. doing business under the laws of any state or of the United States,

b. a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted national banks,

c. supervised and examined by state or federal bank regulators, and

d. not operated for the purpose of evading the Act, or

iv. any receiver or other liquidating agent of any institution listed above.

On several occasions the staff has addressed this exception:

— a foreign bank is not within the exception. Letter to Congressman William J. Hughes (pub. avail. June 4, 1980)

— a state chartered trust company may be a bank under the Act

— an investment adviser subsidiary of a bank holding company is not a "bank holding company" within this exception. William Casey (pub. avail. June 1, 1974)

— a savings and loan association is not a bank under the Act. Ameriway Savings Association (pub. avail. April 28, 1986).

— a Panamanian trust company is not within the exception. Brewer-Burner & Associates, Inc., pub. avail. Feb. 7, 1974

2. Any Lawyer, Accountant, Engineer, or Teacher

Paragraph (B) of the adviser definition excepts four classes of professionals, so long as they provide investment advice solely incidental to the practice of their profession. The key determination under this exception is whether advice is provided solely incidental to the profession, and the staff looks to the following factors:

— does this person hold himself out to the public as an adviser or financial planner or as providing pension consulting or other financial advisory services — if so, the exception is not available (e.g., Release 770: LaManna & Hohman, pub. avail. March 21, 1983 (accountant); Hauk, Soule & Fasani, P.C., pub. avail. May 2, 1986

— any advisory services rendered must be reasonably related to professional activities

— any charge for advisory services should be based on same factors that determine the professional's usual charges

3. Any Broker or Dealer

Paragraph (C) excepts any broker/dealer who provides investment advice solely incidental to the conduct of its business as a broker/dealer and who receives no special compensation for such advice. Most questions under this exception concern what is "special compensation." In Robert S. Strevell (pub. avail. April 29, 1985), the staff discussed the special compensation issue at length. The staff concluded that brokerage commissions generally would not constitute special compensation unless a clearly definable part of the commission is for investment advice. The staff also has stated that:

- the exception is available to any registered representative of a broker who provides investment advice in that capacity, i.e., the registered representative provides advice in his capacity as a supervised employee of his employer broker (Id.)

- the exception is not available to any registered representative acting as a financial planner outside of the scope of his employment with his broker employer (Id.)

The Commission has stated that a broker-dealer or a registered representative thereof who employs the term "financial planner" merely as a device to induce the sale of securities might violate the antifraud provisions of the Securities Act of 1933 and Securities Exchange Act of 1934. In the Matter of Haight & Co., Inc. Securities Exchange Act Rel. No. 9082 (Feb. 19, 1971).

The SEC staff has stated that a registered representative who holds himself out to the public as a financial planner cannot rely on the broker-dealer exception unless he receives no special compensation therefor and gives investment advice solely in his capacity as a registered representative. The registered representative also must be subject to control by his employer broker-dealer and must be providing investment advice with the knowledge and approval of his employer. See Elmer D. Robinson (pub. avail. Jan. 6, 1986); Brent A. Neiser (pub. avail. Jan. 21, 1986). As for what constitutes "control," that staff has stated that the presumption that an independent contractor cannot be subject to the control of its employer is incorrect in the context of the Securities Exchange Act of 1934. Furthermore, the staff has stated that where a firm forms a relationship with an independent contractor, the firm must assume supervisory responsibility for that contractor or else ensure that the contractor is itself registered. See Letter from Douglas Scarff, Director, Division of Market Regulation, to Gordon S. Macklin, President, National Association of Securities Dealers, Inc. (June 18, 1982).

4. Any publisher

Section 202(a)(11)(D) excepts from the Act the publisher of any bona fide newspaper or financial publication of general and regular circulation.

i. Lowe - the Supreme Court defines the scope of the publishers' exception

Prior to the recent Supreme Court decision in Lowe v. Securities and Exchange Commission, 53 U.S.L.W. 4705 (June 10, 1985), the Commission interpreted this exception to be available "only where, based on the content, advertising material, readership, and other relevant factors, a publication is not primarily a vehicle for distributing investment advice." Investment Advisers Act Rel. No. 563, n. 1 (Jan. 10, 1977), citing Securities and Exchange Commission v. Wall Street Transcript Corp. 422 F.2d 1371, cert. denied, 398 U.S. 958 (1970). The Court rejected this subjective approach, stating that the language of the exception and its legislative history support a broad reading of the publishers' exception.

The Court concluded that the exception is available to any publisher satisfying three elements:

a. Its publication must offer only impersonal advice i.e., advice not tailored to the individual needs of a specific client or portfolio

b. Its publication must be "bona fide" — in the sense that it would contain disinterested commentary and analysis rather than promotional material disseminated by a "tout" or a "hit and run tipster." Lowe at 24-25.

c. Its publication must be of general and regular circulation — it must not be timed to specific market activity or to events affecting the securities industry. Id. at 27-28.

ii. Effects of Lowe: Positive and/or Negative

a. Investors

— more reliance on caveat emptor in dealing with publishers

— the Court preserved the Commission's jurisdiction to take action against publishers offering fraudulent investment advice

— the Court cut back the Commission's ability to proceed against fraud unless it relates to investment advice

b. Publishers

— the Court found the legislative history reflected Congressional concern over the First Amendment and took a very expansive view of the publishers' exception to effectuate that Congressional intent

— most publishers have been carved out of Act

c. SEC

— the Court preserved the Commission's jurisdiction to proceed against fraudulent securities advice

— the Court left unanswered a number of questions

iii. <u>Post-Lowe Developments</u>

— Possible Commission Actions

a. legislation - none to date

b. rulemaking - none to date

c. interpretations - The staff will not issue no-action letters on the question whether a publisher may de-register (or not register) relying on <u>Lowe</u>. However, if a publisher voluntarily registers or remains registered, the staff has stated that the publisher will be treated in the same manner as other registered advisers. Vincent J. Cosentino (pub. avail. Feb. 13, 1986).

5. <u>Government Securities Advisers</u>

Paragraph (E) excepts any person whose advice or reports are limited to securities which are direct obligations of the United States or securities of corporations in which the United States has a direct or indirect interest.

6. <u>Other Persons</u>

Paragraph (F) gives the Commission authority to designate, by rule or by order, such other persons who are not within the intent of the adviser definition. There presently are no rules adopted under this authority. Any person seeking an order pursuant to this provision should refer to Rule 0-5 under the Act (17 CFR 275.0-5), which describes the procedures for filing the application necessary to obtain such an order. This rule also applies to applications filed under Section 206A of the Act, which gives the Commission broad authority to exempt any person from any or all provisions of the Act. In Spring 1985, the Commission published a release advising prospective applicants of procedures and guidelines they should follow in submitting exemptive applications. Investment Company Act Rel. No. 14492.

III. WHICH Investment Advisers Must Register Under the Act?

Section 203(a) of the Act provides that every investment adviser who uses the means of interstate commerce must register with the Commission unless exempted from registration by Section 203(b). This latter provision exempts 3 classes of investment advisers. Any adviser relying on an exemption is not subject to the Act's registration requirements but is subject to Section 206, the antifraud provision. The exemptions are discussed below:

A. intrastate adviser in unlisted securities — Section 203(b)(1) exempts any adviser all of whose clients are within the same state as the adviser's principal business office and who does not provide advice or issue reports about securities listed on any national securities exchange.

B. advisers to insurance companies — Section 203(b)(2) exempts any adviser whose only clients are insurance companies.

C. private advisers — Section 203(b)(3) exempts any adviser who

— during previous 12 months has had fewer than 15 clients

— does not hold itself out generally to the public as an adviser, and

— does not act as investment adviser to any registered investment company or business development company

The most common interpretive questions under the private adviser exception are as follows:

1. <u>What constitutes holding oneself out to the public as an adviser?</u>

   — Factors that indicate an adviser is holding itself out:

   a. Does the adviser advertise?

   b. Does it refer to "investment adviser" or a similar term on a business card or stationery?

   c. Is it listed as an investment adviser in a telephone, business, or building directory? (Dale M. Mueller, pub. avail. Feb. 20, 1984)

   d. Does it let it be known generally by word of mouth that it is available to provide investment advice (Peter H. Jacobs, pub. avail. Feb. 7, 1979) or to accept new clients? (Richard W. Blanz, pub. avail. Jan. 28, 1985)

2. <u>Should foreign clients be counted the same as American clients?</u>

   Yes (Walter L. Stephens, pub. avail. Nov. 18, 1985)

3. <u>How should trusts be counted?</u>

   a. for purposes of Section 203(b)(3), each trust is a "client" (Phillip Eiseman, pub. avail. July 22, 1976)

   b. trusts count as separate clients even if they share a common trustee (OSIRIS Management, pub. avail. Feb. 17, 1985)

   c. trusts with the same beneficiaries count as a single client (<u>Id</u>; First Security Investment Management, pub. avail. March 25, 1985)

4. <u>How should a general partner acting as adviser to a limited partnership count the limited partners?</u>

   i. The Problem

Section 203(b)(3) exempts from registration any adviser with fewer than 15 clients during the preceding year who does not hold himself out to the public and doesn't advise any registered investment company or electing business development company, but it does not define the term "client." How does one know when he has 15 clients and must therefore register? The answer may be common sense in some instances. More difficult questions arise in determining how to count a trust? An investment club? A partnership? (Is the limited partnership or each limited partner the "client"?)

ii. Background

In 1977, the Second Circuit wrestled with the question of how an adviser should count the partnership he manages. Abrahamson v. Fleschner, 568 F.2d 862, cert. denied, 436 U.S. 913 (1978). It originally characterized the individual limited partners as the "clients," but it later withdrew this characterization (apparently in response to the SEC's request), and the question remained unresolved.

iii. Commission Action

In February, 1985, the Commission proposed Rule 203(b)(3)-1, to provide a safe harbor permitting an adviser to count the partnership as a single client under certain circumstances (IA-956, February 25, 1985). The final rule was adopted in IA-983 (July 12, 1985).

iv. Rationale for Rule

Passive investment vehicles organized as limited partnerships should be accorded the same treatment as passive investment vehicles organized as corporations. Moreover, Section 203(b)(3) had been amended by the Small Business Investment Incentive Act of 1980 to solve this problem in the business development company context.

v. Significance of Rule

The rule creates a "safe harbor" which allows general partners or other persons advising a limited partnership to count the partnership, rather than the individual limited partners, as the "client" for purposes of Section 203(b)(3). This increases the possibility that the general partner or other person will not have to register as an adviser under the Act and, therefore, will not be subject to the Act's prohibition on performance fees and its recordkeeping requirements.

vi. Summary of Rule

a. Preliminary Note 1: reiterates that the rule is a safe harbor, and is not intended to prescribe the exclusive means for a general partner to count limited partnerships.

b. Preliminary Note 2: a reminder that Section 208(d) makes it illegal to do indirectly what one cannot do directly. The note warns a registered adviser who sets up a limited partnership to take advantage of the rule that the adviser and the general partner may be viewed as one for purposes of Section 203(b)(3) absent separate and distinct operations (see Richard Ellis/R.E. Holdings Limited, pub. avail. September 17, 1981) which sets forth a five-factor test of when the staff will view operations as separate and distinct).

c. Paragraph (b)(1): sets forth the general proposition that a limited partnership shall be counted as one client.

d. Paragraph (b)(2): sets forth the corresponding proposition that a limited partner of a partnership will not be counted as a client (separate from the partnership) if two conditions are met:

(1) paragraph (b)(2)(i): the limited partnership interests are securities; and

(2) paragraph (b)(2)(ii): the general partner or other person advising the partnership does so on the basis of the investment objectives of the partnership (rather than based on the objectives of some, but not all, the limited partners)

e. Paragraph (b)(3): specifies certain situations in which the safe harbor is unavailable with respect to a particular limited partner.

IV. HOW does an investment adviser register?

Generally speaking, registration is a fairly simple procedure — an investment adviser must file a Form ADV and pay a $150 registration fee. Form ADV is primarily a disclosure document which gives information both to the Commission and the States for its administrative purposes and to advisory clients for disclosure purposes. A new, uniform Form ADV — jointly drafted by the SEC and, on behalf of the States, the North American Securities Administrators Association ("NASAA") — has been approved by both the Commission and NASAA. All registrants must file a new ADV with the Commission by March 31, 1985. Unlike the broker-dealer regulatory framework, the adviser's registration statement covers his employees and those be controls — so long as their advisory activities are undertaken on behalf of the registered adviser — and the adviser's employees do not have to register themselves individually as investment advisers or as agent of an adviser.

A. Part I of Form ADV

This part of the form is primarily for SEC and State use, and it contains information such as:

- the adviser's trade name
- whether the adviser holds itself out as a financial planner and, if it does, the number of those clients and the size of their investments
- who controls the adviser and how are the adviser's operations financed
- the states in which the investment adviser is licensed/registered
- how the adviser will maintain custody of client assets
- a description through schedules of the ownership structure of the investment adviser. Anyone who beneficially owns 5% or more of any class of the adviser's equity securities must be listed on an ownership schedule.
- whether the adviser has been involved in material civil litigation
- number and size of discretionary and non-discretionary accounts

B. Part II of Form ADV

This part of the form, which can be given to the client to satisfy the "brochure rule" requirement (Rule 204-3) (see discussion in Part B.4, infra), is primarily for clients' use and contains information such as:

- whether the adviser calls any of its services "financial planning"
- a balance sheet (this is required only of those few advisers who have custody or possession of clients' assets or who require large prepayments of advisory fees.)
- discussion of the types of advisory services the adviser provides and the advisory fees it charges
- a discussion of the types of securities about which the adviser provides advice

- a description of the methods of security analysis the adviser uses

- disclosure of the adviser's affiliations with other securities professionals

- whether the adviser effects securities transactions, as broker or as principal, for advisory clients

- whether the adviser has brokerage or investment discretion on behalf of clients

- a description of the education and business background of investment adviser (but note, the Act does not require any qualifications for registration)

Registration on Form ADV is effective automatically 45 days after filing unless the Commission institutes proceedings to deny registration. It can do so where the applicant has been convicted of a felony involving the purchase or sale of securities, or involving theft, larceny, forgery, etc. If the staff which processes the Form ADVs has questions or problems with a filing, it typically will phone or write the registrant. If the staff needs to, it may ask the registrant to agree to delay the effectiveness of its ADV so that any problems can be resolved.

To keep this registration in good standing, an adviser must comply with 2 more requirements:

1 - it must amend its ADV when its answers to the questions change. Rule 204-1 sets forth guidelines as to when one must amend. Basically, routine items require amendment within 90 days after end of registrant's fiscal year if they become inaccurate for any reason. More significant items require prompt amendment if they become inaccurate in a material manner.

2 - it must file a short annual supplement, Form ADV-S, within 90 days after its end of fiscal year (Note: the Commission may terminate an adviser's registration for failure to file annually a Form ADV-S).

C. <u>Other Disclosure Requirements Relevant to Registered Investment Advisers</u>

In addition to the disclosure requirements imposed on advisers by the Act, several provisions of the Securities Exchange Act of 1934 may be relevant to an adviser, particularly where the adviser has discretionary authority over client assets:

1. Schedule 13D - This schedule must be filed by any person who, after acquiring directly or indirectly more than 5% of the beneficial ownership of any equity security

of a class registered pursuant to §12 of 1934 Act or any equity security of an insurance company relying on §12(g)(2)(G) or any closed-end investment company registered under 1940 Act. It must be filed within 10 days after such acquisition with (1) the SEC, (2) each exchange where security is traded, and with (3) the principal office of the issuer. The duty to amend 13D is found in rule 13d-2 under the 1934 Act.

2. <u>Schedule 13G</u> - This schedule may be filed in lieu of a Schedule 13D if such person has acquired securities in the ordinary course of business and not with purpose of changing or influencing control of the issuer and such person is a registered investment adviser. Rule 13d-1(b)(1)(ii)(E) under the 1934 Act. Schedule 13G must be filed within 45 days after end of calendar year in which the obligation arose. The schedule need not be filed if the person does not own more than 5% at the end of the calendar year. If the person no longer holds such securities in the ordinary course of its business, it must promptly file a 13D. The duty to amend 13G is found in Rule 13d-2.

The phrase "beneficial ownership," as defined in rule 13d-3, includes any person who directly or indirectly has or shares:

(i) voting power, which includes the power to vote, or to direct the voting of such security; and/or

(ii) investment power, which includes the power to dispose, or to direct the disposition of such security.

3. <u>Form 13F</u> - This form must be filed by any institutional investment manager which exercises investment discretion with respect to accounts holding equity securities having an aggregate fair market value of at least $100 million. Basically, any person subject to this provision must file within 45 days of end of each quarter. There are some provisions for the confidentiality of these reports, <u>e.g.</u>, open risk arbitrage positions. See §13(f)(3) of the 1934 Act and Part D of the General Instructions accompanying Form 13F.

V. WHAT Requirements Apply to a Registered Investment Adviser?

The Act imposes four types of requirements on a registered investment adviser: (1) a fiduciary duty to clients; (2) substantive provisions; (3) recordkeeping requirements; and (4) administrative oversight by the SEC, primarily by inspection. These requirements are discussed below.

A. Fiduciary Duty to Clients

Fundamental to the Act is the notion that an adviser owes its clients a fiduciary obligation which is intended to eliminate conflicts of interest and to prevent the adviser from overreaching or taking unfair advantage of a client's trust. A fiduciary owes its clients more than honesty and good faith alone. A fiduciary must be sensitive to the conscious and unconscious possibility of rendering less than disinterested advice, and it may be faulted even where it did not intend to injure the client and even if the client does not suffer a monetary loss. The landmark court decision defining the duties of a fiduciary is Justice Cardozo's opinion in Meinhard v. Salmon, 249 N.Y. 458, which states, in relevant part:

> many forms of conduct permissible in the workaday world for those acting at arm's length, are forbidden by those bound by fiduciary ties. A fiduciary is held to something stricter than the morals of the market place. Not honesty alone but the punctilio of an honor the most sensitive, is then the standard of behavior.

The essential sentiment of this approach was adopted by the Supreme Court in its 1963 decision in Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, the seminal decision on the fiduciary duty of an adviser under the Act. As the Court stated:

> [t]he Investment Advisers Act of 1940 reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship as well as a congressional intent to

> eliminate, or a least to expose, all conflicts of interest which might incline an investment adviser - consciously or unconsciously - to render advice which was not disinterested. Id. at 191-192.

The "delicate fiduciary nature of an investment advisory relationship" was reiterated in In the Matter of Alfred C. Rizzo, Investment Advisers Act Rel. No. 897 (Jan. 11, 1984), where the Commission stated that an adviser's duty to have a reasonable, independent basis for his investment advice flowed from such a fiduciary relationship. Other fiduciary principles to be kept in mind are the adviser's duty of (1) best execution (see Interfinancial Corporation, pub. avail. March 18, 1985), (2) suitability, and (3) utmost and exclusive loyalty to the client. An adviser naturally might ask, "What is the source of the fiduciary duty? An adviser's fiduciary duty is not

- specifically set forth in the Act, although sections 206(1) through 206(4) deal generally with fiduciary duty
- delineated by SEC rules, or
- a result of a contract between the adviser and the client (i.e., it is not something that can be negotiated away)

Rather, a fiduciary duty is imposed on an adviser by operation of law because of the nature of the relationship between the two parties. The fiduciary duty concept is incorporated indirectly into the Act in various prohibitions and disclosure requirements, discussed below.

B. Substantive Provisions

1. Performance Fees: Section 205(1)

The Act prohibits a compensation arrangement known as a "performance fee," which is defined as an investment advisory fee that varies with the adviser's success in managing his client's money — a fee based on a share of the capital gains or appreciation of a client's funds. Congress included this prohibition in the Act because of its concern that a performance fee would encourage undue speculation with clients' investments. It felt that this type of fee might encourage an adviser to seek the maximum gain and thereby take the maximum risk with its clients' assets. Any fee that is contingent upon some level of investment performance would generally be considered a performance fee and, thus, unlawful. See Investment Advisers Act Rel. No. 721 (May 16, 1980). A fee based on a percentage of premium income received for writing options also is a performance fee. Oppenheimer Capital Corp. (pub. avail. April 18, 1985); In the Matter of Roman S. Gorski, Investment Advisers Act Rel. No. 214 (Dec. 22, 1967).

Exceptions to the Prohibition

i. Statutory. The statute excepts from the performance fee prohibition a type of fee known as a "fulcrum fee." This is a fee for "big players," where the investment advisory contract involves registered investment companies or certain persons or entities with $ 1 million of assets. The fee must be based on the asset value of the fund under management averaged over a "specified period" and must increase and decrease proportionately with the "investment performance" of funds under management in relation to an "appropriate index of securities prices." Rules 205-1 and 205-2 define the terms quoted above.

ii. Administrative. The Commission recently adopted a rule that relaxes the performance fee prohibition, but still only in the case of certain persons and entities with significant assets. Rule 205-3 permits an adviser to receive a performance fee if the following conditions are met:

- the client has at least $500,000 under the adviser's management or a net worth over $1 million;

- compensation is based on a formula including capital losses;

- compensation is based on gains less losses in the client's account for a period of at least one year

- the investment adviser "reasonably believes" that the fee is an "arms-length" arrangement between the parties and that the client understands the risks involved.

- particular disclosures are made

2. Agency Cross Transactions and Principal Transactions: Section 206(3)

Section 206(3) makes it unlawful for an adviser, in certain cases, to act as broker for a client or to act as principal in buying or selling securities from a client.

Agency Cross Transactions (where adviser acts as broker to both the advisory client and the other side of the transaction)

An adviser can not

A. Acting as broker for a person other than its client, knowingly

- buy any security for its client

- sell any security to its client

B. Without

i. disclosing to the client the capacity in which it is acting

- in writing and

- before completion of the transaction, and

ii. obtaining the client's consent to the transaction.

Principal Transactions

Similarly, an adviser can not:

A. Acting as principal for his own account, knowingly

- buy any security from a client, or

- sell any security to a client

B. Without

i. disclosing to the client the capacity in which it is acting

- in writing and

- before completion of the transaction, and

ii. obtaining the client's consent to each such transaction.

Agency Cross Transaction Rule - Rule 206(3)-2

Section 206(3), as a practical matter, makes it impossible for an adviser to do agency cross transactions. The Commission has recognized, however, that agency cross transactions may be beneficial to clients, provided certain conditions are met. Accordingly, it adopted Rule 206(3)-2, which provides a safe harbor for agency cross transactions meeting the following conditions:

- the client executes a written consent prospectively authorizing such transactions

- the adviser makes full written disclosure to the client of

  i. the capacity in which it is acting and

  ii. its possible conflicting division of loyalty and responsibility

- the adviser sends the client written confirmation of each agency cross transaction

- the adviser annually sends the client a statement of all agency cross transactions for the year, and

- all disclosure statements must advise the client that it can revoke the authority granted the adviser at any time

In addition, paragraph (c) of the agency cross transaction rule admonishes advisers that the rule does not relieve them of their responsibility to act in the best interests of their clients, including fulfilling their duty of obtaining best price and execution for any transaction.

3. <u>Antifraud Provision: Section 206(4)</u>

The antifraud provision, section 206, makes it unlawful for any investment adviser using the mails or interstate commerce to defraud, deceive, or manipulate any client or prospective client, and section (4) of the antifraud provision gives the Commission authority, by rule or regulation, to define and prescribe those acts or business practices which are fraudulent, deceptive, or manipulative. The Commission has adopted three rules pursuant to this section, and these rules deal with advertising, custody of clients' assets, and solicitation of clients.

i. <u>Adviser Advertising: Rule 206(4)-1</u>

Rule 206(4)-1 prescribes various advertising practices as fraudulent, deceptive, or manipulative within the meaning of section 206(4).

a. Testimonials cannot be used. 206(4)-1(a)(1).

b. Past specific recommendations that were profitable can not be referred to but an adviser can offer to furnish a list of all recommendations made during the past year. 206(4)-1(a)(2).

c. An adviser cannot represent that any graph, chart, or formula can in and of itself be used to determine which securities to buy or sell. 206(4)-1(a)(3).

d. An adviser canot advertise any report, analysis, or service as free unless it really is. 206(4)-1(a)(4).

e. Catch-all: adviser cannot use any advertisement which contains any untrue statement of a material fact or which is otherwise false or misleading. 206(4)-1(a)(5).

ii. Custody of Client Assets: Rule 206(4)-2

The Commission adopted Rule 206(4)-2 to deal with advisers who have custody or possession of the funds or securities of their clients. It requires that:

a. all securities of each client must be segregated, marked to identify the particular client who owns them, and held in safekeeping;

b. all funds of clients must be deposited in a bank account which contains only client funds and the adviser must maintain a separate record for each such account;

c. the adviser must notify each client as to where it will hold the client's securities and funds and of any changes in the place or manner such assets are held;

d. the adviser must send to each client, at least quarterly, an itemized statement of all of the client's securities and funds it holds; and

e. all such funds and securities must be verified at least once a year by a surprise audit by an independent public accountant.

This rule does not apply to an adviser who also is registered as a broker-dealer under §15 of the 1934 Act if such person is in compliance with the net capital requirements, rule 15c3-1, of that act or is a member of an exchange whose members are exempt from that rule.

iii. Solicitations: Rule 206(4)-3

The solicitation rule makes it unlawful for any adviser to pay a cash fee to one who solicits clients unless

(a)(i) the adviser is registered;
(ii) the solicitor is not a "bad boy" (not subject to court order or administrative sanction);

(iii) such cash fee is paid pursuant to a written agreement to which the adviser is a party; and if the solicitor is not an officer, employee, or partner of adviser and is not controlled by adviser, the written agreement required above must:

(1) describe the solicitation activities to be undertaken

(2) require the solicitor, at the time of solicitation, to provide client with a copy of the adviser's "brochure" and the separate disclosure agreement mandated by this rule. This separate disclosure agreement must describe, among other things, any affiliation between the solicitor and the adviser, the terms of the solicitor's compensation, and the difference, if any, in the adviser's advisory fee that is attributable to the solicitation arrangement.

4. "Brochure Rule": Rule 204-3

The brochure rule requires an adviser to provide certain information to its clients.

What - investment adviser generally must provide clients' with a written disclosure statement containing information about background and business practices — Part II of Form ADV or a written document containing at least the information required by Part II (because the balance sheet requirement is found in Part II, this is how advisory clients who prepay their advisory fees or who give custody of their assets to their adviser get to check on the financial well-being of their adviser). Paragraph (d) of the brochure rule allows an adviser to omit from its brochure information in Part II applicable only to a type of advisory service or fee not charged to that client.

When - brochure must be delivered at least 2 days before the advisory contract is entered into or at the time contract is entered into if the client can terminate the contract within 5 days.

An investment adviser also must deliver, or offer in writing to deliver, annually, an updated brochure. This requirement is not required for advisory clients receiving advisory services solely pursuant to a contract for impersonal advisory services requiring a payment of less then $200 (see rule 204-3(b)(2)).

A "contract for impersonal advisory services" means a contract whereby investment advice is provided solely by means of oral statements or written materials which do not purport to meet the investment needs of specific individuals or statistical information not expressing any opinions about the investment merit of particular securities (see Rule 204-3(f)(1)).

5. Duty of Supervision: Section 203(e)(5)

Registered investment advisers have a continuing responsibility to comply with the Advisers Act, and this duty includes the supervision of and responsibility for anyone acting in their behalf. Justin Federman Stone, 41 S.E.C. 717 (1963); TBA Financial Corporation (pub. avail. Dec. 7, 1983). This duty to supervise is comparable to the duty to supervise imposed upon broker-dealers in the 1934 Act.

C. Recordkeeping Requirements: Rule 204-2

The Act generally requires an adviser to maintain two types of books and records: (1) the typical accounting records that any business would normally keep, and (2) certain additional records the Commission believes are necessary in light of the advisory's fiduciary duty, as discussed below:

1. Typical accounting records

i. all check books, bank statements, cancelled checks. (a)(4) of 204-2.

ii. all written agreements entered into by investment adviser with any client or otherwise relating to the business of the investment adviser. This would include rental and service agreements, mortgages, employment contracts, and contracts for investment advisory services. (a)(10).

iii. all bills or statements relating to adviser's business as such. (a)(5).

iv. all trial balances, financial statements, and internal audit working papers relating to business of investment adviser. (a)(6).

2. Additional records

i. a record of the personal securities transactions of the adviser and its employees. (a)(12).

ii. a memorandum of each order given by the investment adviser for the purchase or sale of any security and any instruction from the client concerning such purchase or sale. (a)(3).

iii. the originals of all written communications received and copies of all written comunication sent by the adviser relating to

a. any recommendation made or proposed to be made, any advice given or proposed to be given

b. any receipt, disbursement or delivery of funds or securities, or

c. the placing or executing of any order to purchase or sell any security. (a)(7).

iv. a copy of all circulars, advertisements, newspaper articles, etc. sent to 10 or more persons. (a)(11).

v. a list of all accounts that investment adviser has authority over. (a)(8).

vi. a copy of each written statement given to any client in compliance with brochure rule. (a)(14).

vii. client's acknowledgement of receipt of solicitation agreement. (a)(15).

3. Other Requirements Regarding Recordkeeping

i. An investment adviser who has custody or possession of securities or funds of any client must keep additional records regarding that activity. Rule 204-2(b).

ii. An investment adviser who renders any investment supervisory service (i.e., the giving of continuous advice as to the investment of funds on the basis of individual need of each client) or management service must also keep additional records regarding that activity. Rule 204-2(c).

iii. All books and records required to be kept by the rule must be maintained and preserved in an easily accessible place for a period of not less than 5 years. Rule 204-2(e).

iv. Records required by the rule may be kept on film or computer. Rule 204-2(g).

v. The recordkeeping rule provides an exemption to the extent that the investment adviser is a broker-dealer keeping the same records pursuant to rules 17a-3 and 17a-4 of the 1934 Act. Rule 204-2(h).

vi. The recordkeeping provisions for non-resident investment advisers are set forth in Rule 204-2(j).

4. Administrative Oversight

Inspections are usually done by personnel in the Commission's various Regional Offices, although Division of Investment Management personnel occasionally accompany the Regional Offices. There are two types of inspections;

(1) Routine inspections

(2) For cause inspections, which may be based on

- receipt of a public complaint
- rumors of trouble
- anonymous tips

Inspectors look particularly for evidence of:

1 - churning — excessive trading

2 - scalping — is the adviser trading on short-term market activity caused by his recommendations

3 - is the adviser engaging in brokerage practices that are not in the client's interest (e.g., failure to obtain best execution)

4 - suitability — are the adviser's recommendations suitable for client's finances

5 - deceptive advertising

6 - improper recordkeeping

There are generally three possible results from a inspection

1 - the adviser receives a clean bill of health (a rare event!)

2 - the staff sends a "deficiency letter" informing the adviser of any violations or possible violations found and requesting the adviser to contact the staff regarding any necessary corrective steps.

3 - the staff commences an enforcement proceeding - this result is not common as a first step

VI. CURRENT EVENTS

A. POSSIBLE FUTURE LEGISLATION AND PROPOSALS

On February 20, 1986, the SEC authorized the Division to discuss various legislative and rulemaking staff proposals with the North American Securities Administrators Association ("NASAA"). Among these proposals were rules that would exempt certain investment advisers who were registered in states where they conducted business, had a limited number of clients, and had no custody or possession of client funds or securities. At present, the staff is exploring the rules with NASAA, but they have not yet been proposed by the Commission.

On May 27, 1986, the SEC approved submitting to Congress the Investment Advisers Amendments Act of 1986, which incorporated many of the legislative proposals considered in February. However, the initial submission was withdrawn for technical reasons and the Commission's staff is continuing to work on the legislation. The Amendments Act included provisions to clarify ambiguities which had arisen in the aftermath of the Supreme Court's decision in Lowe. The provisions would have modernized the definition of an investment adviser while exempting from registration those advisers providing solely impersonal investment advice through communications media.

Other provisions of the Amendments Act provided for greater information-sharing with other federal, state and foreign securities regulators or law enforcement officials. In addition, the proposals included an increase in the registration fee for advisers and the establishment of an annual fee. Finally, the Amendments Act would have clarified the SEC's authority to require advisers to file certain documents electronically.

B. SELF-REGULATORY ORGANIZATION FOR FINANCIAL PLANNERS

1. Background

The International Association for Financial Planning has established a committee to promote the establishment of one (or more) self-regulatory organizations (an "SRO") for financial planners. The SRO would be under SEC oversight and would be implemented by various amendments to Act, including a definitional amendment to make clear that all financial planners are "investment advisers" for purposes of the Act. These amendments, generally speaking, will provide for SEC delegation to the SRO of certain existing functions under the Act as they relate to financial planners. Under the proposal, the SRO would:

- register "financial planners"
- be mandatory for financial planners
- be a non-profit organization funded through "user fees"
- perform field examinations

- process complaints against financial planners

- develop professional qualification standards for financial planners

- impose continuing education requirements

- coordinate activities with the states

2. SEC and Industry Reaction

To date, the SEC has not taken a formal position on the SRO proposal. The staff of the Division of Investment Management has indicated its view that an SRO is an interesting idea that should be explored further. A similar opinion was expressed by NASAA. At the SEC's Roundtable on Investment Advisers and Financial Planners, held May 7, 1986, this concept was discussed at greater length by members of the Commission and various industry practitioners. While growth in the financial planning industry is apparent there was no consensus that self regulation was necessary or practical, though several Roundtable participants endorsed some degree of self regulatory responsibility. In addition, the NASD announced that it had recently established a pilot program to explore the possibility of the NASD's serving as an SRO for advisers. The pilot, which will be coordinated with the SEC and is scheduled to be completed by year-end, would apply only to NASD member broker-dealers and their associated persons who are investment advisers. It could later be extended to evaluate self regulation of advisory affiliates of NASD members.

3. Congressional Hearings on Financial Planners and Investment Advisers

On June 11, 1986, the Chairman of the SEC, along with self regulatory representatives, trade association and industry members, and victims of fraudulent advisers testified before the House Subcommittee on Telecommunications, Consumer Protection and Finance. As a result of this testimony, which focused on the growing financial planning and investment advisory industries, Congress may require the SEC to conduct a study on the industry, its problems, and possible solutions.

SECOND GUEST LECTURE PROGRAM (PUBLIC SERVICE CONFERENCE)

On September 25, 1986, the Department of Banking sponsored the second in a series of Guest Lectures at the Stamford branch of the University of Connecticut. The conference addressed some of the regulatory concerns and problems encountered by small businesses in raising capital. Specifically, there was an overview of the venture capital industry and the Investment Advisers Act of 1940. There was also a discussion of the private placement exemptions under both federal and state securities laws as well as a discussion of the financial programs administered by the Connecticut Development Authority of the Department of Economic Development.

Lectures were given by representatives from the Securities and Exchange Commission, Hartstone and Dickstein, Inc. of Hartford, Shipman & Goodwin of Hartford, Cummings & Lockwood of Stamford and the Department of Economic Development.

*ANGELA C. HALL, ESQ.**
DIVISION OF INVESTMENT MANAGEMENT
UNITED STATES SECURITIES AND
EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

Excerpts of Speech Taken From The
Second Guest Lecture Program

I will discuss only two of the topics covered in the outline included in your materials. The two topics I will discuss will be first, to what extent a general partner or other person giving advice to a limited partnership can deem the limited partnership rather than the limited partners to be his client for purposes of determining whether he is exempt from registration under the under Section 203(b)(3) of the Investment Advisers Act of 1940 which generally exempts from federal registration requirements those advisers with fewer than fifteen clients.

After I discuss that, I will discuss the rule adopted by the Commission in November of last year that, to a great extent, relaxes the prohibitions that were in effect inhibiting registered investment advisers from charging their clients a performance-based fee.

Section 203(b) of the Investment Advisers Act of 1940 is the registration section. It generally provides that every investment adviser who comes within the Act's definition, and who uses the means of interstate commerce, must register with the Commission, unless he is specifically exempted from registration under Section 203(b).

I will deal with the first two subsections very briefly. Section 203(b)(1) generally exempts any adviser all of whose clients are within the same state where he maintains his principal place of business so long as the adviser does not render any advice as to any securities listed on a national securities exchange. That is 203(b)(1).

Briefly, Subsection 203(b)(2) exempts advisers who only have insurance companies as their clients. I understand you're particularly interested in Section 203(b)(3), which exempts any adviser who, during the previous twelve months, has had fewer than fifteen clients so long as first, he does not hold himself out to the public as an adviser; and, second, he does not have as a client any registered investment company or any business development company.

*The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. Thus, the views expressed herein are those of the authors (speaker) and do not necessarily reflect the views of the Commission or its staff.

A very common question that gets a lot of attention from advisers trying to determine whether they can rely on 203(b)(3), is what do we mean by holding yourself out to the public as an adviser? A lot of times this is a very common-sensical question.

If you are advertising, we are going to say you are holding yourself out to the public as an adviser. If you have business cards that refer you to an investment adviser or investment counsel, we would consider that to be holding yourself out to the public and other things, such as being listed in a telephone directory, building directory, or business directory as an adviser counsel.

We have also taken the position that even if you do not advertise and don't use business cards, if you have some clients and let them by word of mouth tell other people about your business and you accept new clients in that fashion, that could be considered holding yourself out to the public. And if you do that, you cannot rely on 203(b)(3).

We have taken a number of positions on trusts. Generally speaking, a trust will count as one client. We have even alluded to the fact that when different trusts have identical beneficiaries, we might consider that to be one client.

We have issued no-action letters in that area, but the question arises as to what does a general partner do when he finds himself acting as an adviser to a limited partnership and he wants to know whether or not he can rely on §203(b)(3). It is an important question for an adviser because being exempt from federal registration requirements means you are exempt from all provisions of the Act but for the anti-fraud sections. This means you are not subject to the record keeping requirements and you don't have to pay attention to performance fee restrictions. It is a very important question for someone who finds himself in that position.

In 1977, the Second Circuit tried to deal with the question. In Abrahamson vs. Fleschner, the court originally characterized the individual limited partners as clients. They later withdrew this characterization, but left the question unresolved.

In February of 1985, the SEC proposed Rule 203(b)(3)-1 to provide a safe harbor for an adviser to count the partnership as a single client rather than the individual limited partners. The final rule was adopted in July of last year.

The rationale for the rule I think is very easy to understand. The idea is that when you have a passive investment vehicle set up as a limited partnership, it should be given the same treatment as other passive investment vehicles, such as a corporation. Someone who is acting as an investment adviser to a corporation and is not giving individualized investment advice to the shareholders in their individual capacity counts the corporation, not the individual shareholders, as his client in most situations.

The Commission felt the time was right to allow limited partnerships to be accorded the same treatment. It is important to note that the rule creates a safe harbor. It is not intended to be the exclusive means in determining when you can count the partnership as the client or limited partners themselves, but it is a safe harbor. If you come within the terms you're home free. If you don't, you can still make the argument, but you probably should get some assurance from your counsel or from the Commission staff.

I will summarize the rule and just go through its most important points. The rule has a couple of preliminary notes. Preliminary Note One states the rule is a safe harbor and not the exclusive means for a general partner to count limited partnerships.

Preliminary Note Two represents a change from the rule as proposed. It contains a reminder to the industry that Section 208(d) of the Investment Advisers Act makes it illegal for an adviser to try to do indirectly what he is not allowed to do directly. We have a 1981 no-action letter out to Richard Ellis. It sets out a five-factor test as to when we would view operations as separate and distinct. It deals with the question whether the subsidiary is adequately capitalized, whether the subsidiary comes up with its own advice or merely relies on the advice from the parent and only receives the investment advice that the parent is giving to other clients.

Paragraph (b)(1) sets forth the general proposition that a limited partner of a partnership may be counted as one client. Paragraph (b)(2) sets forth the corresponding proposition that a limited partner of a partnership shall not be counted as a client separate from the partnership if two conditions are met: first, the limited partnership interest must be a securities interest. The reason for this is so that the protection of the antifraud section will apply and give the holders of the limited partnership those protections.

Also, the Uniform Limited Partnership Act, I believe, also protects the limited partners to some extent. I think it makes the general partner liable for the debts and puts the general partner in the capacity of acting as a fiduciary towards the limited partners. But that requirement is clear, the limited partnership interest must be securities.

The second condition is certainly important, it is that the general partner or other person advising the partnership must do so on the basis of the investment partnership as a whole. He cannot be gearing his investment advice to the investment objectives of any of the limited partners as individuals. Of course this requirement is there to make sure that this is not a sham to avoid the requirement of the Act. We would not want someone setting up a limited partnership where they were in reality looking through and giving each of the represented partners specialized advice. The advice rendered must be to the partnership as a whole.

Paragraph (b)(3) of the rule sets forth certain situations in which the safe harbor is unavailable with respect to a particular limited partner. The best example I can think of here would be where I am the general partner of a limited partnership. There is -- let's say it has ten limited partners and I want to count the partnership as one client. I can do that, but if one of the limited partners is also someone I've known fifteen years and I have been giving him and his wife individualized investment advice, he has a status as a client apart from the limited partnership and I can't, by virtue of him being a limited partnership, take away his separate status as a client in his own right, and that is pretty much what it is intended to prevent.

Stephen J. Benedetto
Loan Officer
Connecticut Development Authority
Department of Economic Development
210 Washington Street
Hartford, CT. 06106

Excerpts of Speech Taken From The Second Guest Lecture Program

The Connecticut Development Authority ("CDA") was formed in 1973 and is part of the Connecticut Department of Economic Development. The chairman of CDA is the Commissioner of Economic Development. We provide funding under a wide variety of programs mostly to manufacturers and wholesalers throughout Connecticut.

We have a financing arrangement known as the self-sustaining program which is an individual bond or an individual industrial revenue bond. Generally, those loans are from one to ten million dollars and are made to large companies for land, building, machinery and equipment. We have a direct loan program called the umbrella program which provides funding up to eight hundred thousand dollars for land, building, machinery and equipment.

Under the umbrella program, we borrow on a line of credit from a consortium of Connecticut and New York banks and we lend this money out to businesses secured by real estate. We have a mortgage insurance program, under which we can provide loan guarantees up to ten million dollars for a term of twenty-five years on land and building projects.

We can finance ninety percent of the cost or appraised value, whichever is lower. We can guarantee a loan made by a private lending institution, generally a bank or insurance company. This enables our borrowers to generate funds sometimes at a lower rate and most times at a longer term.

We can also provide fixed mortgage insurance for production machinery financing, guaranteeing eighty percent of the cost, for a maximum term of ten years. And that's also been a very successful program and something that has been in existence for many years.

I also administer the small manufacturers revolving loan fund. In municipalities such as Bridgeport, we can lend up to $150,000 or eighty percent of the cost of any fixed asset purchase for the maximum term of ten years. The interest rate today would be 7.6 percent fixed for the term of the loan. There is a small application fee, which does not exceed two hundred dollars. In addition to the loans already described, we can make working capital loans for that program in most municipalities up to two hundred fifty thousand dollars for a term up to seven years at a rate of interest presently 7.6% fixed for the term of the loan.

With working capital financing, there must be a match, generally bank borrowings or equity equal to every dollar we lend. We are the first state in the country to have enterprise zone legislation. We have six enterprise zones in Connecticut that are located in three municipalities with populations of 80,000 or more and three municipalities with less than 80,000. The larger communities that have enterprise zones are Bridgeport, New Haven and Hartford. The smaller municipalities are Norwalk, New London and New Britain. There are a wide variety of tax incentives and job creation grants and other incentives that are provided by the Department of Economic Development.

Our maximum loan under the enterprise zone program is $200,000 and our maximum term, if we are financing a portion of real estate, is ten years. If no real estate is being financed, it is seven years. The interest rate is 7.6 percent fixed for the term of the loan. There is no application fee of any sort. In the case of a new business, a minimum of ten percent of the start-up capital must be contributed by the owner or officers of the business.

No capital infusion is necessary in the event of an existing business. There must be some kind of expansion for job creation. There are some rules about that. Our loan must be matched dollar for dollar from money derived from internal or external sources. We have another loan program for small construction contractors. If someone is a construction contractor, has been in business for a period of more than one year, has sales of less than $1.5 million their most recently completed fiscal year, they are eligible.

Last, the Connecticut Development Authority has within its structure a separate and distinct corporation known as the Connecticut Business Development Corporation. CBDC finances land, building and machinery equipment on a long term basis through the small business administration 504 program.

Frank J. Marco, Esq.
Shipman & Goodwin
Counselors at Law
799 Main Street
Hartford, CT 06103

Excerpts of Speech Taken From The Second Guest Lecture Program

A venture capital firm creates new businesses by investing in businesses, either start-ups or later stage companies or turn-around-type situations. Its investments are usually high risk investments with a view to earning a high return on the investment. Usually, the structure used is based on an equity investment of some sort which is appropriate to the venture capital investor. Historically, the objective has been to maintain a long-term capital gains orientation. The founder typically "earns" his equity by putting in the sweat of the company. The venture capitalist's objective is to invest money and to receive long term capital gains.

The venture capitalist usually is actively associated with the company and often serves on the board of directors. He attempts to help the company through its ups and downs as it matures. The venture capitalist, in addition, usually looks to obtain a portion of the gain, personally, by having a piece of the action in his venture capital fund.

In terms of the structure of a typical venture capital enterprise the investors are limited partners. They thus have limited financial risks and certain legal rights as partners.

The management group, the venture capitalists themselves, are usually the general partner. They receive an annual fee for their expenses, and then in addition usually have some override or carried interest to the extent that the fund is profitable. Often a board of advisors consisting of people from industry including representatives of the limited partners themselves, act in an advisory capacity. Typically the fund has a lifetime of about ten years, that being the time it takes to get the fund or money invested and to work with these early stage companies to have them grow.

Typically, the way the funds are structured is that capital gains are returned pro rata to the investors, i.e., ninety-nine percent to the limited partners; one percent to the general partner, until some point in time, when the limited partners have recovered the original investment. Once that hurdle is achieved, then the limited partners' allocation would go down to eighty percent and the allocation to the general partner would go to twenty percent. It is fairly typical for the venture capitalist or the general partner to set up a corporation, the venture management company, of which they would become employees. Usually, there is a management fee paid to the management company annually, usually around two-and-a-half percent of the capital under management.

Right now in the United States as of the end of 1985 there was approximately $19.5 billion of venture capital under management. Of that amount, about seventy-five percent was managed by independent private venture capital firms. About thirteen percent was managed by corporate financial institutions.

In addition, industrial companies, many of which are located in Connecticut, manage about eight percent of venture capital, and venture capital small business investment companies represent four percent.

California had thirty-three percent of the total venture capital under management. Connecticut was fifth on the list with five percent, or approximately one billion dollars. Of course this is just capital that has been reported.

Of the $2.6 billion disbursed in 1985, approximately 25% went into early stage companies. This represents a significant number of companies because early stage financings are a higher risk and a smaller type of investment than the later stage expansion or public offering financing.

More and more money is going into marketing types of enterprises. Traditionally, venture capitalists have looked for companies they feel are going to have some proprietary position, where the company has a good chance of going from $50 to $100 million worth of sales in five years. These criteria are usually associated with a leading edge technology.

There are a number of reasons for the resurgence of venture capital from 1969 to date. Probably one of the primary ones was the capital gains tax reductions that took place in 1978 when the capital gains tax was reduced to twenty-eight percent. In 1981, when it went to twenty percent, the differential between ordinary income and capital gains fueled a lot of the growth in the public stock markets and made the investment in equity securities attractive.

Institutions and other investors invest in venture capital because of the pay back from the high values that those companies might ultimately obtain when they go public, which means there has to be a healthy securities market. The liberalization of SEC Rule 144 made it easier to sell restricted securities without going through the registration process. In addition, many high tech companies are acquired by larger companies looking for ways of getting into new growth areas of business. The ERISA plan asset exemption was another factor leading to the resurgence in venture capital. There was doubt about the ability of pension fund or regulated entities to invest in venture capital firms. A question existed whether the assets of the fund constituted "plan assets," thereby subjecting the fund and its managers to various types of fiduciary as well as prohibited transaction problems. There have been a number of proposed regulations that have been outstanding that have provided some relief in that area.

All this really has led to a tremendous interest by money sources in venture capital as a means of diversifying portfolios and of achieving high gains on investment. One of the basic objectives that a venture capitalist typically looks for in structuring an investment in a portfolio company is a senior security, usually some sort of a preferred stock or debt security. Typically, the venture capitalist is not a lender, but may receive between forty and sixty percent of the postfinancing equity, particularly for a start-up type investment.

The venture capitalist is often actively involved with the company, typically either controlling the board or having at least certain controlling rights over what the company does.

In addition, he will look for a means for liquidity. Liquidity may either be from a private sale of securities, a public offering, a merger or sale. The venture capitalist usually has the right to put his securities back to the company, or at least have the company redeem the securities. This is often used in a so-called living deadtype of situation where at some point in time the venture capitalist wants to get out of a flat situation.

The Connecticut Uniform Securities Act is very similar to the federal Investment Advisers Act of 1940 in its treatment of venture capital firms as investment advisers. The definition of "investment adviser" states that any person who, for compensation, engages in the business of advising others as to the value of securities is an investment adviser. Of course, a threshold issue is whether a venture capitalist or a general partner is advising others as to the value of securities.

The definition goes on to state that certain persons are not included within the definition of investment adviser. Excluded from the definition are persons whose only clients in the state are institutional investors, or any person who has no more than five clients in the state and doesn't hold himself out to the public as an investment adviser.

These definitional exclusions are similar to those in Section 203(b) of the Investment Advisers Act, which exempts people who advise less than fifteen clients.

Venture capital firms typically take the position that first of all they are not advisers. No advisory relationship really exists and that they do not give advice to the investors in the fund. Further, it is argued that, if any advisory relationship exists, then the fund constitutes only one client.

The situation became complicated in June of 1983 when a regulation was adopted under the Connecticut Uniform Securities Act which said that a corporation and a partnership are deemed to be a single client but only if the entity was not formed for the purpose of purchasing securities or seeking investment advice.

Of course, by definition, a venture capital firm is formed for the purpose of purchasing securities. The regulation doesn't say explicitly that a venture capital fund or entity formed for the purpose of purchasing securities is an adviser, but by implication, of course, the definition does cause some trouble.

By Order dated July 23, 1984, the Connecticut Banking Commissioner stated that certain institutional-type venture capital firms were not within the intent of the definition of an investment adviser. The Order was based on several findings which included, among other things: 1) fact that the funds invested a substantial part of their assets in securities of privately held companies; 2) the sale of the interests in the funds had to comply with applicable state securities laws when they were issued; 3) the manager in the fund could not render advisory services to more than five funds which have a Connecticut investor (other than certain institutional investors); and certain prescribed disclosure requirements had to be met. The disclosure requirements are very similar to the ones which are stated under SEC Rule 205-3.

CORRECTIONS

The following corrections should be noted pertaining to Ms. Joan K. Willin's presentation at the First Guest Lecture held in Hartford, which was included in the May 1986, Volume II No. 3 Securities and Business Investments Division Bulletin:

- The quotation marks should be closed at the end of the fifth paragraph at the bottom of page 45.
- In the second paragraph of page 46, the reference to George Gould should be as <u>under</u>-secretary for domestic finance.
- In the fifth paragraph of page 46 the first sentence should read "Central to an understanding of the litigation involving the Fund is the Glass-Steagall Act case, <u>ICI V. Camp</u>, the 1971 Supreme Court decision in which Citibank's commingled managing agency account was held to violate the Glass-Steagall Act."
- In the second paragraph on page 47, the fourth sentence should read "As they are getting larger year by year, people are going to be looking at them as more than just a tax <u>deduction</u>."
- In the fourth paragraph on page 47, there should be a parenthesis as follows: "The OCC approved the establishment of collective funds by Citibank in 1982 and (of course the timing was crucial, it came the year after the passage of ERTA, that's why there was the economic incentive then to begin offering these funds), to Wells Fargo and Bank of California 1984 and to CBT in 1985."

In the third sentence of the third paragraph of page 48, the word "mutual" should be deleted and an "s" added to account.

In the third sentence of the third paragraph on page 49, there should be a semi-colon as follows: "This is the only criteria that nobody seems to be able to meet; the applicant will stand ready to broker a large number of investment companies securities at least through the fund, including funds from at least five different families of funds."

In the fifth paragraph on page 50, the reference to the Bankers Trust subsidiary should be to BT Securities Corporation, not "ET Securities Corporation."

In the fourth sentence of the sixth paragraph at the bottom of page 50 the reference to Judge Green should be "She" rather than "He" and the sentence should read as follows: "She held that there was underwriting and that there was no Section 16 agency exception available."

In the second sentence of the fourth full paragraph on page 51 the reference should be to "our legislative experts" rather than to "legislature".