U.S. Regulation of the International Securities and Derivatives Markets, § 16.01, INTRODUCTION

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 16.01 (11th and 12th Editions 2014-2017)
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The internationalization of the securities markets is strongly evidenced in the investment advisory business. Many money management organizations have operations in the major international financial centers, and their advisory clients are in the United States and elsewhere around the world. How such organizations are run both within and outside the United States can be significantly affected by regulation under the Advisers Act.

The SEC staff had long taken the position that if an organization—wherever domiciled—was (or should have been) registered under the Advisers Act, the regulatory scheme of the Advisers Act applied to the adviser's worldwide advisory activities, including those undertaken with its non-U.S. clients outside the United States. [1] The SEC staff has moderated this view, however, in the case of advisory services provided to the non-U.S. clients of registered advisers located outside the United States. [2]

In the first of a series of no-action letters advancing this view, *Uniao de Bancos de Brasileiros S.A.* ("*Unibanco*"), [3] the staff agreed that a foreign adviser need not comply with all of the provisions of the Advisers Act in providing services to its non-U.S. clients. The relief was subject to certain procedural requirements, including the maintenance of books and records, to ensure the SEC had adequate access to the foreign adviser for enforcement purposes.

Unibanco and its progeny reflect in large measure preliminary conclusions set forth in the SEC staff report, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION (the "1992 Report"). [4] The 1992 Report included a wide-ranging analysis of the then-existing regulatory consequences for foreign and multinational advisers and recommended certain alternatives. On the basis of *Unibanco* and subsequent no-action letters, the SEC staff has backed away from seeking to regulate the worldwide activities of advisers located outside the United States. Rather, the staff is moving towards regulating the U.S. activities of these advisers and assuring that the activities outside the United States of non-U.S. advisers and non-U.S. affiliates of U.S. advisers do not adversely affect U.S.

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clients, U.S. investors in clients that are investment funds, or the U.S. market. [5] The staff's position regarding the degree of regulation under the Advisers Act of activities outside the United States remains a threshold issue in structuring investment advisory operations.

Money managers that provide advice for compensation in the United States concerning securities are generally subject to regulation under the Advisers Act. [6] The Advisers Act provides for:

- registration of the adviser and disclosure concerning its business practices and personnel;
- substantive regulation of many aspects of the adviser's ongoing relationships with its clientele, particularly under general antifraud prohibitions and with respect to the ability of an adviser to charge performance-based or nonrefundable fees with certain clients and to engage in transactions with advisory clients as principal; and
- SEC oversight, inspection and disciplinary authority with respect to the adviser's activities.

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Certain U.S. advisers are also subject to regulatory requirements imposed by state securities authorities that in some cases are more comprehensive than those applicable under federal law and, as discussed below, to state oversight rather than federal oversight by the SEC.

Several securities derivative products are used by investment advisers. Certain of these derivative products, such as futures, options and swaps on financial instruments and currencies, are in some instances regulated in the United States under the CEA. If an adviser's activities involve such futures, options or swaps, the adviser may also be subject to regulation as a "commodity trading advisor" (a "CTA") under the CEA. Like the Advisers Act, the CEA and the regulations promulgated by the Commodity Futures Trading Commission ("CFTC") thereunder provide for a comprehensive regulatory scheme applicable to CTAs, including registration and ongoing recordkeeping requirements, substantive restrictions on relationships with clients (including a prohibition against holding

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customer funds related to futures contracts and commodity options in its own name) and extensive disclosure obligations, as well as CFTC oversight. [7]

Following the explosive growth experienced by the money management business and numerous investor fraud scandals, U.S. Congressional and SEC attention is increasingly focused on existing regulation and the level of resources currently devoted to oversight. [8] The Investment Advisers Supervision Coordination Act of 1996 [9] effected a significant delegation of authority over investment advisers from the SEC to state securities commissions. Numerous other

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proposals have been considered by Congress and industry groups but have not been adopted, and include the creation of one or more self-regulatory organizations or the extension of the jurisdiction of the Financial Industry Regulatory Authority ("FINRA"), an existing broker-dealer self-regulatory organization ("SRO"), to include investment advisers [10] and the creation of a private right of action to permit advisory clients to sue their advisers for failure to adhere to regulatory requirements, particularly those relating to fraudulent and deceptive practices. [11] Other legislative proposals have included provisions imposing higher and ongoing registration fees on advisers, additional disclosure obligations and a requirement to obtain greater information regarding their clients' financial circumstances to ensure the suitability for those clients of the adviser's trading strategies. [12] In 1994, the SEC proposed rules that would expressly prohibit investment advisers from making unsuitable recommendations to clients. [13] Title IV of the Dodd-Frank Act, or the Private Fund Investment Advisers Registration Act of 2010 (the "Private Fund Advisers Act"), required many advisers to hedge funds and private equity funds that were formerly exempt from registration under the so-called "*de minimis*" exemption under the Advisers Act to register as investment advisers, imposed significant new reporting requirements on advisers to private funds and venture capital funds, including information about fund clients, and shifted regulation of many smaller and mid-size advisers from SEC oversight to oversight by the states. [14]

The management of accounts where the beneficiary is a regulated entity, such as an investment company [15] or a pension plan, raises additional regulatory considerations. [16] In such cases, registration as an investment adviser may be

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desirable or required as a condition to the adviser's ability to manage the assets of such entities, notwithstanding that under the Advisers Act itself an exemption from registration may be available.

Footnotes

1 *See* § 16.02.

2 The SEC staff continues to take the position that the regulatory scheme of the Advisers Act applies to activities of advisers located in the United States with all U.S. and non-U.S. clients.

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3 *Uniao de Bancos de Brasileiros S.A.* (avail. July 28, 1992); *see also infra* Note 58 for related no-action letters.

4 SEC, Division of Investment Management, *Protecting Investors: A Half Century of Investment Company Regulation* (May 1992). Many of the conclusions embodied in the 1992 Report resulted from comments received in response to a "concept release" that was part of a comprehensive SEC study of the Investment Company Act and the Advisers Act. SEC Release No. 33-6868 (June 15, 1990) (the "1990 Concept Release").

5 The SEC subsequently confirmed that—in keeping with *Unibanco*—it does not apply most of the substantive provisions of the Advisers Act to the non-U.S. clients of a non-U.S. adviser. SEC Release No. IA-2333 (Dec. 2, 2004) (the "Hedge Fund Release"). Title IV of the Dodd-Frank Act significantly expanded the regulatory scope and obligations of advisers, but it reconfirmed the view expressed in the Hedge Fund Release relating to the application of the Advisers Act to the non-U.S. clients of non-U.S. advisers. SEC Release No. IA-3222 (June 22, 2011), 76 Fed. Reg. 39,646, 39,681 (July 6, 2011).

6 Money managers that provide such advice concerning security futures products may also be subject to regulation as commodity trading advisors under the Commodity Exchange Act (the "CEA"). *See* § 16.16.

7 Such advisers may also be subject to regulation as "commodity pool operators" under the CEA if they manage (*i.e.*, "operate") a collective investment vehicle that trades in futures contracts, commodity options or swaps. Regulations applicable to commodity pool operators ("CPOs") are discussed U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, Chapter 7. As noted above, advisory activities with respect to transactions in security futures products may be subject to regulation under both the CEA and the Advisers Act, absent an exemption. *See* §§ 16.16 and 12.16[5]. The Dodd-Frank Act expanded the definition of CPO and CTA in the CEA to require that entities engaging in swaps activity, in addition to using or advising on futures and options, be subject to this regulatory framework. The CFTC has adopted rules in the context of rulemaking under the Dodd-Frank Act that rescind important exemptions from CPO registration and impose significant additional requirements on CTAs and CPOs. 77 Fed. Reg. 11,252 (Feb. 14, 2012).

8 The SEC conducted a Study on Investment Advisers and Broker-Dealers, required by the Dodd-Frank Act, in January 2011 with the goal of harmonizing regulation of investment advisers and broker-dealers. SEC, Study on Investment Advisers and Broker-Dealers (Jan. 2011) (the "Advisers and Broker-Dealer Study"). As of October 2015, there were 11,956 registered investment advisers. SEC Office of Inspector General, Rept. No. 533, Office of Compliance Inspections and Examinations' Management of Investment Adviser Examination Coverage Goals (Mar. 10, 2016). Although SEC staff resources dedicated to adviser examination has decreased while the number of registered advisers has increased in recent years, the Advisers and Broker-Dealer Study indicates that the SEC continues to make adviser oversight a priority. The SEC uses risk-based methods to focus resources and compliance examinations on firms that present the greatest risks to investors. In 2015, the SEC conducted "nearly 2,000 formal examinations of registrants, an increase over each of the prior five fiscal years." SEC, 2015 Annual Report at 24. On February 3, 2017, President Trump directed the Secretary of Labor to reexamine the Fiduciary Duty Rule. *See* Presidential Memorandum on Fiduciary Duty Rule (Feb. 3, 2017).

Following the Advisers and Broker-Dealer Study, the SEC's Investor Advisory Committee recommended a framework for a new fiduciary duty standard applicable to broker-dealers under the Advisers Act. *See* Recommendation of the Investor Advisory Committee Broker-Dealer Fiduciary Duty (Nov. 2013). The SEC has not yet proposed rules to implement the recommendations of the Investor Advisory Committee; however, Chair White testified before Congress in 2016 on the SEC's 2017 budget request indicating that while the issue is "complicated" and not "quick" she supports advancing "a uniform fiduciary rule for broker-dealers and investment advisers" under § 913 of the Dodd-Frank Act. *See* Hearing to Review the FY17 Budget Request for the SEC & CFTC Before the S. Comm. on Appropriations, Subcomm. on Financial Services and General Government, 114th Cong. (2016) (testimony of SEC Chair White), http://www.appropriations.senate.gov/hearings/hearing-to-review-the-fy17-budget-request-for-the-sec-and-cftc.

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For a discussion of the 2016 Department of Labor rule defining a "fiduciary" of employee benefit plans under ERISA and certain retirement plans, *see* § 14.07[1][a].

9 *See infra* Note 19 and accompanying text.

10 *See* §§ 14.06[2] and 14.07[3] for a description of SRO activity and certain aspects of FINRA.

11 *See, e.g.*, Roberta S. Karmel, *The Challenge of Fiduciary Regulation: The Investment Advisors Act After Seventy-Five Years*, 10 BROOK. J. CORP. FIN. & COM. L. 405, 429–30 (2016); Richard Y. Roberts, Commissioner, Remarks at Midwest/Midsouth Securities Law Conference, Investment Adviser Reform (Feb. 14, 1992).

12 The Investment Advisers Modernization Act of 2016, if enacted, would make a number of changes to the Advisers Act and certain of its rules with respect to advisory services provided to clients other than registered investment companies. It proposes among other things to exempt certain communications from the books and records rule and amend the custody rule to only require publicly-traded securities and cash to be maintained with a qualified custodian. *See* Investment Advisers Modernization Act of 2016, H.R. 5424, 114th Cong. (2016).

13 SEC Release No. IA-1406 (Mar. 16, 1994). No further action has been taken with respect to this proposed rulemaking.

14 §§ 403, 407, 408 and 410 of the Dodd-Frank Act.

15 For a discussion of the Investment Company Act and the types of investment companies regulated thereunder, *see* Chapter 15.

16 Additionally, there are circumstances where even a registered adviser is prohibited from providing investment management services to certain types of clients. Advisers that have been convicted of felonies or have been subject to other forms of disciplinary action (so-called "bad actors") are prohibited from acting as the investment manager of hedge funds, private equity funds, registered investment companies or any other form of collective investment pool that offers its securities through private placement under Rule 506 of Regulation D. *See* SEC Release No. 33-9414 (July 10, 2013); *see also* § 7.02[2] for a description of the recently adopted "bad actor" rules for Regulation D offerings.

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U.S. Regulation of the International Securities and Derivatives Markets, § 16.02, ADVISERS ACT

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 16.02 (11th and 12th Editions 2014-2017)
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[1] Jurisdiction

The jurisdiction of the SEC to compel registration under the Advisers Act depends in the first instance on the existence of contacts with the United States. The requisite jurisdictional nexus may be established through the provision of services from or within the United States. Thus, an adviser domiciled in the United States who provides advice to non-U.S. persons, [17] as well as a foreign adviser providing advisory services to U.S. persons, will be subject to regulation under the Advisers Act. The staff of the SEC has taken the position, however, that a foreign adviser to foreign clients may use U.S. jurisdictional means to acquire information about the securities of U.S. issuers and may effect transactions in those securities through U.S. broker-dealers without registration under the Advisers Act. [18]

[a] Allocation of Regulatory Authority Between the SEC and the States

The Investment Advisers Supervision Coordination Act of 1996 (the "Coordination Act") effected a significant reallocation of the responsibilities for regulating investment advisers between the SEC and the state securities regulatory authorities, [19] and the Private Fund Advisers Act further reallocated responsibilities. Generally, the Coordination Act required advisers with $25 million or more of assets under management to register with the SEC; advisers with less than $25 million of assets under management that were registered with a state were prohibited from registering with the SEC. This reallocation of regulatory

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responsibilities from the SEC to the states primarily grew out of Congress's concerns that the SEC's resources are inadequate to supervise the activities of the growing number of investment advisers registered with the SEC and that many large advisers operating nationally have faced significant regulatory burdens in being subject to the differing laws of many states. The Coordination Act added § 203A to the Advisers Act, which provides that an investment adviser that is regulated or required to be regulated as an investment adviser in the state in which it maintains its principal office and place of business is prohibited from registering with the SEC unless such adviser (i) has assets under management [20] of not less than $25 million (or such higher amount as the SEC may by rule deem appropriate) or (ii) is an adviser to a registered investment company. [21]

The Private Fund Advisers Act maintains the $25 million threshold, but modifies § 203A of the Advisers Act to create a new group of "mid-sized" advisers and shifts primary regulatory oversight from the SEC to the state securities authorities for these advisers. [22] An investment adviser that (i) has assets under management between $25 million and $100 million (or such higher amount as the SEC may by rule deem appropriate) and (ii) is required to be registered in the state in which it maintains its principal office and place of business and subject to examination as an investment adviser by such state, is considered a "mid-sized" adviser and is prohibited from registering with the SEC. [23]

The SEC is authorized to deny registration to any applicant that does not meet the criteria for SEC registration, [24] and is directed to cancel the registration of any adviser that no longer meets the criteria for registration. [25] The SEC has the power to exempt investment advisers from the prohibition on SEC registration if the application of the prohibition would be "unfair, a burden on interstate commerce, or otherwise inconsistent with the

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purposes" of § 203A. [26] Rule 203A-2 under the Advisers Act exempts six types of advisers from the prohibition on SEC registration, and the SEC has adopted rule amendments to these exemptions:

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- nationally recognized statistical rating organizations ("NRSROs");
- pension consultants that provide investment advice to certain employee benefit plans with respect to assets having an aggregate value of at least $200 million; [27]
- any adviser that directly or indirectly controls, is controlled by or is under common control with an investment adviser that is eligible to register (and is, in fact, registered) with the SEC;
- newly formed investment advisers that have a reasonable expectation that, within 120 days, they will become eligible to register with the SEC;
- any adviser that is required to register as an investment adviser in 15 or more states; [28] and
- certain investment advisers that provide advisory services primarily through the Internet. [29]

Under § 203A(a)(1) of the Advisers Act, advisers that are not regulated or required to be regulated as investment advisers in the state in which they have their principal office and place of business must register with the SEC regardless of the amount of assets they have under management. This provision makes clear that the SEC will retain regulatory responsibility for an adviser in a state that has not enacted an investment adviser statute and for foreign advisers doing business in the United States.

A mid-sized adviser that relies on a state law registration exemption, or is otherwise "not required to be registered in a state," must register with the SEC unless another exemption applies. [30] Most states require registration unless the adviser has both no place of business in the state and relatively few clients in the state (following the national *de minimis* standard set forth in Section 222 of the Advisers Act). A small handful, including New York and New Jersey have a

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de minimis exemption regardless of whether an adviser has an office in the state. [31] However, if the state securities authority does not conduct compliance examinations, then the mid-sized adviser must register with the SEC. [32] The SEC has surveyed each state and made available a list of those non-examining states on its website. Notably, New York does not conduct examinations and as such, mid-sized advisers in New York are required to register with the SEC. [33]

In order to facilitate transition of mid-sized advisers to state regulation, the SEC amended Rule 203A-1. [34] If any SEC-registered adviser files an annual updating amendment to its Form ADV reporting it is not eligible for SEC registration, Rule 203A-1 requires such adviser to withdraw from SEC registration within 180 days of its fiscal year end. [35] During the transition period while the adviser is registered with both the SEC and the state securities authority, the Advisers Act and applicable state law would apply to the adviser's advisory activities. [36] Revised Rule 203A-1 also requires any state-registered adviser to apply for registration with the SEC within 90 days of filing an annual updating amendment to its Form ADV reporting eligibility for SEC registration and no reliance on an exemption. [37]

The Coordination Act gives the SEC primary responsibility for the regulation of advisers that remain registered with the SEC by preempting certain state laws with respect to those advisers, and the Dodd-Frank Act leaves this unchanged. The Coordination Act provides that no state laws regulating investment advisers or supervised persons of investment advisers shall apply to any person (i) that is registered under § 203 of the Advisers Act as an investment

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adviser or a supervised person of an investment adviser, except that a state may license, register or otherwise qualify any investment adviser representative who has a place of business located within that state, [38] or (ii) that

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is not registered under § 203 because that person is excepted from the definition of investment adviser under § 202(a)(11) of the Advisers Act. [39]

The Coordination Act also added § 222 to the Advisers Act. Section 222(b) provides that no state may enforce any law or regulation that would require an investment adviser to maintain any books or records in addition to those required under the laws of the state in which it maintains its principal office and place of business [40] if the investment adviser (i) is registered or licensed as such in the state in which it maintains its principal office and place of business and (ii) is in compliance with the applicable books and records requirements of the state in which it maintains its principal office and place of business. [41] Section 222(c) sets forth a similar rule regarding minimum net capital and bond posting requirements for investment advisers. Section 222(d) provides that no state may require an investment adviser to register with the securities commissioner of the state or to comply with such state's investment adviser law (except antifraud provisions) if the investment adviser (i) does not have a place of business located within the state, and (ii) during the preceding 12-month period, has had fewer than six clients who are residents of that state. [42]

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The Coordination Act preserves state authority over SEC-registered advisers in three areas. First, states may investigate and bring enforcement actions against SEC-registered advisers with respect to fraud and deceit. [43] Second, states may require SEC-registered advisers to file, for notice purposes only, documents filed by such advisers with the SEC. [44] Third, states may require SEC-registered advisers to continue paying state filing, registration and licensing fees. [45]

[b] Consequences of Registration

A foreign adviser who registers under the Advisers Act may well expect that the Advisers Act's requirements will apply to its activities in the United States, but may not appreciate that in the SEC's view the Advisers Act may be applicable to all of its activities, including those relating exclusively to offshore clientele. The impact on offshore business operations can include:

- requirements to deliver disclosure documents;
- limitations on principal transactions between an advisory client and an adviser or its affiliates;
- requirements to adopt, maintain and enforce a compliance program and a code of ethics;
- general antifraud prohibitions;
- reporting requirements with respect to advisers to "private funds" and "venture capital funds"; [46] and
- application of the SEC's recordkeeping and oversight requirements, which can entail disclosure of customer identities, if the SEC so determines in the case of enforcement proceedings. [47]

[c] Section 203(d)

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The SEC's position had historically been that if an adviser located outside the United States chose to register, the Advisers Act applied to all of its activities wherever conducted. This position was based on a 1970 amendment to the Advisers Act adding § 203(d). The amendment stated that registered advisers were prohibited from certain acts, practices or courses of conduct irrespective of whether they used the "mails or any means or instrumentality of interstate commerce." [48] Although the legislative history indicates that the addition of § 203(d) was intended to serve an evidentiary purpose—to eliminate the often burdensome requirement of showing that the adviser had used jurisdictional means in connection with its U.S. activities [49]—the SEC had taken the position that the addition of this provision permitted the SEC to apply the provisions of the Advisers Act to the wholly foreign activities of a registered non-U.S. investment adviser. [50]

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The apparent conflict between the SEC's position and the legislative history of § 203(d) [51] engendered a good deal of criticism by the private bar and market participants alike as contradicting the SEC's initiatives to promote internationalization of securities markets, such as Regulation S, [52] that are premised on a territorial approach and a desire to avoid extraterritorial extension of the regulatory (as opposed to antifraud) provisions of the U.S. securities laws in situations free of significant U.S. consequences. [53]

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In connection with its comprehensive study of the Investment Company Act and the Advisers Act, including a request for comment on the practicality of its extraterritorial application of Advisers Act, [54] the staff concluded that existing interpretations of the Act's reach required revision. In particular, in the 1992 Report, the staff endorsed a narrower, territorial approach to regulation of advisers based on a more traditional "conduct" and "effects" test. According to this approach, "the Advisers Act would apply to activities where a sizable amount of advisory services takes place *in the United States* or where the advisory services have effects *in the United States*." [55] This approach is consistent with the Dodd-Frank Act and related SEC rulemaking, both of which focus on advisers with a principal office and place of business in the United States and advisers with clients in the United States. However, the new exemptions from registration under the Private Fund Advisers Act as applied to foreign advisers focus also on the location of investors in private funds managed by the adviser and may require filings by a foreign adviser even if the foreign adviser has no place of business in the United States and no U.S. clients, if the foreign adviser has U.S. investors in the non-U.S. private funds it manages. *See* § 16.03[3] *infra*.

More difficult questions are raised by a multinational registered adviser and its non-U.S. clients, particularly where personnel from both U.S. and foreign offices provide services to a single client. The staff indicated that where the foreign client deals exclusively with personnel outside the United States and where the adviser has a policy that portfolio decisions for that client be in fact formulated by the non-U.S. office, the Advisers Act should not apply. [56] Advisers Act protections would, in contrast, seem appropriate in the case of foreign clients seeking advice regarding the U.S. market and employing principally the U.S.-based personnel of the adviser. [57]

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The staff first implemented certain elements of its revised interpretation of the jurisdictional reach of the Advisers Act in *Unibanco*, [58] in which it concluded that the registered foreign advisory subsidiary of a foreign bank need not comply with the Advisers Act with respect to its non-U.S. clients. [59] Relief was granted based in part on undertakings made by both the bank and its subsidiary to maintain books and records in compliance with SEC requirements that would "clearly reflect the investment advice given to [the subsidiary's] clients." [60] These undertakings reflect the staff's interest, first articulated in the 1992 Report, in ensuring that activities involving non-U.S. clients do not adversely affect U.S. clients or the integrity of the U.S. markets. [61]

[2] Subsidiaries and Affiliates

Many foreign entities wishing to conduct an advisory business with U.S. clients have organized separate entities to isolate the provision of those services that would require registration under the Advisers Act. Although the staff suggested in the 1992 Report that the "conduct" and "effects" test would result in diminished need by foreign advisers to create special subsidiaries to isolate their U.S. advisory activities, it recognized that for tax, internal policy or other reasons some advisers may nevertheless continue to operate their U.S. advisory business through a separate subsidiary. In such situations, the issue arises whether the new subsidiary entity is, in fact, the "investment adviser," or whether the offshore parent is merely doing indirectly what it could not do directly without registration, thereby violating § 208(d) of the Advisers Act. [62] The SEC staff has taken the position that the parent remains subject to the registration obligation if the subsidiary, rather than being the true adviser, is only an undercapitalized "shell" or alter ego established (i) to shield the parent from regulatory scrutiny and liability or (ii) to permit the parent to profit by trading

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based on recommendations made by the controlled entity to its clients (a practice sometimes known as "scalping"). [63]

Prior to the 1992 Report and *Unibanco*, the staff's position regarding integration of advisory entities was best articulated in its no-action letter *Richard Ellis, Inc.* ("Richard Ellis"). [64] In *Richard Ellis*, the staff indicated that a subsidiary may be considered independent of its parent for purposes of the Advisers Act if the subsidiary:

- is adequately capitalized;
- has a buffer (such as a board of directors with a majority of members independent of the parent) between the subsidiary's personnel and the parent;
- does not have personnel who participate directly in rendering advice to both the subsidiary's clients and the parent's clients;
- decides by itself what investment advice to communicate to, or use on behalf of, its clients, and has and uses sources of investment information that are not limited to its parent; and
- keeps its investment advice confidential until communicated to its clients.

A registered advisory subsidiary of an unregistered entity could nonetheless have a significant degree of shared personnel with its parent or other affiliate without subjecting the unregistered entity to the Advisers Act registration requirement. The registered adviser could also receive investment research services, including general economic or market analyses and advice, from its unregistered parent or other affiliate as long as (i) the parent or other affiliate is not the only source of the service, (ii) the service does not purport to meet the investment needs of a particular client or clients of the registered adviser or to recommend the purchase or sale of specific securities and (iii) the research or advice is not passed directly on to the clients of the registered adviser. The staff had also indicated that other support services and personnel, such as computer facilities and marketing personnel not otherwise involved in negotiating advisory contracts, could be shared between an investment adviser subsidiary and its parent

and other affiliates without subjecting the parent and affiliates to registration under the Advisers Act. [65]

In the 1992 Report, the staff concluded that the SEC should "recognize separateness if the affiliated companies are separately organized (*i.e.*, two separate entities), and if the registered entity is staffed with personnel (whether physically located in the United States or abroad) who are capable of providing investment advice." [66] The staff nevertheless emphasized that advisory and supervisory personnel of the unregistered entity involved in advisory services provided to U.S. persons should be within the SEC's jurisdiction and that the unregistered entity should be subject to SEC access for monitoring purposes to ensure compliance with the Advisers Act.

The staff's view on the subject is exemplified in *Thomson Advisory Group, L.P.* [67] There the staff made clear that the concerns of §§ 203(a) and 208(d) of the Advisers Act are adequately addressed when (i) the unregistered affiliates of a registered adviser do not themselves provide investment advice (the affiliates' activities were limited to activity as general partners of investment partnerships), (ii) the unregistered affiliates and each of their employees are deemed "associated persons" [68] of the registrant when they have access to the investment recommendations of the registered adviser or information concerning the recommendations prior to the effective dissemination of the recommendations and (iii) the SEC has access to the unregistered affiliates' books and records to the extent necessary to examine the business of the registered adviser. [69]

As mentioned above in § 16.02[1][c], the staff originally implemented this approach in *Unibanco* where it agreed that the foreign parent of a foreign-domiciled registered investment adviser would not be subject to Advisers Act registration. [70] No-action relief in *Unibanco* was conditioned on several undertakings made by the parent to ensure SEC jurisdiction over the parent's operations to the extent relevant to the SEC's supervision of the registered advisory subsidiary. These conditions included, first, the appointment by the unregistered parent of an

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agent to accept service of process in SEC enforcement proceedings,

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as well as other proceedings arising out of or relating to the activities of its subsidiary or "any related securities transactions"—a term the staff stated would be construed broadly. [71] Second, the parent agreed to maintain books and records with respect to "related securities transactions" in English and in accordance with certain SEC rules and to cause its subsidiary to comply with Advisers Act recordkeeping requirements. Third, the parent agreed that its personnel involved in U.S. advisory activities would become "associated persons" of the subsidiary. [72] Finally, the parent agreed that it would produce its employees in connection with any SEC proceeding and authorize them to testify regarding their knowledge of the activities of the advisory subsidiary and "related securities transactions." Employees would be authorized to provide information relating to customers of the parent only with the consent of the parent, although the parent's agreement not to contest SEC proceedings otherwise than under U.S. law did not extend to any contest relating to customer identities. [73]

In subsequent no-action letters, the SEC staff has confirmed the position taken with respect to a parent and its SEC-registered subsidiary in *Unibanco* and has extended its approach to registered and unregistered affiliated companies. In *The National Mutual Group*, [74] the staff concluded that, subject to satisfaction of conditions substantially similar to those set out in *Unibanco*, each of several affiliated companies domiciled outside the United States could register under the Advisers Act without the need to comply with specified provisions of the Advisers Act in the case of its non-U.S. clients, including the "brochure" rule, prohibitions against performance fees and agency cross and principal transactions with affiliates, compliance with Advisers Act limitations on payments for client solicitations and certain recordkeeping requirements. The SEC staff also confirmed that it would not recommend enforcement action against any company within *The National Mutual Group* if it failed to enforce any policy or procedure required by or established pursuant to § 204A of the Advisers Act [75] or for other actions that may be deemed to violate the antifraud provisions of the Advisers

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Act to the extent that the action or omission in question would involve no conduct, or would have no effects, in the United States, or would have no effects on the U.S. clients of the company. [76] In addition, guidance that the so-called "substantive" requirements of the Advisers Act do not apply to a registered offshore adviser and its relationship with its non-U.S. clients was subsequently affirmed more recently in rule releases. [77] The "substantive" provisions the SEC staff has stated do not apply to the non-U.S. clients of an SEC-registered foreign adviser include the "compliance rule, custody rule, and proxy voting rule," "certain provisions that would otherwise be required by section 205 … section 206(3)'s restrictions … rules governing adviser advertising, or cash solicitations…." [78] Further, the SEC staff confirmed such an adviser is "not require[d] to deliver a written disclosure brochure to its offshore clients (or to any investors in an offshore private fund it advises) under rule 204-3, although the adviser does have a fiduciary duty to provide those clients with full and fair disclosure of conflicts of interest." [79] In addition, a registered offshore adviser, with respect to its non-U.S. clients, "will not be required to adopt a code of ethics but must retain its access persons' personal securities reports that would otherwise be required under such a code." [80]

Furthermore, in *Mercury Asset Management*, [81] the staff concluded that a foreign-domiciled SEC-registered adviser need not comply with the Advisers Act in the case of its non-U.S. clients and that the adviser's affiliates need not register under the Advisers Act solely by reason of providing research or other advisory services to the U.S. clients of the registered adviser through the registered adviser (*e.g.*, dual-hatted employees). While not withdrawing the position regarding subsidiaries in *Richard Ellis*, the staff stated its view that affiliated companies are separate if:

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> they are separately organized (*i.e.*, two distinct entities); the registered entity is staffed with personnel (whether physically located in the United States or abroad) who are capable of providing investment advice; all persons involved in United States advisory activities are deemed "associated persons" of the registrant; and the [SEC] has access to trading and other records of each affiliate involved in United States advisory activities, and to its personnel, to the extent necessary to monitor and police conduct that may harm United States clients or markets. [82]

Among the specific conditions to the relief granted in *Mercury Asset Management* was a requirement that the registered adviser list on its Form ADV (in addition to its directors) each of its investment managers expected to formulate investment advice for U.S. clients, as well as the names of each other individual and affiliate of the adviser involved in the formulation of such advice. The SEC also required that the registered adviser not hold itself out as such to its non-U.S. clients so as not to foster any expectation that the adviser's activities were governed by U.S. law. Each of the adviser's unregistered advisory affiliates was required to provide advisory services to U.S. persons solely through the registered adviser and to submit to the jurisdiction of the SEC to the extent previously required in *Unibanco*.

In *Kleinwort Benson Investment Management Ltd.*, [83] the staff concluded that certain foreign advisory affiliates of a U.S.-domiciled registered adviser need not register under the Advisers Act if they share certain portfolio managers with the registered adviser, subject to specific conditions substantially similar to those required in *Mercury Asset Management*. In a departure from prior practice, however, the staff did not require certain affiliates of the registered adviser whose activities were confined to publication of research reports to make the undertakings required of the other foreign affiliates. The staff noted that the materials received from the research affiliates would not be prepared specifically for the registered adviser's clients, and information barriers had been implemented to prevent the affiliates from obtaining information about the registered adviser's trade recommendations. [84]

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In *ABN AMRO Bank N.V.*, [85] the staff concluded that even though the adviser and its affiliates were restricted by Dutch law from making certain undertakings made in *Unibanco* and its progeny, they could still share personnel and provide certain services if certain substitute undertakings were made. Under Dutch law, ABN AMRO Bank was unable to make undertakings with respect to (i) providing the SEC staff with access to staff trading records and (ii) the availability of personnel for questioning by the staff. ABN AMRO Bank undertook, however, (a) to make a good faith effort to obtain written authorizations to provide staff trading records, (b) to make available for SEC inspection redacted staff trading records for those staff for which an authorization was not in effect and (c) to assist the SEC in enlisting the assistance of the Dutch regulatory authorities if the SEC determined it required information not in the trading records. [86]

Although the above no-action letters for the most part involved the relationship of U.S. based SEC-registered advisers with their foreign affiliates, the SEC generally has not addressed the applicability of the Advisers Act to the non-U.S. clients of a foreign unregistered adviser that is controlled by a U.S. person, where the U.S. person either is itself, or also controls, a U.S.-registered adviser. The staff stated in the 1992 Report that whether registration of the foreign adviser should be required in these circumstances is a difficult question, the resolution of which could turn on whether the non-U.S. client has substantial and direct contact with U.S.-based advisory personnel. [87] This approach was reaffirmed by the Private Fund Advisers Act exemptions to registration under the Advisers Act, which limit exemptions for foreign advisers based on having offices in or assets managed from the United States. Although such contacts can

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raise the specter of the "Barbary Coast" [88] (that is, the United States providing a haven for investment advisers

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seeking to avoid regulation in any jurisdiction), the better view is that registration of the foreign adviser should not be required either as a matter of law or policy. First, a separate non-U.S. adviser's non-U.S. activities should be relevant to U.S. regulators only insofar as they affect U.S. investors or U.S. markets. Second, the imposition of a registration requirement in these circumstances would place U.S. firms that seek to isolate their non-U.S. activities at a significant disadvantage relative to their foreign competitors. In this regard, the SEC staff has already acknowledged that the location of an adviser's personnel is not a relevant consideration in determining the independence of an advisory entity from its affiliates, [89] a conclusion largely motivated by the staff's concerns about competition and efficiency. [90] Finally, principles of comity and the problems inherent in reconciling U.S. law to often inconsistent provisions of foreign law make registration in such circumstances undesirable and impracticable. Nevertheless, in light of the staff's cautions in the 1992 Report, [91] pending further guidance in this area, it is not altogether clear whether the staff would extend its territorial approach to the Advisers Act in circumstances involving the provision of advisory services to the non-U.S. clients of a foreign adviser that is controlled by a U.S. person.

Notwithstanding the revised approach reflected in the 1992 Report and the *Unibanco* letters, which all post-date *Richard Ellis*, the SEC staff has not withdrawn *Richard Ellis*. It would seem reasonable to conclude that the staff's positions in *Unibanco* and its progeny are not exclusive, such that advisers that are unable or unwilling to accede to *Unibanco*-style procedural conditions [92] may continue to structure their operations to achieve a satisfactory degree of independence in reliance on *Richard Ellis*. Indeed, the SEC staff's position in the 1992 Report suggests that adequate independence can be achieved, without the necessity for the procedural requirements delineated in *Unibanco*, with some relaxation of the *Richard Ellis* requirements (*e.g.*, in the use of common employees providing investment advice, as suggested in *Kleinwort Benson Investment Management Ltd.*). [93] The SEC's adopting release for the final rules implementing the Private Fund Advisers Act generally affirms the *Unibanco* line of no-action letter guidance as applicable to foreign advisers, sanctioning, under certain conditions, interactions between a non-U.S. unregistered adviser and its U.S. registered affiliate. [94] In addition, the adopting release notes the *Richard Ellis* no-action letter providing certain requirements for recognizing the separateness of affiliated entities. [95]

Footnotes

17 *See infra* Note 162.

18 *See, e.g., Vocor International Holding S.A.* (avail. Apr. 9, 1990) (citing *Gim-Seong Seow* (avail. Nov. 30, 1987)); *Double D Management, Ltd.* (avail. Jan. 31, 1983). The staff has taken this position notwithstanding that "means or instrumentality of interstate commerce" is defined to include the facilities of a national securities exchange. § 202(a)(14) of the Advisers Act.

19 National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, Tit. III, 110 Stat. 3416, 3436 (1996) ("NSMIA").

20 The SEC's rules provide that the calculation of assets under management for registration purposes refers to an adviser's "regulatory assets under management," which is described in further detail in § 16.03[3][a][i].

21 § 203A(a)(1) of the Advisers Act and Rule 203A-1(a) thereunder.

22 An adviser with its principal office and place of business outside the United States is permitted to register with the SEC regardless of its assets under management.

23 § 410 of the Dodd-Frank Act.

24 § 203(c) of the Advisers Act.

25 § 203(h) of the Advisers Act.

26 § 203A(c) of the Advisers Act.

27 The value threshold under the former Rule 203A-2 was $50 million. 17 C.F.R. § 275.203A-2.

28 The state registration threshold under the former Rule 203A-2 was 30 or more states. 17 C.F.R. § 275.203A-2.

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29 Rule 203A-2 under the Adviser's Act; *see also* SEC Release No. IA-3221 (June 22, 2011); SEC Release No. IA-2091 (Dec. 12, 2002). An adviser is eligible for registration under Rule 203A-2(e) if the adviser provides investment advice to all of its clients exclusively through the adviser's interactive website, except that the adviser may advise fewer than 15 clients through other means during the preceding 12 months.

30 § 410 of the Dodd-Frank Act.

31 *See* N.Y. GEN. BUS. LAW § 359-eee(1)(a)(5) (excluding from the definition of "investment adviser" any "person who sold, during the preceding twelve month period, investment advisory services to fewer than six persons residing in this state, exclusive of financial institutions and institutional buyers …"); N.J. STAT. ANN. § 49:3-56(g)(1), (2) (exempting from registration a person with or without a place of business in the state if the person has had no more than five clients who are New Jersey residents other than certain financial institutions).

32 § 410 of the Dodd-Frank Act. The SEC also adopted Rule 203A-5, which required SEC-registered advisers that no longer qualified for SEC registration under the new assets under management threshold to transition from SEC to state registration by June 28, 2012.

33 SEC, Division of Investment Management, Frequently Asked Questions Regarding Mid-Sized Advisers (June 28, 2011). A mid-sized adviser with a principal office and place of business in Wyoming (which does not require adviser registration) or New York (which does not subject advisers to examination) must register with the SEC regardless of regulatory assets under management unless another exemption applies. "Regulatory assets under management" is described in further detail in § 16.03[3][a][i]. All other states subject state-registered advisers to examination.

34 *See* SEC Release No. IA-3221 (June 22, 2011).

35 Rule 203A-1(b)(2) under the Advisers Act.

36 Rule 203A-1(a)(1) provides a buffer for mid-sized advisers with regulatory assets under management between $90 million and $110 million. Such advisers may, but are not required to, register with the SEC (if below $110 million) or withdraw from SEC registration (if above $90 million).

37 Rule 203A-1(b)(1) under the Advisers Act.

38 Rule 203A-3 under the Advisers Act defines "*investment adviser representative*" as a supervised person of an SEC-registered investment adviser who has more than five clients who are natural persons and more than 10% of whose clients are natural persons.

39 § 203A(b)(1) of the Advisers Act.

40 § 985(c)(4) of the Dodd-Frank Act changed references in § 222 of the Advisers Act from "principal place of business" to "principal office and place of business."

41 § 222(b) of the Advisers Act.

42 § 222(d) of the Advisers Act. The SEC rules implementing the Private Fund Advisers Act amended Rule 222-2 under the Advisers Act, which explains how clients are counted for purposes of the national *de minimis* threshold of § 222(d) of the Advisers Act. The amended Rule 222-2 states that for purposes of the national *de minimis* threshold described in the text above, an adviser may rely on the definition of "client" provided by Rule 202(a)(30)-1 rather than Rule 203(b)(3)-1, which has been rescinded. Rule 202(a)(30)-1, like Rule 203(b)(3)-1, treats as a single client, among others, any natural person and (i) any relative or spouse of the natural person sharing the same principal residence and (ii) all accounts of which such persons are the sole primary beneficiaries. The rule also treats as a single client a corporation, partnership, trust or other legal organization that receives investment advice based on the objectives of the entity (and not its shareholders, partners, beneficiaries or members). *See* SEC Release No. IA-3222 (June 22, 2011). Unlike Rule 203(b)(3)-1, Rule 202(a)(30)-1 does not include a "special rule" providing advisers with the option of not counting as a client any person for whom the adviser provides investment advisory services without compensation. 17 C.F.R. § 275.203(b)(3)-1. *See* § 16.03[3][b][i] for a discussion of determining the number of clients for purposes of the foreign private adviser exemption.

43 § 203A(b)(2) of the Advisers Act.

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44 § 307(a) of the Coordination Act.

45 § 307(b) of the Coordination Act.

46 §§ 407 and 408 of the Dodd-Frank Act.

47 See Rule 204-2(c) under the Advisers Act (permitting designation of client identities on an adviser's books by numerical, alphabetical or other code) and § 209(b) of the Advisers Act (granting authority to the SEC to obtain such information under certain circumstances in an enforcement proceeding). However, certain provisions (*e.g.*, limitations on performance fees) do not apply to an adviser's dealings with offshore clients. *See* § 16.06.

48 § 203(d) of the Advisers Act. Section 203(d) provides that:

> Any provision of this title … which prohibits any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce are used in connection therewith shall also prohibit any such act, practice, or course of business by any investment adviser registered pursuant to this section or any person acting on behalf of such an investment adviser, irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith.

49 H.R. Rep. No. 1382, 91st Cong., 2d Sess. 40 (1970); S. Rep. No. 184, 91st Cong., 2d Sess. 47 (1969).

50 SEC Release No. IC-17534 (June 15, 1990); *Gim-Seong Seow* (avail. Nov. 30, 1987).

51 Among other things, the SEC's continued use, subsequent to the enactment of § 203(d), of a form (applicable solely to advisory conduct arising in any place subject to the jurisdiction of the United States) that registered, nonresident advisers are required to file consenting to service of process in legal actions had suggested that the SEC did not believe that registration alone provides a sufficient jurisdictional nexus to reach the wholly foreign activities of a foreign adviser. *See* Rule 0-2 under the Advisers Act. A senior staff member of the Division of Investment Management of the SEC—the division responsible for administering the Advisers Act—had endorsed this view and the conclusion that the Advisers Act should not apply to the wholly foreign activities of a nonresident adviser. Stanley B. Judd, *International Investment Advisers*, 19 REV. SEC. & COMM. REG. 1 (1986).

52 *See* Chapter 8.

53 *See* Edward F. Greene, Mitchell S. Dupler & Alan B. Cohen, *Jurisdictional Reach of the Investment Advisers Act of 1940*, 4 INSIGHTS 21 (1990); *see also* Stanley B. Judd, *International Investment Advisers*, 19 REV. SEC. & COMM. REG. 6–7 (1986) (suggesting that the SEC's exemptive power under § 206A of the Advisers Act should be exercised to exempt a foreign adviser from prohibitions relating to activities that are permitted under the law of the adviser's domicile). A number of the comment letters received by the SEC in response to the 1990 Concept Release also supported this position. *See, e.g.*, Letter from the American Bar Association (Oct. 18, 1990); Letter from Cleary, Gottlieb, Steen & Hamilton (Oct. 12, 1990); Letter from Davis, Polk & Wardwell (Oct. 10, 1990); Letter from Ropes & Gray (Oct. 9, 1990).

54 1990 Concept Release.

55 1992 Report at 222. The staff noted that the "conduct" and "effects" approach was supported not only by traditional principles relating to the appropriate jurisdictional reach of U.S. law, but also by numerous policy considerations, including comity. For example, the staff noted that the United Kingdom does not apply certain of its advisory regulations to the foreign activities of foreign advisers registered as such under U.K. law. Non-U.S. clients of a non-U.S. adviser would also be less likely to expect that U.S. law would govern the advisory relationship. 1992 Report at 229 n.26.

56 1992 Report at 233.

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57 1992 Report at 233.

58 *Unibanco* (avail. July 28, 1992); *see also American Bar Association Subcommittee on Private Investment Entities* (avail. Aug. 10, 2006) (the "ABA Private Investment Subcommittee"); *Royal Bank of Canada* (avail. June 3, 1998); *ABN AMRO Bank N.V.* (avail. July 1, 1997); *Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994); *Kleinwort Benson Investment Management Ltd.* (avail. Dec. 15, 1993); *Mercury Asset Management* (avail. Apr. 16, 1993); *The National Mutual Group* (avail. Mar. 8, 1993).

59 SEC rulemaking in response to the Dodd-Frank Act generally affirmed the *Unibanco* line of no-action letters. *See infra* Note 94 and accompanying text.

60 *Unibanco* (avail. July 28, 1992).

61 *Unibanco* (avail. July 28, 1992).

62 Section 208(d) of the Advisers Act provides that "[i]t shall be unlawful for any person indirectly, or through or by any other person, to do any act or thing which it would be unlawful for such person to do directly under the provisions of [the Advisers Act] or any rule or regulation thereunder."

63 *See*, *e.g.*, *Price Waterhouse* (avail. Oct. 1, 1987); *Kenneth Leventhal & Co.* (avail. Feb. 7, 1983); *United Asset Management Corp.* (avail. Nov. 2, 1981); *Richard Ellis, Inc.* (avail. Sept. 17, 1981); SEC Release No. IA-353 (Dec. 18, 1972).

64 *Richard Ellis, Inc.* (avail. Sept. 17, 1981) (involving an indirect subsidiary of a U.K. real estate investment adviser).

65 *Richard Ellis, Inc.* (avail. Sept. 17, 1981); *see also Gartmore Investment, Limited Investors Diversified Services, Inc.* (avail. Oct. 29, 1981); *C.B. International Investment Ltd.* (avail. Oct. 29, 1981); *Prudential Corp. Ltd.* (avail. Nov. 6, 1981).

66 1992 Report at 233–34.

67 *Thomson Advisory Group, L.P.* (avail. Sept. 26, 1995).

68 *See infra* Notes 72 and 426. Generally, an adviser's associated persons will be subject to the adviser's policies and procedures as if they were employees of the adviser.

69 *Thomson Advisory Group, L.P.* (avail. Sept. 26, 1995); *see also John W. Henry & Co., Inc.* (avail. Sept. 20, 1996); *Lazard Freres Asset Management* (avail. Feb. 12, 1996).

70 *Unibanco* (avail. July 28, 1992).

71 *Unibanco* (avail. July 28, 1992). The SEC staff has approved a specific form of appointment of an agent for these purposes. *See Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994); *Kleinwort Benson Investment Management Ltd.* (avail. Dec. 15, 1993); *Mercury Asset Management* (avail. Apr. 16, 1993).

72 § 202(a)(17) of the Advisers Act. A registered adviser has certain supervisory and other obligations with respect to its associated persons under §§ 203(e)(6) and 204A, which require, for example, implementation of policies and procedures preventing the misuse of material nonpublic information. Violations of these obligations can lead to regulatory proceedings against the adviser, including monetary penalties.

73 *Unibanco* (avail. July 28, 1992).

74 *The National Mutual Group* (avail. Mar. 8, 1993).

75 § 204A of the Advisers Act requires investment advisers, including state-registered advisers and unregistered advisers (other than those relying on exemptions in § 203(b) of the Advisers Act) to establish, maintain, and enforce policies and procedures to prevent the misuse of material nonpublic information. *See* § 16.13 for further discussion of the obligations of registered investment advisers regarding such policies and procedures.

76 *The National Mutual Group* (avail. Mar. 8, 1993).

77 Hedge Fund Release, 69 Fed. Reg. 72,054, 72,072–72,073 (Dec. 10, 2004). In its adopting release for the final rule implementing the new Dodd-Frank exemptions from the registration requirements of the Advisers Act, the SEC said that it does not "apply most of the substantive provisions of the Advisers Act to the non-U.S. clients of a non-U.S. adviser registered with the [SEC] and that nothing in that final rule "is intended to

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withdraw any prior statement of the [SEC] or the views of the staff as expressed in the *Unibanco* letters." SEC Release. No. IA-3222, 76 Fed. Reg. 39,646, 39,681 (July 6, 2011). Non-U.S. advisers with no U.S. clients may still be required to register with the SEC if, for instance, they provide advisory services from a place of business in the United States, even if their principal place of business is offshore.

78 Hedge Fund Release, 69 Fed. Reg. 72,054, 72,073 n. 221 (Dec. 10, 2004).

79 Hedge Fund Release, 69 Fed. Reg. 72,054, 72,073 (Dec. 10, 2004).

80 Hedge Fund Release, 69 Fed. Reg. 72,054, 72,073 (Dec. 10, 2004).

81 *Mercury Asset Management* (avail. Apr. 16, 1993).

82 *Mercury Asset Management* (avail. Apr. 16, 1993).

83 *Kleinwort Benson Investment Management Ltd.* (avail. Dec. 15, 1993).

84 *Kleinwort Benson Investment Management Ltd.* (avail. Dec. 15, 1993). The *Unibanco* letters generally permit a registered adviser and its participating affiliate to share personnel and other resources under certain conditions. For example, in the *Murray Johnstone* no-action letter, the permitted shared personnel included directors, officers, and employees, so long as any of these personnel participating in the advisory business of the U.S. registered adviser or having access to information concerning securities recommended to its U.S. clients were deemed "associated persons" of the U.S. registered adviser. *Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994).

85 *ABN AMRO Bank N.V.* (avail. July 1, 1997).

86 *ABN AMRO Bank N.V.* (avail. July 1, 1997). In *Royal Bank of Canada*, the staff reaffirmed the *Unibanco* position with regard to a group of affiliated entities under the Royal Bank of Canada umbrella and added that it would not recommend enforcement action if certain foreign trust company affiliates delegated investment discretion over the assets held by certain offshore trusts to a registered investment adviser affiliate or an unaffiliated registered investment adviser. *Royal Bank of Canada* (avail. June 3, 1998).

87 1992 Report at 233. The SEC staff previously took the position that if a foreign affiliate of a U.S.-domiciled registered adviser had no U.S. business, registration under the Advisers Act was not required, even where both entities were controlled by a U.S. person and without regard to the degree of independence between the registered entity and the foreign affiliate. *Double D Management, Ltd.* (avail. Jan. 31, 1983); *see also BOH Investment Management Co.* (avail. Jan. 2, 1987); *TAC America Ltd.* (avail. July 25, 1984). In a subsequent no-action letter, however, the staff appeared to cast doubt on the continued viability of these letters, at least in extreme circumstances. *H.P. Hambrick Co., Inc.* (avail. Oct. 14, 1988) (in refusing to grant relief, SEC staff noted that an issue was raised under § 208(d) where a U.S. resident was providing advisory services to foreign clients through a wholly owned offshore, unregistered entity, "particularly if the individual also provides advice to U.S. clients through another wholly-owned corporation registered as an adviser with the Commission").

88 *SEC v. Kasser*, 548 F.2d 109, 116 (3d Cir. 1977), *cert. denied, Churchill Forest Industries Ltd. v. SEC*, 431 U.S. 938 (1977); *see also Morrison v. National Australia Bank, Ltd.* 561 U.S. 247, 270 (2010); *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1017 (2d Cir. 1975).

89 1992 Report at 233–34.

90 1992 Report at 226.

91 *See supra* text accompanying Note 57.

92 Many offshore advisers may, for example, be reluctant to submit their unregistered advisory activities to the level of SEC scrutiny implied by the *Unibanco* conditions, particularly to the extent such scrutiny risks disclosure of customer identities. Although Rule 204-2(d) under the Advisers Act permits client identities to be indicated on an adviser's books by numerical, alphabetical or other similar code, ultimately that information could be obtained by the SEC in an enforcement proceeding. *See* § 210(c) of the Advisers Act.

93 *Kleinwort Benson Investment Management Ltd.* (avail. Dec. 15, 1993).

94 SEC Release No. IA-3222 (June 22, 2011). The adopting release notes, however, that the *Unibanco* letters

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were developed by the SEC staff in the context of the *de minimis* exemption, which was repealed by the Dodd-Frank Act. The release states that, while nothing in the newly adopted rules is intended to withdraw any prior statement of the SEC or the views of the staff as expressed in the *Unibanco* letters, the SEC expects that the staff will provide guidance, as appropriate, based on facts that may be presented to the staff regarding the application of the *Unibanco* letters in the context of the new foreign private adviser exemption and the private fund adviser exemption. *See*, *e.g.*, *Zenkyoren Asset Management of America, Inc.* (avail. June 30, 2011) (granting no-action to a wholly owned subsidiary of a Japanese insurance "federation" advising only the parent via funds in which the parent is the only investor).

95 SEC Release No. IA-3222 (June 22, 2011). The SEC also mentions several times in the adopting release § 208(d) of the Advisers Act (the prohibition against doing anything indirectly that the adviser would not be permitted to do directly) and the possibility of conflating entities that, while separately organized, are "operationally integrated" or otherwise appear to be in contravention of § 208(d) of the Advisers Act. *See In the Matter of TL Ventures Inc.*, SEC Release No. IA-3859 (June 20, 2014) (SEC charged that two affiliated exempted (one venture capital, one private fund) fund advisers were not operationally independent and should have been regarded as a single advisory organization in determining whether to rely on registration exemptions).

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U.S. Regulation of the International Securities and Derivatives Markets, § 16.03, REGISTRATION REQUIREMENT

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 16.03 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Any person, regardless of whether resident in or organized under the laws of the United States, who for compensation provides, in or from the United States, investment advisory services concerning securities, must register with the SEC as an investment adviser and comply with other provisions of the Advisers Act unless an exclusion or exemption is available. [96]

[1] Investment Adviser Defined

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The Advisers Act provides that an "*investment adviser*" is:

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.... [97]

Whether a person providing securities advisory services will satisfy this definition depends on all of the facts and circumstances.

[a] Providing Advice

It is clear that a person who offers advice on the value of specific securities, or issues reports including recommendations on specific securities, satisfies the first element of the definition of investment adviser. [98] Questions have

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been raised whether a database service that provides information regarding market conditions, industry sectors and the like would constitute an "analysis or report concerning securities" so as to require registration under the Advisers Act. In no-action correspondence, the SEC staff has taken the position that information relating to securities does not constitute an analysis or report within the meaning of § 202(a)(11) of the Advisers Act if (i) the information is readily available to the public in its raw state, (ii) the categories of information are not highly selective and (iii) the information is not organized or presented in a manner that suggests the purchase, holding or sale of any securities. [99] The staff has, on the other hand, refused to grant no-action relief where the information to be provided in the database relates to "closely held businesses which may expect to raise capital in future transactions exempt from the registration requirements of applicable securities laws." [100]

The SEC staff has also stated that persons who, as part of a regular business, provide advice or issue reports concerning securities in general or the relative value of investing in securities as compared to other types of

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investments would satisfy the definition of investment adviser, although financial planners who provide integrated financial services may make general recommendations regarding asset allocation among a variety of investments, including securities, without becoming subject to registration as an adviser. [101] Services for matching entrepreneurs with potential investors are, by contrast, generally not subject to registration if participants pay only an initial administrative fee and a periodic renewal fee to defray the costs of maintaining the database and the service does not participate in negotiations between the entrepreneurs and investors. [102]

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For many years, the staff also took the position that persons receiving compensation for referring clients to registered investment advisers were themselves subject to registration as investment advisers, unless they were in the employ or otherwise under the supervision and control of a registered investment adviser. [103] This position reflected the staff's view that conflicts of interest arising in the context of paid solicitation activities are inherently fraudulent and not susceptible to cure by disclosure. [104] The staff clarified its position with the adoption of Rule 206(4)-3 under the Advisers Act, which prohibits payment of cash fees for client solicitation otherwise than in accordance with the terms of the rule. [105]

[b] Engaging in a Business

Although the "business" component of the definition of investment adviser is stated somewhat differently in the Advisers Act depending on whether the person is providing advice or issuing reports, the SEC staff has stated its intention to interpret the requirement in the same fashion for both activities. [106] Satisfaction of the "business" component does not require that the person engage exclusively in securities advisory activities or that the activities be the person's principal line of business, but only that they constitute "a business activity occurring with some regularity." [107] In the case of financial planners who provide integrated investment and retirement planning services, the SEC staff has stated that it would consider a person to be "in the business" of providing advice if the person:

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(i) holds himself out as an investment adviser or as one who provides investment advice;

(ii) receives any separate or additional compensation that represents a clearly definable charge for providing advice about securities, regardless of whether the compensation is separate from or included within any overall compensation, or receives transaction-based compensation if the client implements the investment advice; or

(iii) on anything other than rare, isolated and nonperiodic instances, provides specific investment advice. [108]

The staff has also stated its intention to consider other financial services activities offered to clients in determining the presence of a business, such that a financial planner who limits his planning activities to general recommendations as to allocation of portfolio assets, but who also gives investment advice as to specific securities in his capacity as a registered representative of a broker-dealer, would be considered to be "in the business" of providing advice. [109]

The staff has also made clear that an employer that provides investment-related information to its employees who participate in the employer's defined contribution plan would not be an "investment adviser" as defined in the Advisers Act. [110] Although this exclusion applies regardless of the type of investment-related information provided by the employer, the exclusion only applies to employers and not to others who may provide investment-related information to plans or plan participants. [111]

In the case of publications, the staff has taken the position that the publication of an isolated book, pamphlet or article would not constitute the conduct of a "business," and thus generally would not subject the author or publisher to registration, if no specific recommendations of securities or issuers were made in the publication and if the publication were not part of a series or intended to be supplemented. [112]

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The staff's interpretive advice did not extend, however, to the licensing or use, particularly as part of computer programs or models, of mathematical or investment formulas to assist clients in making investment decisions. [113] In this connection, the staff has distinguished between mathematical formulas and computer models that are mere arithmetic tools, which would fail the "advice" component of the investment adviser definition, and those that may be used to make investment decisions. Thus, if a computer model generates information related to actual historical prices of securities or a client's particular financial and investment circumstances and suggests the purchase or sale of a category of securities or a particular security, the model would probably not be characterized as an arithmetic tool. [114]

[c] Receiving Compensation

The compensation component of the "adviser" definition is interpreted broadly by the SEC staff. [115] The receipt of any direct or indirect economic benefit, including commissions for directed brokerage, [116] is

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sufficient. [117] The compensation need not be paid directly by the client if the compensation or other benefit received relates to the advisory services rendered. [118] The fact that a person does not charge a separate fee for advisory services will not be dispositive of the compensation question, if the fee relates to a variety of services, including securities advice. [119] Additionally, although an adviser does not meet the definition of "investment adviser" unless it receives compensation for providing advice to others, once an adviser meets the definition by receiving compensation from one client, the Advisers Act applies to the relationship between the adviser and all of its advisory clients, including clients from which the adviser does not receive compensation. [120]

[2] Exclusions

The Advisers Act excludes certain entities from the definition of "investment adviser" and exempts certain investment advisers from its registration requirements. In most cases, entities are excluded or exempted because their activities are separately regulated under U.S. laws or because those activities are not considered to raise risks for investors requiring the protections afforded by the Advisers Act. The principal difference between exclusion and exemption is that persons exempt (but not those that are excluded) from registration remain subject to the restrictions on principal and agency cross-trading and other antifraud provisions of § 206 of the Advisers Act. Both excluded and exempted persons are subject to potential regulation by state and other local securities authorities [121] and remain liable to clients under state common law principles applicable to fiduciaries.

[a] Banks

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Among those persons excluded from the definition of investment adviser are U.S. banks [122] (and bank holding companies as defined by the Bank Holding Company Act of 1956) that are not "investment companies" within the meaning of the Investment Company Act. [123] Foreign banks do not meet the definition of "bank" since they are neither organized under U.S. law nor subject to U.S. regulation, and thus do not qualify for the Advisers Act exclusion. [124] Foreign banks with U.S. banking operations are treated as "bank holding companies" for purposes of U.S. banking law [125] and, although the SEC has yet to address the issue, may also qualify as such for purposes of § 202(a)(11)(A). If so, foreign banks

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may be excluded from regulation under the Advisers Act since, following the SEC's adoption of Rule 3a-6 under the Investment Company Act, such entities are no longer "investment companies." In any event, U.S. bank

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affiliates and branches (and, in some cases, perhaps agencies) of foreign banks are now typically considered "banks" under the Investment Company Act and are expressly included in the definition of "bank" under the GLB Act. [126] Accordingly, these entities will not be subject to any of the provisions of the Advisers Act, including its antifraud prohibitions.

[b] Broker-Dealers

A broker-dealer, including a foreign broker-dealer engaged in advisory activities permitted by Rule 15a-6 under the Exchange Act, [127] that provides investment advisory services solely incidental to the conduct of its business as a broker-dealer and that receives no special compensation for the services is excluded from the Advisers Act definition of "investment adviser." [128]

The SEC sought, by adopting Rule 202(a)(11)-1 under the Advisers Act, to address the applicability of the Advisers Act to broker-dealers offering certain types of fee-based (as opposed to commission-based) brokerage programs and to further clarify the meaning of the terms "solely incidental" and "special compensation." [129] In particular, the rule aimed to reconcile the increasing use of fixed or asset-based fees charged by broker-dealers for a package of services (including brokerage and incidental advice) with the statutory exclusion. Prior to Rule 202(a)(11)-1, such fees could be considered "special compensation" because they were not commission-based compensation, even if the package of services covered by the fee was commensurate with the services provided in a traditional brokerage arrangement.

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In 2007, the U.S. Court of Appeals for the District of Columbia Circuit vacated Rule 202(a)(11)-1, concluding that the SEC did not have the authority to broaden the exception from the definition of "investment adviser" for broker-dealers provided under § 202(a)(11)(C) of the Advisers Act. [130] The court held that, with § 202(a)(11)(C) of the Advisers Act, Congress unambiguously created a precise exemption from the adviser definition applicable to broker-dealers. Accordingly, "because broker-dealers are already expressly addressed in subsection (C), they are not ‘other persons' under subsection (F)," and the SEC cannot use such authority "to establish new, broader exemptions for broker-dealers." [131] In addition, the court noted that the SEC's general rulemaking authority under § 211(a) of the Advisers Act could not ignore this distinction. [132]

After determining not to appeal the *Financial Planning Association* decision, [133] the SEC proposed a new rule that would reinstate certain interpretative provisions of the vacated rule clarifying what services are considered "solely incidental" to a broker-dealer's business. [134] Under the proposal, a broker-dealer's exercise of investment discretion with respect to a customer account would *not* be considered a service solely incidental to brokerage services unless such discretion were granted by the customer on a "temporary or limited basis." In addition, investment advice provided for a separate fee or under a separate contract would *not* be solely incidental to brokerage services.

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The proposed rule would also reinstate an interpretation of "special compensation" that a broker-dealer would *not* be deemed to have received such compensation solely because it charged one customer a commission, mark-up, mark-down or similar fee for brokerage services that was greater or less than the fee it charged another customer. Under earlier SEC staff interpretations, full-service broker-dealers are potentially subject to the Advisers Act with respect to accounts for which they provide advice incidental to their brokerage services simply because they also offer discount brokerage services for a lower fee to other accounts. [135] The proposed rule also would clarify that broker-dealers are advisers only with respect to those accounts for which they provide services or receive compensation that subjects them to the Advisers Act.

The *Financial Planning Association* decision accelerated the release of a report the SEC had commissioned from the RAND Corporation addressing how the twin regulatory systems for broker-dealers and advisers affect investors. [136] Released in January 2008, the report concluded that, despite high levels of satisfaction, investors

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"typically fail to distinguish broker-dealers and investment advisers along the lines federal regulations define." [137] The report also surveyed industry practices and found them "very heterogeneous, with firms taking many different forms and offering a multitude of services and products." In a statement accompanying the release, the SEC stated it is studying the results of the report and is considering the potential regulatory implications of its findings. [138]

The Dodd-Frank Act requires the SEC to further consider the regulatory requirements applicable to broker-dealers and advisers through various studies, many of which have been completed and delivered to Congress for further consideration, and additional rulemaking authority. [139] The regulatory regime governing broker-dealers and advisers may be shaped by the findings,

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recommendations and conclusions of the mandated studies. However, as of publication, no new rules have been proposed in light of the studies.

[c] Publishers and Authors

Section 202(a)(11)(D) of the Advisers Act excludes from the definition of investment adviser "the publisher of any *bona fide* newspaper, news magazine or business or financial publication of general and regular circulation." [140] In one of the few instances in which it has addressed the Advisers Act, the U.S. Supreme Court interpreted this exclusion in a case involving an investment adviser who was statutorily barred from registering under the Advisers Act due to his previous disciplinary history. [141] The adviser had published a newsletter containing recommendations for "buying, selling, or holding stocks." On the facts, the Court held that the adviser was not required to be registered because his activities were within the publisher exclusion. [142] The Court based its holding on a finding that

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the newsletter was *bona fide*. As opposed to a "tip" sheet used to tout a security, the newsletter contained only "disinterested commentary and analysis," no "promotional material," and was of general and regular circulation. It was offered to the public at large and was not "timed to specific market activity or to events affecting or having the ability to affect the securities industry." [143] The Court indicated that inclusion of general recommendations concerning specific securities will not vitiate the *bona fides* of a publication so long as the recommendations are not based on the investment objectives of a particular customer. In addition, the Court suggested that a publication would not fail to be of regular circulation merely because the publication schedule was not "consistent." [144]

Although the Court's focus on "impersonal" advisory services creates an exemption that could be of substantial breadth, it should not be read as a means to avoid the antifraud provisions of the Advisers Act. One former SEC staff member has urged that if a publication of general and regular circulation were used as a "tout" or "tip" sheet, it would fail the *bona fides* test and subject the creator of the "tout" or "tip" sheet to the Advisers Act's antifraud provisions and possible SEC enforcement action. [145]

[d] Other Exclusions

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The Advisers Act also excludes from the definition of "investment adviser" certain professionals whose advice is solely incidental to their primary occupation [146] and persons whose advice relates exclusively to securities issued or guaranteed by the U.S. government or its corporate instrumentalities. [147] The Private Fund Advisers Act added a new exclusion for any family office, as defined by the SEC. [148] In addition, the Advisers Act delegates to the SEC the authority to designate other persons as not being within the scope of the definition. [149]

[3] Exemptions

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Even if an entity satisfies the definition of "investment adviser," it still may escape most of the Advisers Act provisions if it is eligible for one of the exemptions from registration provided in § 203(b) of the Act. [150] As stated above, an

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exempt adviser nevertheless continues to be subject to the antifraud provisions contained in § 206 of the Advisers Act. [151]

The Private Fund Advisers Act eliminated the most significant exemption from registration provided for in the Advisers Act that was relied upon by many advisers to hedge funds, private equity funds and other pooled investment vehicles, the so-called "*de minimis*" exemption. [152] The *de minimis* exemption was available to an adviser who (i) during the prior 12 months had fewer than 15 clients [153] (none of which is an investment company, or business development company, registered under the Investment Company Act) and (ii) did not "hold himself out generally to the public as an investment adviser." [154] To limit the expanded scope of the Advisers Act following the elimination of the *de minimis* exemption, the Private Fund Advisers Act established several new exemptions, including exemptions for "foreign private advisers," "private fund" advisers with assets under management in the United States of less than $150 million, and "venture capital fund" advisers.

On June 22, 2011, the SEC adopted new rules and rule amendments under the Advisers Act (the "Private Fund Advisers Rules") to implement the Private Fund Advisers Act, including the new exemptions replacing the *de minimis* exemption. [155] The Private Fund Advisers Rules clarify and define terms in the exemptions for foreign private advisers, private fund advisers and venture capital fund advisers.

[a] Private Fund Adviser Exemption

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The Private Fund Advisers Act creates an exemption from registration under the Advisers Act for an adviser that acts solely as an adviser to "private funds" (which is defined as an issuer that would be required to register as an investment company but for § 3(c)(1) or § 3(c)(7) of the Investment Company Act) and has assets under management in the United States of less than $150 million. [156]

[i] *Assets Under Management*

The Private Fund Advisers Rules change the way assets under management are calculated for purposes of adviser registration. The Private Fund Advisers Rules define a term "regulatory assets under management" ("R-AUM") to provide a uniform calculation of an adviser's assets under management when determining an adviser's eligibility for an exemption from registration with the SEC. [157] The calculation includes any proprietary assets, assets managed without receiving compensation [158] and assets of non-U.S. clients, all of which an adviser was permitted to exclude from its calculation of its assets under management under the former rules. [159] In addition, an adviser may not subtract outstanding indebtedness and other accrued but unpaid liabilities, which remain in a client's account and are managed by the adviser. [160] Furthermore, in the case of private funds, the calculation must include uncalled capital commitments and be based on the current market value (or fair value) of fund assets.

[ii] *In the United States*

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The SEC's interpretation of the phrase "in the United States" turns on whether the adviser is a U.S. or non-U.S. adviser. In calculating its R-AUM for purposes of this exemption, a U.S. adviser is required to include all private fund assets in its calculation, whereas a non-U.S. adviser is only required to include the amount of private fund assets it manages *at* a place of business in the United States. [161] Whether an adviser is a U.S. or non-U.S.

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adviser depends on where that adviser's "principal office and place of business" is located, which is understood to be the executive office of the investment adviser from which the officers, partners or managers of the investment adviser direct, control and coordinate the activities of the investment adviser. [162] The Private Fund Advisers Rules make clear that an adviser has only one "principal office and place of business." [163]

[iii] *Advisers Solely to Private Funds*

Under the Private Fund Advisers Rules, for non-U.S. advisers the condition that such advisers advise solely private funds is deemed fulfilled as long as all of the non-U.S. adviser's clients that are U.S. persons [164] are private funds. The requirement that an adviser advise solely private funds requires that an

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adviser relying on this exemption not advise any managed accounts that do not fit under the definition of private fund. [165]

While advisers who rely on the private fund adviser exemption are exempt from registering under the Advisers Act, they are still required to make certain disclosures to the SEC (as described in § 16.03[3][d] *infra*).

[b] Foreign Private Adviser Exemption

The Private Fund Advisers Act exempts from registration any investment adviser that is a "foreign private adviser," which it defines as an adviser that (i) has no place of business in the United States, (ii) has (a) in total, fewer than 15 U.S. person clients and investors in private funds advised by the adviser [166], and (b) aggregate assets under management attributable to such U.S. clients and investors of less than $25 million, and (iii) neither "holds itself out generally to the public in the United States as an investment adviser" [167] nor acts as an investment adviser to any investment company registered under the Investment Company Act or to an entity that is or has been elected to be treated as a business development company as defined in the Investment Company Act. [168] This

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exemption is similar in concept to the former *de minimis* exemption, except that the foreign private adviser exemption is available only to non-U.S. advisers, both investors and clients are counted for purposes of the exemption and there is an AUM threshold component. Unlike advisers to "private funds" and "venture capital funds," which are subject to reporting requirements despite exemption from registration, exempt foreign private advisers are not subject to reporting requirements.

The Private Fund Advisers Rules broadly define "place of business" as any office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts any such activities. [169] This definition captures advisers with any place of business in the United States and is particularly broad when compared with the current application of the Advisers Act, which distinguishes between advisers whose principal places of business are inside or outside the United States. Furthermore, a pure marketing or client service office that involves contacting clients, even if it does not provide any investment advice, will likely be captured by this definition, whereas an office that does not conduct advisory activities or communicate with clients likely would not be captured. [170] This may cause many foreign advisers to be ineligible for this exemption, but they may qualify for the private fund adviser exemption.

[i] *Determining the Number of Clients and Investors*

Each separate person or entity in the United States that receives investment advice from the adviser must be counted as a separate client in determining the availability of the foreign private adviser exemption. As under the prior rules regarding the *de minimis* exemption, "single advisee" treatment is accorded under the Private Fund Advisers Rules to trusts where the only beneficiaries are natural persons, their minor children, relatives and

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spouses. [171] Similarly, a

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corporation, general partnership, limited partnership, limited liability company, trust (other than of the type referred to in the preceding sentence) or other legal organization that receives investment advice based on its investment objectives rather than the individual objectives of its shareholders, partners, limited partners, members or beneficiaries, is deemed a single client. [172] "Single advisee" treatment will not be accorded, however, where any shareholder, partner, limited partner, member or beneficiary is otherwise an advisory client of the person (or any party related to such person) seeking to rely on it. [173] The Private Fund Advisers Rules also eliminate a "special rule" under the Advisers Act permitting an adviser not to count as a client any person for whom the adviser provides advisory services without receiving compensation. [174]

Unlike the former *de minimis* exemption, the foreign private adviser exemption counts not only U.S. clients but also each U.S. investor in private funds advised by the adviser. The Private Fund Advisers Rules define an "investor" as any person who would be included in determining the number or identity of beneficial owners or qualified purchasers under §§ 3(c)(1) and 3(c)(7) of the Investment Company Act. [175] To avoid double-counting, an adviser (i) does not need to count a private fund as a client if the adviser counted the investors in

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that private fund as investors with respect to that private fund for purposes of determining the availability of the exemption and (ii) is able to treat as a single investor any person who is an investor in two or more private funds advised by the investment adviser. [176] The Private Fund Advisers Rules do not include "knowledgeable employees" (as defined in Rule 3c-5 under the Investment Company Act) in the definition of "investor"; thus, a non-U.S. adviser need not count U.S. knowledgeable employees toward the 14 U.S. client and investor in private fund limit. [177]

[ii] *Holding Out to the Public*

A key component of the former *de minimis* exemption from registration as an investment adviser was the prohibition against the adviser's holding itself out to the public as an investment adviser. [178] Under the Private Fund Advisers Act, the same prohibition against "holding out" applies to foreign advisers relying on the foreign private adviser exemption but extends only to the adviser's activities in the United States—thus a foreign private adviser cannot hold itself out to the public in the United States as an investment adviser. [179] The SEC staff has taken a broad view of the types of activities that constitute "holding out to the public." The staff has repeatedly stated that if an adviser, by word of mouth or otherwise, lets it be known to the public that he is willing to take on new clients, or uses the term "investment adviser" or "investment counselor" on business cards, on stationery, or in a telephone or building directory, the staff will deem the adviser to have held himself out to the public as an investment adviser. [180] The SEC staff has also stated that participation in a "mini-account" or similar investment advisory program [181] and using a publicly available electronic medium, such as an Internet site, to provide information about the adviser's U.S. activities would be

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deemed "holding out" to the public. [182] In addition, the retention of a client referral service would in most, if not all, cases constitute *per se* "holding out" to the public. [183] As a practical matter, the difficulties of establishing an advisory business (other than as a private fund adviser, which regularly relied on the now rescinded *de minimis* exemption from Advisers Act registration, which included the same "holding out" criterion as noted below) without some kind of "holding out" to the public had substantially reduced the utility of the exemption.

Where entities act as advisers to private limited partnerships or other investment vehicles, the SEC departed from the harsh guidelines otherwise governing the "holding out" element. In response to concerns that the disclosure of an adviser's name in any offering document used to market limited partnership interests might constitute "holding out to the public," the SEC had included in Rule 203(b)(3)-1 under the Advisers Act a

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statement that a nonpublic offering of limited partnership interests in an entity for which a person acts as adviser is not "holding out to the public" by that person. [184] The same principle would appear to apply in the case of other passive investment vehicles.

[c] Venture Capital Fund Adviser Exemption

Advisers solely to venture capital funds are exempt from registration with the SEC under the Private Fund Advisers Act. The Private Fund Advisers Rules define a venture capital fund as a private fund that (i) holds no more than 20% of the fund's capital commitments in "non-qualifying investments" (other than short-term holdings), [185] (ii) does not borrow, provide guarantees or otherwise

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incur leverage in excess of 15% of the fund's capital contributions and committed capital (other than limited short-term borrowing), and any such borrowing or leverage (excluding certain guarantees by the fund of qualifying portfolio obligations) is for a non-renewable term of no longer than 120 calendar days, (iii) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances, (iv) represents itself as pursuing a venture capital strategy to investors, and (v) is not registered under the Investment Company Act and has not elected to be treated as a business development company. [186] A non-U.S. adviser may rely on the venture capital fund exemption if all of its clients, whether U.S. based or otherwise, are venture capital funds. [187]

The Private Fund Advisers Rules define "qualifying investment" generally as any equity security acquired directly from a "qualifying portfolio company" and certain equity securities exchanged for the directly acquired securities, and "qualifying portfolio company" as one that (i) is not a reporting or foreign traded company and does not have a control relationship with such a company, (ii) does not incur leverage in connection with the investment by the private fund and distribute the proceeds of any such borrowing to the private fund in exchange for the private fund investment, and (iii) is not itself a fund (*i.e.*, is an operating company). [188]

The definition of "venture capital fund" includes a grandfathering provision for any private fund that (i) represented to investors and potential investors at the time the fund offered its securities that it is a venture capital fund, (ii) has sold securities to one or more investors prior to December 31, 2010, and (iii) does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011. [189] Venture capital fund advisers that meet these requirements are not required to register with the SEC under the Private Fund Advisers Rules. These advisers, however, are still required to make certain disclosures to the SEC (as described in § 16.03[3][d] below).

No exemption from registration may be used for purposes of evading the application of the Advisers Act. [190] Accordingly, the activities of an unregistered adviser and a related registered adviser, or two or more related unregistered

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advisers, may be collapsed if the advisers do not have sufficiently distinct operations to permit the unregistered advisers to qualify separately for the exemptions relied upon. [191]

[d] Exempt Adviser Reporting Requirements

The Private Fund Advisers Act requires the SEC to determine reporting requirements as necessary and appropriate for advisers exempt from registration under the exemptions for advisers to venture capital funds and private funds ("Exempt Reporting Advisers"). [192] The reporting requirements, however, do not apply to exempt foreign private advisers. [193]

Under the Private Fund Advisers Rules, Exempt Reporting Advisers are required to complete a limited subset of the SEC's revised Form ADV. As a result, the Form ADV serves as both a registration and a reporting form, with the reporting section to be made publicly available on the SEC's website. [194] Exempt Reporting Advisers are

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required to file their initial Form ADV within 60 days of relying on an exemption that requires reporting. [195]

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Rule 204(b)-1 under the Advisers Act requires that SEC-registered investment advisers report systemic risk information to the SEC on Form PF if they advise at least $150 million in assets of one or more private funds. [196] Form PF elicits non-public information about private funds and their trading strategies the public disclosure of which, in many cases, could adversely affect the funds and their investors. The SEC does not intend to make public Form PF information identifiable to any particular adviser or private fund, although the SEC may use Form PF information in an enforcement action. The SEC requires Form PF to be filed each year, or in the case of certain "large private fund advisers" managing over an aggregate of $1 billion in private fund assets, each quarter.

[e] Other Exemptions

Section 203(b) of the Advisers Act currently provides for six other exemptions: (i) the "intrastate" exemption for advisers (other than advisers to private funds) operating exclusively within a single state whose advice is limited to nonexchange traded—or listed—securities, (ii) an exemption for advisers whose only clients are insurance companies, (iii) an exemption for certain advisers who are charitable organizations and provide advice only to charitable organizations, (iv) an exemption for certain advisers whose only clients are church-sponsored employee pension plans, (v) an exemption for certain registered CTAs performing limited securities advisory activities; and (vi) an exemption for certain advisers to small business investment companies that are regulated by the Small Business Administration. [197]

With respect to the intrastate exemption, the staff has taken the position that an adviser providing advice on the unlisted securities issued by a mutual fund that invests in exchange-listed securities would not satisfy the second element of the exemption. [198] For purposes of determining whether a client is a resident of a state, the staff has generally found that a corporation that is incorporated and domiciled [199] or has its principal place of business within a state [200] will qualify as a "resident" for purposes of the exemption.

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The exemption for registered CTAs, part of which was enacted as part of the Commodity Futures Modernization Act ("CFMA"), [201] applies to a registered CTA whose business does not consist "primarily of acting as an investment adviser" and who does not act as an investment adviser to a registered investment company. [202] There is currently no guidance as to the level of securities advisory activity that would cause a CTA to be acting "primarily" as an investment adviser. The Private Fund Advisers Act added an exemption for registered CTAs that advise private funds, but requires any such adviser whose business after the date of enactment of the Private Fund Advisers Act becomes predominately the provision of securities-related advice to register with the SEC, unless such adviser could meet another exemption. [203]

Footnotes

96 In addition to its authority to require registration under the Advisers Act, the SEC also has authority to cause the deregistration of any adviser that "is not engaged in business as an investment adviser." § 203(h) of the Advisers Act. As noted above, persons providing investment advice with respect to security futures products, which are defined as both securities and futures contracts, may be required to register as CTAs. U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 8.07. In September 2013, the SEC also adopted rules that provide a means for entities that qualify as "municipal advisors" under § 975 of the Dodd-Frank Act to fulfill the Dodd-Frank Act's requirement that such entities register with the SEC to be able to provide advice to or solicit municipal entities (unless an exception applies). Municipal advisors are deemed under the Exchange Act to have a statutory fiduciary duty to any municipal entity they advise. *See* SEC Release No. 34-70462 (Sept. 20, 2013); *see also* Rules 15Ba1-1 through 15Ba1-8 and 15Bc4-1 under the Exchange Act. The Dodd-Frank

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Act's definition of "municipal adviser" excludes any adviser registered under the Advisers Act and any CTA registered under the CEA or persons associated with a CTA who provide advice with respect to swaps. *See* § 15B(e)(4)(C) of the Exchange Act; *see also* SEC Release No. 34-63576 (Dec. 20, 2010)

97 § 202(a)(11) of the Advisers Act. A person's status as an investment adviser may also in certain circumstances depend on other laws. For example, § 2(c)(20) of the Investment Company Act defines an "investment adviser" to an investment company, in some respects more broadly than the Advisers Act, as:

> (A) any person … who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company, and
>
> (B) any other person who pursuant to contract with a person described in clause (A) regularly performs substantially all of the duties undertaken by such person.

§ 2(A)(20) of the Investment Company Act.

98 § 761 of the Dodd-Frank Act amended the definition of "security" under the Securities Act and the Exchange Act to include security-based swaps. Although the Advisers Act was not similarly amended, given the SEC Division of Investment Management's expansive views on what constitutes a "security" for Advisers Act purposes, a person who offers advice with respect to security-based swaps is likely to be considered to satisfy this first element. The fact that a person only offers securities advice to registered investment advisers or any other subgroup of the general public will not allow such person to avoid registration as an investment adviser. *David Parkinson, Ph.D.* (avail. Oct. 19, 1995).

99 *Charles Street Securities* (avail. Feb. 27, 1987); *see also Angel Capital Electronic Network* (avail. Oct. 25, 1996) (compilation of small corporate stock offerings arbitrarily ordered and derived from information publicly available or readily available from the issuers would not subject provider to registration); *Missouri Innovation Center, Inc.* (avail. Oct. 17, 1995) (newsletter describing securities offerings in the state of Missouri derived from publicly available information and organized alphabetically with no buy or sell recommendations would not subject provider to registration); *Investex Investment Exchange Inc.* (avail. Apr. 9, 1990) (compilation of limited partnerships and related monthly newsletter describing limited partnerships would not subject provider to registration); *NoLoad Mutual Fund Association, Inc.* (avail. Dec. 31, 1984) (compilation of statistical performance data of mutual funds derived from publicly available information and organized alphabetically with no buy or sell recommendations would not subject provider to registration); *Richard Daniels* (avail. Dec. 12, 1984) (monthly newsletter compiling information derived from official records relating to Arizona limited partnerships would not subject provider to registration).

100 *J.D. Manning, Inc.* (avail. Jan. 21, 1986); *see also Butcher & Singer, Inc.* (avail. Jan. 2, 1987).

101 *See, e.g.*, SEC Release No. IA-1092 (Oct. 8, 1987) (citing *Richard K. May* (avail. Dec. 11, 1979)) (revising and updating the staff's earlier interpretive positions taken in SEC Release No. IA-770 (Aug. 13, 1981)); *see also Pauline Wang* (avail. Mar. 21, 1980); *Hayes Martin* (avail. Feb. 15, 1980).

102 *See*, *e.g.*, *Angel Capital Electronic Network* (avail. Oct. 25, 1996); *Capital Resources Network* (avail. Apr. 23, 1993). The operator of an Internet bulletin board that acts as a passive medium for participants to obtain information about other participants interested in buying or selling the stock of certain companies need not register as an investment adviser where the operator is not providing investment advice. *Internet Capital Corp.* (avail. Jan. 13, 1998).

The staff has also indicated that a company may establish an electronic bulletin board to facilitate the purchase and sale of its common stock without becoming subject to registration as an investment adviser

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so long as the company does not receive compensation for creating or maintaining the bulletin board, is not involved in any purchase or sale negotiations arising from the bulletin board and does not give advice regarding the merits or shortcomings of any particular trade. *Perfect Data Corp.* (avail. Aug. 5, 1996).

103 *See*, *e.g.*, *Rhodes, King, Ruman & Farber* (avail. Nov. 2, 1972); *see also* SEC Release No. IA-1092 (Oct. 8, 1987).

104 *See*, *e.g.*, *Argus Securities Management Corp.* (avail. July 1, 1971).

105 *See* § 16.08[3] for a discussion of Rule 206(4)-3 under the Advisers Act.

106 SEC Release No. IA-1092 (Oct. 8, 1987).

107 SEC Release No. IA-1092 (Oct. 8, 1987), 52 Fed. Reg. 38,400, 38,402 (Oct. 16, 1987); *cf. Technology Capital Network, Inc.* (avail. June 5, 1992) (matching service identifying prospective investors in venture capital enterprises was not subject to registration where, *inter alia*, only an annual subscription fee was charged such that service did not constitute an analysis or report issued "as part of a regular business"); *Capital Resources Network* (avail. Apr. 23, 1993).

108 SEC Release No. IA-1092 (Oct. 8, 1987).

109 SEC Release No. IA-1092 (Oct. 8, 1987).

110 *See Employer Sponsors of Defined Contribution Plans* (avail. Dec. 5, 1995).

111 *See Employer Sponsors of Defined Contribution Plans* (avail. Feb. 22, 1996).

112 SEC Release No. IA-563 (Jan. 10, 1977). This release nevertheless clarifies that, to avail itself of the staff's interpretation, a publisher must not be engaged in any other advisory activities that would otherwise bring the publisher within the definition of investment adviser. An additional requirement previously imposed by the staff in no-action responses—that the publication not contain any investment formulas—was abandoned by the staff because of the difficulty of differentiating "essentially mechanical formulae or guidelines [from] those more general investment philosophies, techniques or analytical approaches for which registration under the [Advisers] Act has not normally been required in the absence of other factors." *See* 42 Fed. Reg. 2953, 2953 (Jan. 14, 1977).

113 *See*, *e.g.*, *Marakon Systems, Inc.* (avail. Sept. 6, 1982); *Syrus Associates, Ltd.* (avail. Oct. 23, 1981). In *Syrus Associates, Ltd.*, the staff clarified in taking this position that the seller or other provider of the formula or model must not provide any information or assistance in preparing data or assumptions for use with the formula or model. *See also Wilson Associates* (avail. May 25, 1988); *cf. Datastream International, Inc.* (avail. Mar. 15, 1993).

114 *See*, *e.g.*, *Computer Language Research, Inc.* (avail. Dec. 26, 1985); *Monchik-Weber Associates, Inc.* (avail. Oct. 23, 1981); *TMI Investment Systems Corp.* (avail. Apr. 15, 1978). *But see*, *e.g.*, *Innosearch Corp.* (avail. Sept. 12, 1985) (computer tool used to evaluate "hypothetical" options contracts); *Warren P. Humphreys* (avail. July 23, 1984) (program indicated whether "stocks" would fall or rise in price).

115 The principal source of elaboration regarding the compensation issue is the exclusion from the definition of investment adviser for any broker or dealer that provides advice solely incidental to its business and not for special compensation, which was the subject of scrutiny both by the SEC and by the broker-dealer community in the wake of U.S. deregulation of commission rates in 1975. The broker-dealer exclusion is discussed in § 16.03[2][b].

An adviser's receipt of compensation may also raise the converse question, that is, whether the adviser must register as a broker-dealer. The SEC staff has taken the position that where, *inter alia*, fees charged by an adviser are not based on transactions effected for the accounts of advisory clients and the adviser does not have actual custody of client funds (even though it may have full discretionary authority with respect to such funds), the adviser need not register as a broker-dealer. *See*, *e.g.*, *Robert R. Jones* (avail. Nov. 14, 1984); *Kirr, Marbach & Co.* (avail. Feb. 6, 1977); *First Atlantic Investment Advisory Corp.* (avail. Mar. 22, 1974); *Fundamental Advisors, Inc.* (avail. Dec. 4, 1971); *Mecs, Ph.D., B.M.* (avail. Dec. 6, 1970); see also Chapter 14 for a discussion of U.S. regulation of broker-dealers.

116 "Directed brokerage" refers to the practice of advisory clients to direct their brokerage transactions to a

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particular broker either as payment for the advisory fees of an affiliated adviser (or as payment for some other service that the broker renders to the adviser, whether or not affiliated) or other expenses of the client or to achieve a favorable commission rate. *See* § 16.09 for a discussion of fiduciary obligations in the context of directed brokerage and "soft dollar" transactions.

117 The staff has refused to grant no-action relief to an individual who proposed not to charge any fees, but instead would ask only for a voluntary commission. *Russell H. Smith* (avail. May 2, 1996).

118 SEC Release No. IA-1092 (Oct. 8, 1987) (citing *Warren H. Livingston* (avail. Mar. 8, 1980)).

119 SEC Release No. IA-1092 (Oct. 8, 1987) (citing *Warren H. Livingston* (avail. Mar. 8, 1980)); *see also United States v. Elliott*, 62 F.3d 1304 (11th Cir. 1995) (holding that defendants were compensated for providing investment advice, despite the fact that plaintiffs did not pay a discrete fee specifically earmarked as payment for investment advice); *Independent Drug Wholesalers Group, Inc.* (avail. Apr. 16, 1992) (no-action relief denied to president of a trade association who proposed to provide to members of the association, free of charge, recommendations regarding stock of pharmaceutical companies based on information in the association's possession regarding sales of specific drugs in part because he would receive indirect compensation in the form of his salary paid out of association members' dues).

120 *See* SEC Release No. IA-3222 (June 22, 2011).

121 *See* § 16.14 for a discussion of state regulation of investment advisers.

122 The Advisers Act defines "*bank*" as:

> (A) a banking institution organized under the laws of the United States or a Federal savings association, as defined in section 2(5) of the Home Owners' Loan Act, (B) a member bank of the Federal Reserve System, (C) any other banking institution, savings association, as defined in section 2(4) of the Home Owners' Loan Act, or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks or savings associations, and which is not operated for the purpose of evading the provisions of [the Advisers Act], and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

§ 202(a)(2) of the Advisers Act.

123 The definition of "investment adviser" was, however, amended by the Gramm-Leach-Bliley Act (the "GLB Act") to include any bank or bank holding company "to the extent that such bank or bank holding company serves or acts as an investment adviser to a registered investment company." Nevertheless, "if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, shall be deemed to be the investment adviser." GLB Act, Pub. L. No. 106-102, 113 Stat. 1338, 1399 (1999).

124 While the definition of "bank" in § 2(a)(5) of the Investment Company Act used to be substantially identical to that provided in the Advisers Act, the GLB Act amended the definition in the Investment Company Act to strike clause (A), which read, as in the Advisers Act definition, "a banking institution organized under the laws of the United States," and inserted a new clause (A), which now reads "a depository institution (as defined in § 3 of the Federal Deposit Insurance Act) or a branch or agency of a foreign bank (as such terms are defined in § 1(b) of the International Banking Act of 1978)." § 2(a)(5)(A) of the Investment Company

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Act. For a discussion of foreign banks and the "bank" exception under the Investment Company Act, see § 15.05[2].

125 Although these entities do not technically meet the definition of a "bank holding company" under the Bank Holding Company Act, they are nevertheless deemed bank holding companies under the Bank Holding Company Act. 12 U.S.C. § 3106 (2010).

See also § 202(a)(2)(C) of the Advisers Act.

126 *See also* § 202(a)(2)(C) of the Advisers Act.

127 *See*, *e.g.*, *Charterhouse Tilney* (avail. July 15, 1993) (no-action relief granted to foreign broker-dealer that proposed to (i) provide research reports to major U.S. institutional investors and to effect transactions in the securities discussed in the research reports with or for these investors and (ii) distribute those reports to U.S. persons other than major institutional investors through its U.S. registered broker-dealer affiliate); *Brown Shipley Stockbroking Limited* (avail. Dec. 6, 1989) (explaining that a foreign broker-dealer not registered with the SEC generally would be required to register as an investment adviser (absent an available exemption or exception from registration) where the foreign broker-dealer sought to manage the investment portfolios of U.S. residents).

128 § 202(a)(11)(C) of the Advisers Act. This exclusion for broker-dealers would also cover a futures commission merchant that has notice-registered as a broker-dealer for the limited purpose of effecting transactions in securities futures products. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 4.07.

129 *See* SEC Release No. IA-2376 (Apr. 12, 2005); *see also Securities Industry Association* (avail. Dec. 16, 2005).

130 *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

131 *Financial Planning Association v. SEC*, 482 F.3d 481, 488 (D.C. Cir. 2007). As the opinion notes, following an amendment to § 202(a)(11) of the Advisers Act by the Credit Rating Agency Reform Act of 2006, subsection (F) was redesignated as subsection (G). The opinion refers to the former designation. *Financial Planning Association v. SEC*, 482 F.3d 481, 483 n.1 (D.C. Cir. 2007).

132 *Financial Planning Association v. SEC*, 482 F.3d 481, 493 (D.C. Cir. 2007).

133 Press Release, SEC, SEC Seeks Time for Investors and Brokers to Respond to Court Decision on Fee-Based Accounts (May 14, 2007). To facilitate the transition of non-advisory fee-based accounts, the SEC sought a 120-day stay of the decision, and provided a temporary alternative method for advisers to comply with certain requirements of the Advisers Act related to principal transactions with advisory clients for whom the adviser does not have discretion, SEC Release No. IA-2653 (Sept. 24, 2007). The sunset period for this temporary alternative method has been extended to December 31, 2016. SEC Release No. IA-3984 (Dec. 23, 2014); *see infra* Note 270.

134 SEC Release No. IA-2652 (Sept. 24, 2007). The SEC removed the proposed rule from the unified regulatory agenda in 2012, but stated that it may consider the reforms at some future point. *See* SEC, The 2012 Regulatory Plan and the Unified Agenda of Federal Regulatory and Deregulatory Actions, RIN 3235-AJ97 http://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201210&RIN=3235-AJ97. If reconsidered and adopted, the new interpretations would be codified as Rule 202(a)(11)-1, replacing the vacated rule.

135 *See* SEC Release No. IA-626 (Apr. 27, 1978); SEC Release No. IA-2 (Oct. 28, 1940).

136 *See* Press Release, SEC, SEC Seeks Time for Investors and Brokers to Respond to Court Decision on Fee-Based Accounts (May 14, 2007); Press Release, SEC, SEC Awards Contract for Study to Compare Roles of Investment Advisers, Broker-Dealers (Sept. 26, 2006).

137 Angela A. Hung, *et al.*, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers* (RAND Corp. 2008).

138 Press Release, SEC, SEC Publishes Text of RAND Report on Investment Adviser, Broker-Dealer Industries (Jan. 3, 2008); *see* Andrew J. Donohue, Director, SEC Division of Investment Management, Remarks at the Tenth Annual Investment Adviser Compliance Best Practices Summit (Mar. 21, 2008); *see*

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also the Advisers and Broker-Dealer Study (citing the RAND report among other SEC-commissioned studies to support the need for uniform treatment of retail investors by broker-dealers and investment advisers).

139 *See*, *e.g.*, § 913 of the Dodd-Frank Act (requiring the SEC to conduct a study concerning the obligations of broker-dealers and investment advisers and authorizing the SEC to promulgate rules concerning, among other things, the legal or regulatory standards of care for broker-dealers, investment advisers and persons associated with these intermediaries for providing personalized investment advice about securities to retail customers) and related Advisers and Broker-Dealer Study (*see supra* Note 8) (while the SEC's Investor Advisory Committee has recommended an enhanced standard of care for broker-dealers, the SEC has not yet proposed any new rules in the area, though Chair White testified before Congress in 2016 on the SEC's 2017 budget request that she "expect[s] to continue to develop support from [her] fellow Commissioners for a uniform fiduciary duty for investment advisers and broker-dealers"); § 914 of the Dodd-Frank Act (requiring the SEC to review and analyze the need for enhanced examination and enforcement resources for investment advisers) and related SEC Study on Enhancing Investment Adviser Examination (Jan. 2011); § 919 of the Dodd-Frank Act (authorizing the SEC to issue rules designating documents or information that shall be provided by a broker or dealer to a retail investor before the purchase of an investment product or service by the retail investor) and related SEC Study and Recommendations on Improved Investor Access to Registration Information About Investment Advisers and Broker-Dealers (Jan. 2011). Separate FINRA proposals to address the study's recommendations by requiring broker-dealer websites to include links to BrokerCheck in different ways were made and withdrawn through the period from 2012 to 2014. *See* FINRA Regulatory Notice 12-10 (Feb. 2012); SEC Release No. 34-68700 (Jan. 18, 2013); FINRA Regulatory Notice 14-19 (Apr. 2014). FINRA proposed a requirement to include a link to BrokerCheck to be "readily apparent" on member websites intended to be viewed by retail investors or that include a professional profile of one or more registered persons who conduct business with retail investors. SEC Release No. 34-75377 (July 7, 2015). The SEC approved the requirement, amending FINRA Rule 2210, in 2015, and the requirement's effective date was in June 2016. *See* SEC Release No. 34-76105 (Oct. 8, 2015); FINRA Rule 2210(d)(8). On February 3, 2017, President Trump directed the Secretary of Labor to reexamine the Fiduciary Duty Rule. *See* Presidential Memorandum on Fiduciary Duty Rule (Feb. 3, 2017).

140 The SEC staff has also found that the exclusion may extend in certain circumstances to video information services, *Reuters Information Services, Inc.—TV 2000* (avail. Jan. 17, 1991), and to telephonic market timing services, *Charles L. Simpson* (avail. July 7, 1992).

141 *Lowe v. SEC*, 472 U.S. 181 (1985).

142 Although the Court decided the case on statutory grounds, First Amendment concerns played a role in its reasoning. The Court noted that:

> [T]he legislative history [of the Advisers Act] demonstrates that Congress was primarily interested in regulating the business of rendering personalized investment advice, including publishing activities that are a normal incident thereto. On the other hand, Congress, plainly sensitive to First Amendment concerns, wanted to make clear that it did not seek to regulate the press through the licensing of nonpersonalized publishing activities.

Lowe v. SEC, 472 U.S. 181, 204 (1985).

In a concurring opinion, in which Chief Justice Burger and Justice Rehnquist joined, Justice White rejected the majority's statutory construction, concluding that the definition of investment adviser could encompass publishers of impersonal investment advice, but that First Amendment principles would not permit the

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blanket injunctive relief at issue in *Lowe*. *Lowe v. SEC*, 472 U.S. 181, 211 (1985).

143 *Lowe v. SEC*, 472 U.S. 181, 206–09 (1985). The staff of the SEC has suggested, for example, that a "900 number" service providing telephonic recorded stock tips may qualify for the publishers' exclusion under *Lowe*. *Mary Lee Botsaris—900 Stock Tip Number* (avail. Mar. 25, 1993).

144 *Lowe v. SEC*, 472 U.S. 181, 209 (1985).

145 David Ferber, *The Narrow Holding of the Lowe Case*, 19 REV. SEC. & COMM. REG. 29 (1986); *see also SEC v. Wall Street Publishing Institute, Inc*., 851 F.2d 365 (D.C. Cir. 1988), *cert. denied*, 489 U.S. 1066 (1989); SEC Litigation Release No. 10813 (July 8, 1985).

In ruling on a motion to dismiss, one court has held that an individual who maintained a website which touted certain stocks and e-mailed his stock picks to subscribers could be considered an investment adviser. *SEC v. Park*, 99 F. Supp. 2d 889 (N.D. Ill. 2000). The court rejected the argument that the service was not personalized and found that the SEC had alleged facts sufficient to show that the defendant may not fall within the publisher's exemption for registration under the Advisers Act.

146 § 202(a)(11)(B) of the Advisers Act excludes "any lawyer, accountant, engineer or teacher whose performance of such services is solely incidental to the practice of his profession."

147 § 202(a)(11)(E) of the Advisers Act. The SEC staff has questioned the availability of the exclusion for advice regarding U.S. government securities where an adviser proposed to advise as to repurchase agreements. *J.Y. Barry Arbitrage Management Inc*. (avail. Oct. 18, 1989) (citing SEC Release No. IC-10666 (Apr. 18, 1979) and *The Prospect Group* (avail. Nov. 29, 1988)). The staff based its conclusion on its position that a repurchase agreement should be viewed as a loan rather than a sale and repurchase of securities, so that the repurchase agreement would constitute an evidence of indebtedness. Under SEC rules, advisers to municipalities are regulated under the Exchange Act. *See supra* Note 96.

148 § 409 of the Dodd-Frank Act. The SEC adopted a new Rule 202(a)(11)(G)-1 under the Advisers Act to define family offices that are excluded from the definition of "investment adviser" under the Advisers Act. Rule 202(a)(11)(G)-1 largely codifies the exemptive orders that the SEC has issued to family offices. Each of these exemptive orders reflected the specific factual situation presented by the family office applicant. *See* SEC Release No. IA-3220 (June 22, 2011); SEC, Division of Investment Management Responses to Questions About the Family Office Rule (Apr. 27, 2012).

149 § 202(a)(11)(H) of the Advisers Act; *see, e.g.*, SEC Release No. IA-2013 (Feb. 7, 2002); SEC Release No. IA-1970 (Aug. 27, 2001).

150 § 203(b) of the Advisers Act exempts, among other persons:

> (1) any investment adviser, other than an investment adviser who acts as an investment adviser to any private fund, all of whose clients are residents of the State within which such investment adviser maintains his or its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange; (2) any investment adviser whose only clients are insurance companies; [or] (3) any investment adviser that is a foreign private adviser.

A person seeking to provide advice on an exempt basis with respect to the trading of security futures products requires an exemption from both the Advisers Act and the CEA. Although currently there is considerable overlap between exemptions under both statutes, the exemptions are not entirely co-extensive. In 2012, the SEC adopted rules that eliminated certain exemptions from the CEA and created a number of new requirements for persons registered under the CEA. *See supra* Note 7.

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151 *See* discussion at §§ 16.07 and 16.08.

152 The Private Fund Advisers Act was Congress's solution to the question of hedge fund regulation. The SEC sought to expand its regulation of hedge funds by adopting a new rule and several rule amendments that took effect in 2005. Hedge Fund Release. The Hedge Fund Release effectively required many hedge fund advisers to register as investment advisers under the Advisers Act by changing the manner in which they counted their clients for purposes of determining the availability of the *de minimis* exemption. In June 2006, the U.S. Court of Appeals for the District of Columbia Circuit vacated the rule and the related rule amendments, concluding that the SEC had acted arbitrarily in determining that the investors in a hedge fund would be deemed clients of an adviser for purposes of the *de minimis* exemption when only the fund itself would be considered the adviser's client for other purposes under the Advisers Act. *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006). The SEC then embarked on an aggressive agenda through rulemaking and staff guidance to address the consequences of this decision. *See* Rule 206(4)-8 under the Advisers Act.

153 For purposes of determining clients under the *de minimis* exemption, no shareholder, partner or beneficial owner of a client entity was considered a client unless such person was a client of the adviser separate and apart from its status as shareholder, partner or beneficial owner. The Private Fund Advisers Act maintained the interpretive provisions for determining who are clients.

154 15 U.S.C. § 80b-3(b)(3) (2006).

155 SEC Release No. IA-3221 (June 22, 2011); SEC Release No. IA-3222 (June 22, 2011).

156 § 402(a) of the Private Fund Advisers Act.

157 R-AUM is reported on Part 1 of Form ADV.

158 In response to commenters citing the statutory definition of investment adviser (which includes a "for compensation" qualifier), the SEC noted in its adopting release that "[a]lthough a person is not an ‘investment adviser’ for purposes of the Advisers Act unless it receives compensation for providing advice to others, once a person meets that definition (by receiving compensation from *any* client to which it provides advice), the person is an adviser, and the [Advisers] Act applies to the relationship between the adviser and any of its clients (whether or not the adviser receives compensation from them)." SEC Release No. IA-3221 (June 22, 2011), 76 Fed. Reg. 42,950, 42,955 (July 19, 2011). Presumably the SEC is only referring to an adviser's *advisory* clients in this context (as opposed to all of the adviser's clients, including non-advisory clients), *i.e.*, if the adviser receives compensation from any one client to which it provides advice then it is an adviser to each client *to which it provides advice* whether or not compensation is received.

159 *See* Rule 202(a)(30)-1(c)(1) under the Advisers Act; Form ADV, Instruction 5.b(1) to Part 1A.

160 *See* Form ADV, Instruction 5.b(1) to Part 1A.

161 For clarification purposes, in its adopting release the SEC changed this wording from the proposal that said "*from* a place of business in the United States" to more clearly reflect a focus on the location at which management is conducted. The SEC also made clear in its adopting release that, for non-U.S. advisers, the analysis likely will not turn on whether the non-U.S. adviser has a place of business in the United States but on whether the adviser manages assets, or has "assets under management," at such a U.S. place of business. "Assets under management" are securities portfolios for which the adviser provides "continuous and regular supervisory or management services." The SEC confirmed that, while this is an inherently factual determination, it would not view providing research or due diligence at a U.S. place of business to be managing assets in the United States if a person outside the United States makes an independent investment decision and implements those decisions. SEC Release No. IA-3222 (June 22, 2011), 76 Fed. Reg. 42,950, 42,955 (July 19, 2011). Presumably, marketing or other client services offices that do not engage in "management" of assets would also be excluded from the calculation of assets under management in the United States for such non-U.S. advisers.

162 Given the focus on assets under management in the United States for a non-U.S. adviser, many non-U.S. advisers may be able to rely on the private fund adviser exemption instead of the foreign private adviser exemption.

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163 *See* § 16.03[3][b] for discussion of the meaning of "place of business."

164 The Private Fund Advisers Rules refer to the definition of a U.S. person in Regulation S. *See* § 8.02 for a discussion of Regulation S and related definitions.

165 SEC Release No. IA-3222 (June 22, 2011). The adopting release states that whether a single-investor fund could be a "private fund" for purposes of the exemption depends on the facts and circumstances. The release notes the SEC's concern that an adviser simply could convert client accounts to single-investor funds—which would be tantamount to separately managed accounts—in order to avoid registering under the Advisers Act. The SEC references § 208(d) of the Advisers Act as anticipating "these and other artifices" and thus prohibiting a person from doing indirectly anything that it would be unlawful to do directly. Although the release acknowledges that there are circumstances in which it may be appropriate for an adviser to treat a single investor fund as a private fund for purposes of the rule, these are likely to be limited—such as where a fund that seeks to raise capital from multiple investors has only a single, initial investor for a period of time or where all but one of the investors in a multi-investor fund have redeemed their interests. 76 Fed. Reg. 39,646, 39,667–39,668 (July 6, 2011).

166 "In the United States" refers to the definition of a U.S. person as provided for in Regulation S. *See supra* Note 164.

167 In the context of the *de minimis* exemption, at least one commentator had suggested that an adviser that offers services to more than 14 persons is not exempt regardless of the actual number of clients, because it would be making a public offering of its advisory services. *See* Tamar Frankel & Ann Taylor Schwing, 2 THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS § 10.02[B] (2d ed. 2001).

168 § 402(a) of the Private Fund Advisers Act. The exemption would thus potentially be available to an adviser providing advice to entities excluded from the definition of investment company specified in § 3(c) of the Investment Company Act. *See*, *e.g.*, *Bache & Co. (Pan America), Inc.* (avail. Sept. 19, 1976). For a description of the types of entities required to register under the Investment Company Act, *see* § 15.03.

169 Rule 202(a)(30)-1(c)(4) under the Advisers Act.

170 The SEC clarified in the adopting release that while a "place of business" as defined would include any office where the adviser regularly communicates with U.S. or non-U.S. clients or regularly conducts research, it would likely not include a place of business used solely for administrative or back office activities if such activities are not "intrinsic to providing investment advisory services" and do not involve communicating with clients. *See* SEC Release No. IA-3222 (June 22, 2011), 76 Fed. Reg. 39,646, 39,679 (July 6, 2011); *see also supra* Notes 161–163 and accompanying text. Even with this clarification, determining whether an operation or office in the United States will count as a "place of business" for purposes of this exemption will be a fact-intensive and difficult analysis, especially given the breadth of activities one can conduct in an office and the ambiguity inherent in the standard the SEC has cited (*i.e.*, "intrinsic to providing advice").

171 Rule 202(a)(30)-1(a)(1) under the Advisers Act; *see also supra* Note 42.

172 Rule 202(a)(30)-1(a)(2) under the Advisers Act. The staff has also indicated that an investment adviser that advised funds through a two-tiered investment structure, where a top-tier fund would invest in several underlying investment funds, need not count the underlying funds as clients for purposes of § 203(b)(3). *See Willkie Farr & Gallagher* (avail. Oct. 30, 1998).

173 Even if "single advisee" treatment is unavailable with respect to a limited partner that is otherwise an advisory client, such treatment may still be available with respect to other limited partners complying with the rule. Rule 202(a)(30)-1(b)(1) under the Advisers Act. Under the prior rules regarding the *de minimis* exception, the SEC has declined to expand this treatment to include general partnerships on the theory that it was intended to establish parity of treatment between limited partnerships and corporate vehicles for passive investment—a function not, in the SEC's view, typically served by the general partnership form. SEC Release No. IA-983 (July 12, 1985).

174 SEC Release No. IA-3222 (June 22, 2011). The SEC also determined to include in the calculation of assets under management assets managed without compensation, noting that if an adviser receives

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compensation from any one client to which it provides advice, then it is an adviser to each advisory client whether or not compensation is received. *See supra* Note 158.

175 Rule 202(a)(30)-1(c)(2) under the Advisers Act. The adopting release clarifies that an adviser must look through nominee and similar arrangements, total return swaps or similar instruments, as well as through master-feeder structures, to the beneficial owners. The SEC introduced a reasonableness standard for this determination, *i.e.*, the adviser may treat as an investor a person the adviser reasonably believes is the actual investor. The same standard may be used in determining if a particular investor is "in the United States." The SEC noted that because private fund advisers already need to "look through" and count investors for purposes of their Investment Company Act exemption, this provides no additional burden to advisers who argue that they may not know the identity or location of each investor. SEC Release No. IA-3222 (June 22, 2011), 76 Fed. Reg. 39,646, 39,678 (July 6, 2011).

176 Rules 202(a)(30)-1(b)(4) and 202(a)(30)-1(c)(2) under the Advisers Act.

177 *See* Rule 202(a)(30)-1(c)(2) under the Advisers Act. Proposed Rule 202(a)(30)-1(c)(1)(i), by reference to Rule 3c-5 under the Investment Company Act, would have counted "knowledgeable employees" as investors for purposes of the foreign private fund adviser exemption. *See* SEC Release No. IA-3111 (Nov. 19, 2010).

178 *See*, *e.g.*, *Alexander, Holburn, Beaudin & Lang* (avail. Aug. 13, 1984).

179 Section 202(a)(30)(D); *see also infra* Note 184.

180 *See, e.g., Mr. R. Bate* (avail. June 28, 1988); *The Gordian Cos., Inc.* (avail. Aug. 20, 1987); *Executive Group* (avail. July 9, 1984); *System Dynamics* (avail. June 21, 1983); *Benedict A. Stanonis* (avail. May 20, 1982); *Bruce O. McCracken* (avail. May 29, 1981); *David Streetman* (avail. Aug. 17, 1979); *Ronald F. Bentley* (avail. Jan. 24, 1978); *ONB Securities, Inc.* (avail. Dec. 17, 1978).

181 SEC Release No. IC-21260 (July 27, 1995), 60 Fed. Reg. 39,574, 39,575 n.8 (Aug. 2, 1995); *Resource Bank & Trust* (avail. Mar. 29, 1991).

182 SEC Release No. 33-7288 (May 9, 1996). An unregistered adviser's Internet site should also be properly legended to indicate that the adviser's services are not available, and are not being offered, to U.S. investors. SEC Release No. IA-1710 (Mar. 23, 1998). The SEC staff has also indicated that an investment adviser that posted information on an Internet site about private funds, whether structured as domestic or foreign partnerships, limited liability companies, trusts or other entities, would not be "holding out" to the public if the operator of the Internet site used procedures designed to limit access to the Internet site information to a select group of accredited investors. *Lamp Technologies, Inc.* (avail. May 29, 1998). In addition, the SEC staff has indicated that it would not recommend enforcement action against advisers relying on the § 203(b)(3) exemption if they provided information to a data service provider that only distributed the information exclusively to the institutional sales and trading desks of broker-dealers. *Thomson Financial Inc.* (avail. July 10, 2002).

183 SEC Release No. IA-688 (July 12, 1979).

184 Rule 203(b)(3)-1(c) under the Advisers Act. The Private Fund Advisers Act rescinded Rule 203(b)(3)-1; however, Rule 202(a)(30)-1 was adopted at the same time and covers substantially the same ground but in the context of the foreign private adviser exemption, which is currently the only exemption that refers to not "holding out" as a criterion. SEC Release No. IA-3221 (June 22, 2011).

185 The fund's compliance with the 20% limit is to be calculated at the time any non-qualifying investment is made, based on the non-qualifying investments then held in the fund's portfolio. SEC Release No. IA-3222 (June 22, 2011).

186 Rule 203(l)-1 under the Advisers Act; SEC Release No. IA-3222 (June 22, 2011).

187 SEC Release No. IA-3222 (June 22, 2011).

188 Rule 203(l)-1(c)(3) and (4) under the Advisers Act.

189 Rule 203(l)-1(b) under the Advisers Act.

190 § 208(d) of the Advisers Act prohibits "any person indirectly, or through or by any other person, to do any

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act or thing which it would be unlawful for such person to do directly under the provisions of the [Advisers Act] or any rule or regulation thereunder." *See also supra* Note 66 and accompanying text.

191 A discussion of SEC positions regarding the integration of advisory activities of different entities for purposes of the Advisers Act registration requirement is included at § 16.02[2]. *See also Murray Johnstone Holdings Ltd*. (avail. Oct. 7, 1994) (granting no-action relief from integration of several unregistered and registered affiliates for purposes of determining the number of U.S. clients serviced by the group and the applicability of Rule 203(b)(3)-1 where the affiliates were operated separately and independently, notwithstanding certain director interlocks).

192 The SEC noted in the adopting release the possibility of recordkeeping requirements for Exempt Reporting Advisers to be addressed in a future release. *See* SEC Release No. IA-3221 (June 20, 2011).

193 §§ 407 and 408 of the Dodd-Frank Act.

194 The rules require that Exempt Reporting Advisers complete the following seven items in Part 1A of Form ADV: Items 1 (Identifying Information), 2.B (Checkbox regarding Exemption Qualifications), 3 (Form of Organization), 6 (Other Business Activities), 7 (Financial Industry Affiliations and Private Fund Reporting), 10 (Control Persons), 11 (Disclosure Information), and the corresponding sections of Schedules A, B, C and D. The Private Fund Advisers Rules do not require Exempt Reporting Advisers to complete and file other items in Part 1A or prepare a client brochure. Items 1, 3 and 10 require basic identification details about an Exempt Reporting Adviser such as name, address, contact information, form of organization and who owns the adviser. Items 6 and 7.A provide details regarding other business activities that the adviser and its affiliates are engaged in. Item 11 requires advisers to disclose the disciplinary history for the adviser and its employees and other advisory affiliates. Exempt Reporting Advisers are also required to complete the newly revised item 7.B, which requires advisers to provide the SEC with basic organizational, operational and investment characteristics of each fund client, the amount of assets held by each fund client, the nature of the fund client's investors and/or owners, the advisory services provided to the fund client, and each fund client's service providers (*i.e.*, auditors, prime brokers, custodians, administrators and marketers). SEC Release No. IA-3221 (June 22, 2011).

195 SEC Release No. IA-3221 (June 22, 2011).

196 *See* SEC Release No. IA-3308 (Oct. 31, 2011).

197 *See supra* Note 150.

198 *Roy Heybrock* (avail. Apr. 5, 1982). *But see Associates in Financial Planning* (avail. Mar. 21, 1977) (granting no-action relief to a company that advised with regard to unlisted mutual fund securities).

199 *See Guardian Investment Services, Inc.* (avail. Sept. 18, 1986).

200 *See, e.g., Crosby Investment Consultants, Inc.* (avail. Oct. 28, 1977) (federally chartered institutions having their principal offices in applicable states were qualifying clients for purposes of the intrastate exemption); *First Federal Savings & Loan Association of Dallas, Texas and F.F. Corp.* (avail. Oct. 2, 1976). *But see Alpha Capital Corp.* (avail. Mar. 3, 1971) (granting no-action relief even where request failed to identify whether corporate advisory clients would be domiciled and have principal place of business within the state).

201 Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554 (Appendix E), 114 Stat. 2763, 2763A-365 (2000).

202 § 203(b)(6) of the Advisers Act

203 § 403 of the Private Fund Advisers Act.

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U.S. Regulation of the International Securities and Derivatives Markets, § 16.04, REGISTRATION PROCESS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 16.04 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Registration under the Advisers Act for those advisers required to register with the SEC is a relatively simple process, requiring the completion of a prescribed application form—Form ADV. [204] Within 45 days after filing, the SEC must either approve the prospective adviser for registration or commence proceedings to determine whether registration ought to be denied. [205] The Advisers Act requires no showing of competence by personnel, such as the passing of an examination, nor does it impose any minimum capital requirements for a registered adviser. [206] It does, however, contain certain "statutory disqualifications"

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from registration, which include: (i) the making of false and misleading statements to the SEC under the Advisers Act, [207] (ii) criminal convictions and violations relating to any of the federal or state securities or commodities laws, [208] (iii) criminal convictions relating to any felony, [209] and (iv) convictions for substantially equivalent crimes and violations of substantially equivalent foreign laws. [210]

In addition to complying with the basic registration requirements, foreign advisers must also file with the SEC an irrevocable consent to service of process and a power of attorney appointing the SEC as agent to receive process, pleadings and other papers in connection with any civil suit or action arising out of the adviser's business, in any place subject to the jurisdiction of the United States, and based upon the Advisers Act, the Securities Act, the Exchange Act, the Trust Indenture Act, the Investment Company Act or any rule or regulation under any of those statutes. [211]

The application for registration as an investment adviser on Form ADV consists of two parts. Part 1 requires a description of the adviser and other information primarily relating to the basics of the adviser's business and the adviser's disciplinary history and ownership, including persons or entities having a controlling influence over its policies. In the case of an adviser in corporate form, the identity of owners of 5% or more of the common stock (voting) of the applicant and the owners of 25% or more of such owners up the ownership chain, unless an indirect owner is subject to the reporting requirements of the Exchange Act, is required to be disclosed. [212] In the case of advisers or their owners that are organized as limited liability companies or limited partnerships, disclosure of

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those persons that have contributed or have the right to receive upon dissolution 5% (in the case of a direct owner) or 25% (in the case of an indirect owner) of such entity's capital is required, resulting in persons with only an economic interest (no voting rights) being subject to disclosure. This requirement may raise issues for foreign advisers with complex and confidential holding company ownership structures, particularly since foreign parents of such advisers are often not Exchange Act reporting companies. Although the SEC staff has not published any no-action or other guidance with respect to this requirement, it has demonstrated a willingness in isolated cases to explore compromise disclosure with an applicant.

The Private Fund Advisers Rules require additional information to be provided on Part 1 of Form ADV. The rules amended Form ADV to require advisers to provide supplemental information about three areas of operation: (i) private funds advised, (ii) advisory activity, including business practices, and (iii) non-advisory activity, including financial industry affiliations. [213]

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Part 2 of Form ADV describes in detail the services provided by the adviser and its primary policies affecting its relationship with its clientele, with emphasis on disclosure of conflicts of interest. Part 2 requires, among other things, details regarding: material changes to the brochure since the last annual update, a description of the adviser's business; the adviser's fee schedule; the amount of assets under management and how such amount is calculated; side-by-side management of performance-based and nonperformance-based fee accounts; the types of clients it advises; the types of securities about which it provides advice; the investment strategies it uses in formulating advice and the risks related thereto; its disciplinary history; its brokerage placement practices; affiliations the adviser may have with other market participants (including broker-dealers, commodity trading advisers, banks and insurance companies); custody of client funds and securities; and the adviser's code of ethics (including a statement that the adviser will furnish a copy of its code of ethics to any client or prospective client upon request). In addition, an adviser that requires its clients to prepay more than $1,200 in fees (per client) six or more months in advance must file with its Form ADV an audited balance sheet for its most recent fiscal year (prepared in accordance with, or reconciled to, U.S. generally accepted accounting principles ("GAAP")). [214] All disclosures in Part 2 of Form ADV must be written in "plain English." [215]

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Form ADV must be promptly amended in the event of material changes in certain information or upon any changes, regardless of materiality, in other information included in the form. [216] In addition, each registered investment adviser is required to file an annual update to its registration statement within 90 days of the close of the adviser's fiscal year. [217]

Footnotes

204 Applications for registration as an adviser must be submitted electronically through the Investment Adviser Registration Depository ("IARD"). SEC Release No. IA-1897 (Sept. 12, 2000). Investment advisers may satisfy filing obligations under both state and federal law with a single electronic filing made through the IARD.

FINRA (the operator of the IARD) typically charges an initial set-up fee and annual fees that vary depending on the amount of assets under management. Rule 204-1(d) under the Advisers Act. Under the current fee structure, the amount of filing fees paid by an adviser depends on its R-AUM. SEC Release No. IA-3126 (Dec. 22, 2010). All states (and the District of Columbia), with the exception of Wyoming, which does not regulate investment advisers, permit registration under local securities laws using Form ADV. Most states now mandate electronic filing. For a discussion of local securities regulation applicable to investment advisers, *see* § 16.14.

205 § 203(c)(2) of the Advisers Act.

206 The SEC staff has taken the position on at least one occasion, presumably on the basis of general antifraud principles, that a person holding himself out as an investment adviser "represents that he has adequate qualifications by virtue of his educational background or experience to engage in that activity." *Edgardo H. Segura* (avail. Apr. 14, 1978). In addition, many state securities authorities require that employees of investment advisers registered in the state that provide clients with investment advice or who supervise such employees pass a standardized examination. *See*, *e.g.*, GA. CODE ANN. § 10-5-41; R.I. GEN. LAWS § 7-11-203. Certain states also require the posting of a bond or the maintenance of professional liability insurance or minimum capital requirements as a condition to registration as an investment adviser in the state. *See*, *e.g.*, GA. CODE ANN. § 10-5-40; ARK. CODE ANN § 23-42-303; 64 PA. CODE § 303.042.

207 § 203(e)(1) of the Advisers Act.

208 § 203(e)(2) of the Advisers Act.

209 § 203(e)(3) of the Advisers Act.

210 §§ 203(e)(2) and 203(e)(3) of the Advisers Act.

211 Rule 0-2 under the Advisers Act. The Advisers Act prescribes the precise form of the required consent to

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service of process. The breadth of inquiry to which the consent exposes a foreign adviser may pose special issues in the case of foreign banks and bank holding companies conducting securities-related activities in the United States in reliance on Rule 15a-6 under the Exchange Act, which provides such entities (and other foreign brokers and dealers) an exemption from broker-dealer registration in limited circumstances. *See* § 14.03[3]. A foreign broker or dealer also registered under the Advisers Act is subject to examination with respect to all of its activities, including securities activities conducted in reliance on Rule 15a-6.

212 There is no published authority to the effect that an entity exempt from reporting requirements pursuant to Rule 12g3-2(b) under the Exchange Act would not be required to disclose its beneficial owners, and it would appear that this disclosure would be required to be made by such an entity. For a further discussion of Rule 12g3-2(b), *see* § 4.02[3].

213 SEC Release No. IA-3221 (June 22, 2011).

214 Form ADV, Part 2, Item 18.

215 The SEC adopted significant amendments to Part 2 of Form ADV that, among other things, (i) expanded the scope of information required on the form, (ii) changed the manner in which the Part 2 information is presented from the prior "check-the-box" form to a narrative discussion, and (iii) required that Part 2 of Form ADV, and any amendments thereto, be filed with the SEC through the IARD. SEC Release No. IA-3060 (July 28, 2010).

216 See Rule 204-1(a) under the Advisers Act.

217 Rule 204-1(a) under the Advisers Act. An annual fee typically must be paid to FINRA, as the operator of the IARD, upon filing of the annual report. *See supra* Note 204.

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U.S. Regulation of the International Securities and Derivatives Markets, § 16.05, "BROCHURE RULE" AND RELATED DISCLOSURE

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 16.05 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Pursuant to the so-called "Brochure Rule," Part 2 of Form ADV, or a comparable document providing at least the information called for by the form, must be provided to advisory and prospective advisory clients before or at the time they enter into an investment advisory contract, unless the client has the right to terminate the contract without penalty for a period of five business days after concluding the contract, in which case the required information must be delivered at the time the contract is entered into. [218]

An adviser to a fund that is also the general partner (or an entity serving in a similar capacity) to the fund typically delivers a copy of its "brochure" to each investor in or beneficial owner of the fund, in addition to delivering a copy of the "brochure" to the fund itself. [219] In addition, it is market practice for advisers who are not also the general partners of the funds to deliver their "brochures" and make certain other disclosures to the investors in or beneficial owners of the funds but these disclosures can be made in the offering materials or in other disclosure documents that investors receive.

The SEC staff has also taken the position that foreign advisers need not deliver a "brochure" to their non-U.S. clients, subject to satisfaction of certain

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conditions. [220] The staff has conditioned the ability of a foreign adviser not to comply with the Advisers Act in the case of non-U.S. advisory clients on the adviser's agreement that it will not hold itself out to such clients as being registered with the SEC. [221]

A brochure need not be delivered in connection with a contract with an investment company registered under the Investment Company Act that has been approved by a majority of its directors who are not interested parties with respect to the contract. [222] The Brochure Rule, as well as the other regulatory provisions of the Advisers Act, only apply to activities concerning advisory clients. A broker-dealer that is also an investment adviser has to comply with the Advisers Act provisions only with respect to its advisory clients. The adviser must offer to deliver its brochure annually to its clients. [223]

Registered investment advisers that are "sponsors" of "wrap fee programs" [224] must provide prospective clients in these programs with a separate narrative brochure, which must also be filed with the SEC as part of Form ADV. [225]

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The brochure must disclose information regarding the programs and related fees and services and include a statement that persons who solicit participation in the programs will be compensated and may have a financial incentive to recommend the wrap fee program over other programs or services. Where a sponsor offers several programs, the sponsor has the option to prepare either a single brochure describing all of its wrap fee programs or separate brochures for each program. The wrap fee brochure is required to be updated promptly after any information in the brochure becomes materially inaccurate. The requirement to deliver a wrap fee brochure does not apply to "managed account programs," defined as programs in which clients are provided with advice about portfolio managers, continuous monitoring of portfolio managers and brokerage services, but are charged advisory fees and transaction-based commissions, or to "mutual fund asset allocation programs," defined as programs that provide recommendations of mutual funds, rather than portfolio managers, and do not involve the

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provision of advisory and brokerage services for a single wrap fee. [226]

Under Regulation S-P, investment advisers (as well as broker-dealers and investment companies) must provide notice to "customers"—that is, clients who are natural persons about the advisers' privacy policies and practices. [227] The notice must be provided to a client when the relationship is established and on an annual basis during the term of the relationship. Regulation S-P also requires an investment adviser not to disclose nonpublic personal information about a client to unaffiliated third parties unless the adviser provides certain information to the client and the client has not elected to opt out of the disclosure. [228] While a fund client is not a "customer" under Regulation S-P, the Consumer Financial Protection Bureau's ("CFPB's") Regulation P applies to private funds, whose "customers" are natural persons who are investors in those funds. [229] In addition, The Federal Trade Commission had similar authority related to privacy notices over financial institutions including private funds before Dodd-Frank, [230] which transferred privacy notice rulemaking authority from a number of agencies over a number of types of institutions to the CFPB. In each case, regardless of the agency imposing the rule, the requirements are generally as described above with regard to Regulation S-P. [231]

Footnotes

218 Rule 204-3 under the Advisers Act; *see also Money-Matters! Limited Partnership* (avail. Oct. 1, 1991) (no-action relief denied to "900 number" telephone call-in advisory service seeking to respond to telephone inquiries without previously providing brochure). Advisers may satisfy their delivery obligations under the Advisers Act by using electronic media as an alternative to paper-based media. In particular, advisers may use electronic media to fulfill their obligations under §§ 205(a)(2), 205(a)(3) and 206(3) of the Advisers Act, and Rules 204-3, 205-3(d), 206(3)-2, 206(4)-2 and 206(4)-3 under the Advisers Act. *See* SEC Release No. IA-1562 (May 9, 1996). Clients also may consent to having their primary adviser receive brochures on their behalf from any subadvisers hired to advise their accounts. *Goldman, Sachs & Co.* (avail. June 20, 2013).

219 However, the SEC has made clear that an adviser is not *required* to deliver its brochure to investors in funds managed by the adviser. *See* SEC, Division of Investment Management, Frequently Asked Questions: Staff Responses to Questions About Part 2 of Form ADV, Question III.2 (Mar. 18, 2011) (responding that brochures need only be delivered to "clients" under Rule 204-3, not to investors in a private fund that is itself the client).

220 Hedge Fund Release. *See also Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994); *The National Mutual Group* (avail. Mar. 8, 1993) (substantive provisions of Advisers Act do not apply to foreign registered advisers with respect to non-U.S. clients).

221 *Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994); *Mercury Asset Management* (avail. Apr. 16, 1993). *But see* Hedge Fund Release, 69 Fed. Reg. 72,054, 72,072 n. 215 (Dec. 10, 2004) ("We are not, at this time, prohibiting offshore advisers from representing themselves as SEC-registered advisers, but we remind them that they remain subject to the Act's antifraud provisions and that substantial clarification and disclosure may be necessary to make the representation not misleading.").

222 Rule 204-3(c)(1) under the Advisers Act. A "brochure" is also not required in connection with a "contract for impersonal services" for a fee of less than $500, whereby the adviser provides advice solely through written statistical or other information that is not designed to meet the specific investment objectives of the client and does not make any recommendation as to the investment merits of a particular security. Rule 204-3(h)(1) under the Advisers Act.

223 Rule 204-3(b)(2) under the Advisers Act. The SEC has indicated that an adviser has a fiduciary obligation to inform its clients every time a material change occurs, and that this duty could be fulfilled through a revised brochure. SEC Release No. IA-3060 (Oct. 12, 2010); SEC Release No. IA-664 (Jan. 30, 1979).

224 *See* § 16.06 for a discussion of wrap fee arrangements.

225 SEC Release No. IA-1411 (Apr. 19, 1994). A "wrap fee program" is defined in Rule 204-3(h)(5) under the Advisers Act as "an advisory program under which a specified fee or fees not based directly upon transactions in a client's account is charged for investment advisory services (which may include portfolio

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management or advice concerning the selection of other investment advisers) and the execution of client transactions." The Glossary of Form ADV defines a "sponsor" as an adviser "that sponsors, organizes, or administers the program, or selects, or provides advice to clients regarding the selection of, other investment advisers in the program." Accordingly, the definition would include only persons who "promote or solicit" clients for programs that have "some degree of uniformity among clients and that are entered into more than occasionally." SEC Release No. IA-1411 (Apr. 19, 1994), 59 Fed. Reg. 21,657, 21,658 n.8 (Apr. 26, 1994). In promulgating these requirements, the SEC stated its expectation that prospective wrap fee clients will generally not be interested in or eligible for other investment programs, so that sponsors will not need to deliver both their general brochure and their wrap fee brochure to a significant number of prospective clients.

226 SEC Release No. IA-1411 (Apr. 19, 1994).

227 SEC Release No. IA-1883 (June 22, 2000).

228 SEC Release No. IA-1883 (June 22, 2000). *See* §§ 248.13, 248.14 and 248.15 of Regulation, 79 Fed. Reg. 64,057.

229 *See* Bureau of Consumer Financial Protection, Amendment to the Annual Privacy Notice Requirement Under the Gramm-Leach-Bliley Act (Regulation P), 79 Fed. Reg. 64,057 (Oct. 28, 2014) (codified at 12 C.F.R. Part 1016 (the "Regulation P Adopting Release").

230 The FTC's Privacy of Consumer Financial Information, 16 C.F.R. Part 313, governed private funds until the CFPB inherited the authority under which it promulgated Regulation P.

231 § 1093 of the Dodd-Frank Act. *See* Regulation P Adopting Release, 79 Fed. Reg. 64,057, 64,058 (Oct. 28, 2014).

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U.S. Regulation of the International Securities and Derivatives Markets, § 16.06, PERFORMANCE FEES AND COMPENSATION ARRANGEMENTS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 16.06 (11th and 12th Editions 2014-2017)
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Among the more significant provisions of the Advisers Act is its prohibition on receipt by an adviser subject to regulation thereunder of certain performance fees that are based on a share of the capital gains or appreciation in a client's account. [232] The prohibition applies to new contracts, as well as to renewals and extensions of existing contracts, thus excluding the possibility for "grandfathering" an adviser's existing client relationships for contracts, which would require renewal or extension. [233]

There are a number of exemptions to the prohibition against performance fees that have significantly reduced the impact of the restriction. First, as a result of the National Securities Markets Improvement Act of 1996 ("NSMIA"), [234] the prohibition does not apply to an investment advisory contract with a person who is not a resident of the United States.

Second, the prohibition does not apply to compensation that is based on a fixed percentage of the value of assets under management as of a particular date or dates or averaged over a definite period of time. [235] The SEC's general antifraud rules would, however, operate to prohibit any advisory fee that is "greater than that normally charged in the industry for investment advisory services" unless appropriate disclosure is made to clients, generally in the adviser's "brochure." [236] The SEC staff has taken the position that an adviser would be required to disclose that an annual advisory fee in excess of 2% of assets under management is greater than that normally charged in the industry." [237]

Third, the prohibition does not apply to a contract with any registered investment company or certain other persons, if the contract relates to at least $1 million of assets, provides for compensation based on the value of assets under management averaged over a specified period and increases and decreases

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proportionately with the investment performance [238] of the assets in relation to the investment record [239] of an index of securities prices or any other measure approved by the SEC. [240] Increases and decreases in the adviser's compensation are measured from the fee, known as the "fulcrum fee," that the adviser would earn if the performance of the company or fund were equivalent to the applicable index. [241]

Fourth, an exemption exists in the case of contracts that investment advisers have with "qualified clients." For these purposes, a qualified client means: (i) a natural person or a company that has at least $1,000,000 [242] under management, (ii) a natural person or company that is reasonably believed by the adviser to have a net worth of more than $2,100,000 [243] or is a "qualified purchaser" as defined in the Investment Company Act or (iii) a natural person who is an executive officer, director, trustee, general partner or person performing a similar function with the adviser or an employee of the adviser who has been performing investment activities for at least 12 months. [244]

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Fifth, compensation including up to 20% of the realized capital gains, calculated as provided in the Advisers Act, may be paid in connection with advice to a limited class of U.S.-domiciled investment companies—known as "business development companies" [245]—that are subject to the reporting requirements of the Exchange Act, have assets invested in specified types of securities and have their principal operations in the United States. [246]

Finally, also pursuant to amendments introduced by NSMIA, the prohibition does not apply to an investment advisory contract with a company excepted from the definition of an investment company under § 3(c)(7) of the Investment Company Act. [247]

Under the Private Fund Advisers Act, the SEC is required to adjust any dollar amounts used in connection with the compensation-related tests discussed above not later than July 21, 2011, and every five years thereafter, for the effects of inflation on such test. [248]

The SEC also has the power to:

> by rule or regulation, upon its own motion or by order upon application, … conditionally or unconditionally exempt any person or transaction, or any class or classes of persons or transactions, from [the prohibition], if and to the extent that the exemption relates to an investment advisory contract with any person that the [SEC] determines does not need the protections of [the prohibition], on the basis of such factors as financial sophistication, net worth, knowledge of and experience in financial matters, amount of assets under management, relationship with a registered investment adviser, and such other factors as the [SEC] determines are consistent with [the prohibition]. [249]

It is also worth noting that a registered investment adviser that provides both securities advice and commodities advice may charge its clients fees based on the capital appreciation in the value of the commodities in the clients' account without complying with the Advisers Act provisions relating to performance fees. [250]

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The Advisers Act proscriptions may also extend to other compensation practices that may not be prohibited or, in fact, may be expressly permitted under an adviser's home country practices. For example, the antifraud provisions of the Advisers Act [251] have been interpreted by the staff, in cases addressing acceptable practices in U.S. financial markets, as requiring *pro rata* refunds for pre-paid advisory fees in the event an advisory contract is terminated by a client (particularly in the case of advisers providing advice tailored to the needs of particular clients), [252] and as prohibiting the imposition of an additional charge on a client for choosing to change his investment [253] or terminate his contract. [254] Such practices are commonly accepted in many other jurisdictions, and SEC staff positions suggest that these prohibitions may (subject to satisfaction of certain conditions) not be applicable in the case of the non-U.S. clients of a registered adviser located outside the United States, except to the extent that the practices in question involve conduct or have effects in the United States or on the adviser's U.S. clients. [255]

An advisory service that has experienced explosive growth over the past two decades is the so-called "wrap fee" arrangement, which can take a variety of forms. Under a common arrangement, a client retains a brokerage firm that assists the client in selecting an adviser from the firm's "approved" list of money managers that may include affiliates of the broker. The broker charges the client a single "wrap fee" that includes fees payable to the adviser for the client's account, as well as custodial and brokerage and other transactional charges. The SEC has provided a "nonexclusive safe harbor from the definition of investment company" for certain wrap accounts, [256] but has not taken any official position regarding the propriety under the Advisers Act of wrap accounts. [257] The SEC

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staff has indicated, however, that the arrangements raise numerous issues under the Advisers Act, as well as

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other federal and state securities laws. [258] Among the issues raised by wrap programs under the Advisers Act is whether the arrangement constitutes an abusive compensation practice in that the fee charged exceeds the sum of the fees that would otherwise be payable for each of the services provided in the program. [259] It is also uncertain whether a wrap program that contemplates the use of a single broker for execution services will satisfy the adviser's obligation to obtain the "best execution" for clients in the program. [260] The payment of a portion of the "wrap fee" to the sponsoring broker may also require compliance with Rule 206(4)-3 under the Advisers Act relating to the payment of fees by advisers to others in exchange for client referrals. [261] Finally, the applicability to wrap programs of the restrictions on principal and agency cross transactions in § 206(3) of the Advisers Act is uncertain. [262]

Footnotes

232 The SEC staff has held that the Advisers Act also prohibits an investment adviser from entering into contingent advisory fee arrangements, such as agreements under which fees are waived or refunded if a client's account does not meet a certain specified level of performance. *See* SEC Release No. IA-721 (May 16, 1980). The staff has also stated that the Advisers Act does not prohibit the voluntary, noncontractual refund of advisory fees by an investment adviser so long as the client had no original understanding with the adviser regarding a fee refund or waiver related to investment performance. *Investment Advisors, Interpretive Matters* (avail. July 18, 1995).

233 § 205(a) of the Advisers Act. The prohibition appears not to apply to an existing contract that does not require renewal or extension.

234 Pub. L. No. 104-290, 110 Stat. 3416 (1996).

235 § 205(b) of the Advisers Act.

236 *See*, *e.g.*, *Commodity Management Service Corp.* (avail. May 19, 1974).

237 *See*, *e.g.*, *Equitable Communications* (avail. Feb. 26, 1975); *Consultant Publications, Inc.* (avail. Jan. 29, 1975).

238 "Investment performance" of an investment company for any period is defined in Rule 205-1(a) under the Advisers Act as "the sum of: (1) The change in its net asset value per share during such period; (2) The value of its cash distributions per share accumulated to the end of such period; and (3) The value of capital gains taxes per share paid or payable on undistributed realized long-term capital gains accumulated to the end of such period; expressed as a percentage of its net asset value per share at the beginning of such period." For these purposes, the amount of certain distributions, dividends and provisions for taxes are deemed to be reinvested in the investment company as described in the rule.

239 Rule 205-1(b) under the Advisers Act defines "investment record" of such an index for any period as "the sum of: (1) The change in the level of the index during such period; and (2) The value, computed consistently with the index, of cash distributions made by companies whose securities comprise the index accumulated to the end of such period; expressed as a percentage of the index level at the beginning of such period." Cash distributions on the indexed securities are considered reinvested in the index as provided in the rule.

240 § 205(c) of the Advisers Act provides that an index of securities will be deemed appropriate unless the SEC by order determines otherwise. *See* SEC Release No. IC-7113 (Apr. 6, 1972) (stating the SEC staff's view on factors to be considered in determining the appropriateness of an index); *see also James R. Waters, CFP* (avail. June 1, 1995).

241 § 205(c) of the Advisers Act. Rule 205-2 under the Advisers Act provides that the specified period during which the asset value of the company or fund is averaged for purposes of determining the fulcrum fee may vary from that during which asset value is averaged for purposes of determining the performance component of the adviser's fee only if certain conditions are met.

242 SEC Release No. IA-4421 (June 14, 2016).

243 SEC Release No. IA-4421 (June 14, 2016).

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244 Rule 205-3(d)(1) under the Advisers Act. For purposes of this exemption, each investor in a registered investment company, a private investment company (*i.e.*, a fund operating pursuant to the exception from investment company registration provided under § 3(c)(1) of the Investment Company Act) or a business development company must be counted as a client of the adviser seeking to charge a performance fee.

245 § 202(a)(22) of the Advisers Act.

246 § 205(b)(3) of the Advisers Act.

247 § 205(b)(4) of the Advisers Act.

248 § 418 of the Dodd-Frank Act; SEC Release No. IA-3372 (Feb. 15, 2012).

249 § 205(e) of the Advisers Act.

250 *John W. Henry & Co., Inc.* (avail. Sept. 20, 1996); *see also EQK Partners* (avail. July 13, 1988) (registered investment adviser may charge fees based on capital appreciation in the value of real estate without complying with § 205 of the Advisers Act and Rule 205-3 thereunder).

251 *See* § 206 of the Advisers Act; §§ 16.07 and 16.08.

252 *See*, *e.g.*, *Churchill Management Corp.* (avail. May 30, 1974); *cf. Wellington Financial Corp.* (avail. Jan. 7, 1983) (no-action relief permitting an investment adviser to enter into an agreement with an affiliated limited partnership to publish a uniform publication without giving existing subscribers an opportunity to terminate their subscription agreements); *Daily Graphs* (avail. Dec. 13, 1978) (failure to provide *pro rata* refund on cancellation or termination would not violate § 206 of the Advisers Act where advisory services were only provided through uniform publications distributed to subscribers pursuant to contracts for "reasonable periods" and adequate disclosure of "no refund" policy was made in advance of execution of subscription agreement); *Anametrics, Inc.* (avail. Oct. 21, 1976). *But see Stephenson and Co.* (avail. Dec. 29, 1980) (termination fee reasonably related to actual services performed would, subject to disclosure and certain other limitations, not necessarily violate § 206 of the Advisers Act).

253 *National Deferred Compensation* (avail. Aug. 31, 1987).

254 *National Deferred Compensation* (avail. Aug. 31, 1987).

255 *The National Mutual Group* (avail. Mar. 8, 1993). *See* Hedge Fund Release.

256 *See* Rule 3a-4 under the Investment Company Act.

257 SEC Release No. IA-1623 (Mar. 24, 1997). The SEC staff has taken the position that a mutual fund wrap fee program may defer, and eventually excuse, the payment of certain broker's fees for those clients that participate in the program for a specified period (and charge the deferred fees to those clients who terminate early), as long as proper disclosure is provided. *Constellation Financial Management L.L.C.* (avail. Jan. 9, 2003); *BISYS Fund Services, Inc.* (avail. Sept. 2, 1999).

258 SEC Release No. IA-1510 (July 27, 1995).

259 To improve disclosure about wrap fee programs, the SEC has adopted rules that require an adviser that sponsors a program (other than managed account programs and mutual fund asset allocation programs) to deliver a separate narrative brochure to prospective clients describing the programs, fees and services. SEC Release No. IA-1411 (Apr. 19, 1994); *see* § 16.05.

260 *See* § 16.09.

261 *See* § 16.08[3]. Another issue raised by wrap accounts is whether clients are in fact accorded individualized investment advisory services or are instead "investors" in an unregistered investment company. *See* § 18.02. Wrap programs can also raise special issues for regulated entities, such as pension plans subject to ERISA. *See, e.g.*, Department of Labor, Opinion 82-26 A (June 9, 1982).

262 SEC Release No. IA-1623 (Mar. 24, 1997). The SEC staff has indicated, however, that they would not recommend enforcement action under § 206(3) of the Advisers Act where an entity registered as both an adviser and a broker-dealer received fees pursuant to a wrap program for executing trades directed to it by another investment adviser, provided that the dual registrant did not recommend, select or participate in the selection of particular securities to be purchased for, or sold on behalf of, clients of the program. *See*

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Morgan, Lewis & Bockius LLP (avail. Apr. 16, 1997).

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U.S. Regulation of the International Securities and Derivatives Markets, § 16.07, PROHIBITED RELATIONSHIPS WITH AFFILIATES

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 16.07 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The Advisers Act prohibits an investment adviser, whether or not subject to registration requirements, from engaging in any principal [263] or agency

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cross [264] transaction with an advisory client unless at or before the completion [265] of the transaction the adviser provides written disclosure to the client of the capacity in which the adviser is acting and obtains the consent of the client to the transaction. [266] This provision, contained in § 206(3) of the Advisers Act, is also interpreted as applying to transactions involving an affiliate of an investment adviser. The SEC staff has taken the position that the prohibition would also bar an adviser from acting as broker in connection with a sale to its advisory clients of interests in an entity controlled by the adviser (in a situation where a controlled entity is also the seller), [267] and has expressed doubt that a "riskless principal" transaction would not be prohibited by § 206(3) of the Advisers Act. [268] The client's consent to a principal or agency cross transaction need not be in writing, although prudence dictates to the contrary; [269] consent must be made on a transaction-by-transaction basis in the context of a principal transaction, whereas a blanket consent is acceptable in the context of an agency cross transaction. [270] The requirement would appear to apply to advisers (whether

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subject to registration or not) to hedge funds or other investment vehicles that are not registered under the Investment Company Act in respect of transactions with an adviser's dealer affiliate. The way in which a fund would give the transaction consent in those circumstances is a matter of some uncertainty, but could depend on the structure and manner of governance of the vehicle.

In addition to disclosure of the capacity in which the adviser is acting in relation to the transaction, the adviser may be required to make additional disclosures to the client, depending on the facts and circumstances. In the first pronouncement on the practical application of § 206(3) of the Advisers Act, the director of the former SEC Division of Trading and Exchange stated that the purpose of § 206(3) was to ensure that the client has all information in his possession to determine whether to enter into a transaction. [271] In the director's opinion, the minimum information that must be disclosed (although not necessarily in writing) would include, in addition to the adviser's capacity:

- the cost to the adviser of any security to be sold to the client;
- in the case of securities to be purchased by the adviser from the client, the price at which the securities will be resold by the adviser, if known by the adviser;
- in the case of an agency cross transaction, the total commission to the broker; [272] and
- the best price at which the transaction could be effected by or for the client elsewhere if that price would be more advantageous for the client. [273]

The staff has taken the position that other information necessary to the client's appreciation of the merits of the investment in question may also be required to be disclosed, including for example the tax consequences to the client of owning a security to be purchased from the adviser. [274] Moreover, the staff

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has suggested that § 206 is intended not only to ensure appropriate disclosure but also to prevent an adviser from "dumping" undesirable securities in client accounts. [275] In any event, the SEC has provided a nonexclusive safe harbor for compliance with § 206(3) in the case of agency cross transactions. [276]

The prohibition of § 206(3) of the Advisers Act is not applicable to a transaction with a broker-dealer that is not acting as an investment adviser in relation to the transaction. [277] Moreover, Rule 206(3)-1 under the Advisers Act provides that a broker-dealer will not be required to obtain a client's consent if it is acting as an investment adviser in relation to the transaction solely by reason of:

- having publicly distributed or made written or oral statements; [278]

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- having issued written materials or made oral statements that do not purport to meet the investment objectives of any individual client; or
- having issued statistical information that contains no opinion as to the merits of any particular security (or any combination of the foregoing activities).

Like the safe harbor provided in Rule 206(3)-2 under the Advisers Act, the availability of the exemption does not affect the applicability of the other antifraud provisions contained in § 206 of the Advisers Act.

As in the case of many of the substantive provisions of the Advisers Act and related regulations, no-action positions taken by the SEC staff suggest that, subject to satisfaction of certain conditions, a registered adviser located outside the United States need not comply with the limitations of § 206(3) with respect to its non-U.S. clients. [279]

Footnotes

263 While a principal transaction includes any sale of a security to, or purchase of a security from, a client by the adviser or its affiliates, the SEC staff has indicated that an investment adviser would not be engaging in a sale of a security to, or a purchase of a security from, an advisory client if the client grants a security interest to the adviser for purposes of maintaining a margin account, the adviser liquidates securities in the margin account or the adviser transfers or loans securities on behalf of a client to facilitate a short sale. *Goldman, Sachs & Co.* (avail. Feb. 22, 1999).

264 An "agency cross" transaction is one in which an adviser or its affiliate acts as broker on behalf of the other party in a transaction involving an adviser's advisory client. Rule 206(3)-2(b) under the Advisers Act.

265 The SEC has stated that "completion" means settlement of the transaction. SEC Release No. IA-1732 (July 17, 1998).

266 Depending on the nature of the client, other prohibitions or restrictions on transactions with affiliates may apply. Investment companies subject to the Investment Company Act and employee benefit plans subject to ERISA are, for example, subject to numerous restrictions on their ability to deal with their advisers and the affiliated persons of such advisers. Transactions in security futures products may be subject to additional restrictions under the CEA. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, §§ 2.16 and 4.07.

267 *Haven Investments, Ltd.* (avail. June 1, 1981); *see also Interplan Securities Corp.* (avail. Feb. 23, 1978) (interrelationships between broker-dealer and adviser required that they be collapsed and treated as a single dually registered entity for purposes of § 206(3)).

The SEC has, however, granted no-action relief under § 206(3) of the Advisers Act to permit a registered investment adviser to invest client funds in mutual funds sponsored, advised and distributed by affiliates of the investment adviser. *Merrill Lynch Trust Co., FSB* (avail. July 6, 2000).

268 *See Municipal Investment Group* (avail. Jan. 5, 1989) (agreeing that an adviser may establish a broker-dealer to transmit orders in municipal securities for execution in "riskless principal" transactions with a

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clearing broker through an omnibus customer account in the name of the adviser, provided adequate disclosure of commissions and other compensation is made, but declining to agree that riskless principal transactions were not principal transactions within the meaning of § 206(3) of the Advisers Act).

269 SEC Release No. IA-40 (Jan. 5, 1945); *see also Dillon Read & Co., Inc.* (avail. Aug. 6, 1975).

270 SEC Release No. IA-40 (Jan. 5, 1945); *see also Dillon Read & Co., Inc.* (avail. Aug. 6, 1975); *Alan R. Gordon* (avail. July 6, 1982). Rule 206(3)-2 under the Advisers Act allows for the blanket consent of certain agency cross transactions effected in accordance with specified restrictions under the Rule. *See infra* Note 276.

In connection with a court decision regarding the treatment of certain fee-based accounts of broker-dealers under the Advisers Act, the SEC has also adopted a temporary rule, Rule 206(3)-3T under the Advisers Act, that provides an "alternative basis" for complying with the consent requirement for certain principal transactions. *See* SEC Release No. IA-2653 (Sept. 24, 2007); § 16.03[2][b]. However, the rule, which was originally effective through December 31, 2009 but has been extended through December 31, 2016, does not provide relief from any transaction-by-transaction consent requirements (although the rule explicitly allows such consent to be provided orally). *See* SEC Release No. IA-3522 (Dec. 20, 2012); SEC Release No. IA-3984 (Dec. 17, 2014).

271 SEC Release No. IA-40 (Jan. 5, 1945).

272 An adviser would not be acting as a broker under § 206(3) of the Advisers Act if it receives no compensation other than its advisory fee for effecting an agency transaction between advisory clients. SEC Release No. IA-1732 (July 17, 1998).

273 SEC Release No. IA-40 (Jan. 5, 1945). The basis for the additional disclosure would be the general antifraud provisions contained in subsections (1) and (2) of § 206, rather than § 206(3) itself. *See*, *e.g.*, *Grover J. Rees* (avail. June 19, 1976).

274 *Edward D. Jones & Co.* (avail. Oct. 29, 1975); *see also Yankee Management of Boston* (avail. June 5, 1974) (registered investment adviser who is also an employee of a registered broker-dealer must disclose all conflicts of interest arising from the dual registration and association). An obligation to disclose material information regarding a security recommended by an adviser may also arise under the general antifraud prohibition of § 206 of the Advisers Act. *See*, *e.g.*, *Dennis M. Hardaker* (avail. Sept. 17, 1977) (adviser may have obligation to disclose risks of investment in foreign securities recommended by the adviser).

275 *Salomon Brothers Asset Management Inc.* (avail. Oct. 10, 1990) (citing Investment Trusts and Investment Companies: Hearing On S. 3580 Before A Subcomm. Of The Senate Comm. On Banking And Currency, 76th Cong., 3d Sess., 322 (1940)).

276 Rule 206(3)-2 under the Advisers Act. In adopting the safe harbor, the SEC expressly rejected requests that similar relief be extended in the case of principal transactions. Rule 206(3)-2 permits an adviser, subject to satisfaction of certain conditions, to comply with the consent requirement of § 206(3) by obtaining a client's prospective blanket consent to such transactions. The safe harbor is not available for any agency cross transaction in which the adviser, or any person controlling, controlled by or under common control with the adviser, has advised both the buyer and seller, and for these purposes, an investment adviser that exercises investment discretion with respect to a client account will be deemed to have "advised" such client. The rule also requires that the adviser provide specified disclosures to its client, including information concerning the potential for conflicts of interest and price, compensation and other details of agency cross transactions effected in reliance on the rule. Each written disclosure required to be made under the rule must also contain a conspicuous statement that the client's consent may be revoked at any time by written notice to the investment adviser or to any other person relying on the rule. The rule does not derogate from the adviser's general obligations as a fiduciary to act in the best interests of its clients and to obtain the best price and execution for its clients, nor does it otherwise relieve the adviser from the applicability of the other antifraud provisions of § 206 of the Advisers Act.

277 § 206(3) of the Advisers Act. The SEC staff has taken the position that a dual registrant, *i.e.*, a firm registered as both a broker-dealer and an investment adviser, would not be deemed to be acting as an

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investment adviser for purposes of § 206(3) if a trade had been directed to the dual registrant by another registered investment adviser. *Morgan, Lewis & Bockius LLP* (avail. Apr. 16, 1997).

278 Rule 206(3)-1(b) under the Advisers Act defines such "publicly" distributed items as those distributed or made to 35 or more persons who pay for access thereto. To avail itself of this exemption, the broker-dealer must include in the written or oral statements in question a statement that if the recipient uses the facilities of the broker-dealer to execute any transaction in a security that was discussed by the broker-dealer, the broker-dealer may be acting as principal or as agent for another person.

279 *The National Mutual Group* (avail. Mar. 8, 1993); *see also Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994); *Mercury Asset Management* (avail. Apr. 16, 1993); *Unibanco* (avail. July 28, 1992); *see* Hedge Fund Release.

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U.S. Regulation of the International Securities and Derivatives Markets, § 16.08, GENERAL ANTIFRAUD PROVISIONS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 16.08 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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In addition to the specific prohibition of § 206(3) of the Advisers Act against dealing with an advisory client, § 206 contains the general antifraud provisions of the Advisers Act. [280] Although originally directed solely at registered investment advisers, § 206 is now applicable to all persons within the statutory definition of "investment adviser," whether or not registered or required to be registered. In the case of advisers located outside the United States, no-action positions taken by the SEC staff suggest that the specific prohibitions under § 206(3) are not applicable with respect to a foreign adviser's non-U.S. clients, subject to conditions substantially similar to those set out in *Unibanco*, except to the extent that any otherwise prohibited practice involves conduct or has effects in the United States or has effects on the adviser's U.S. clients; however, the general antifraud provisions apply to a foreign adviser's interactions

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with all its clients. [281] In response to the court decision vacating the SEC's adoption of a rule that treated investors in hedge funds and other pooled investment vehicles as "clients" for purposes of § 206, the SEC adopted Rule 206(4)-8 under the Advisers Act, which prohibits advisers to such vehicles from defrauding investors and prospective investors in such vehicles. [282]

Although similar in wording to other antifraud provisions of the federal securities laws, the antifraud prohibitions of the Advisers Act have a somewhat different application. For example, unlike § 10(b) of the Exchange Act and Rule 10b-5 thereunder, [283] § 206 of the Advisers Act extends beyond the purchase or sale of a security to encompass the entire relationship of an adviser with its client. In addition, *scienter* [284] is not an element necessary to prove a violation of § 206. [285] However, § 206 has been interpreted as not providing a private right of action for damages, except for rescission and restitution of fees under an advisory agreement, against an adviser for violating its obligations under the Advisers Act. [286]

The prohibitions of § 206 have been applied in a variety of circumstances. The U.S. Supreme Court has found that the provision is violated if an adviser engages in "scalping," that is, recommending purchases of a security that the adviser purchased for its own account shortly before making the recommendation. [287] The SEC staff has also taken the position that § 206 may be violated if an adviser receives both an advisory fee and a fee for advising an investment company in which its clients invest, unless the fees are netted or the adviser's services fully justify the additional cost. [288] Similarly, the staff has stated that

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"hedge" clause provisions included in advisory agreements to limit the liability of the adviser to cases of negligence or intentional misconduct may constitute a breach of the adviser's fiduciary obligations to its clients by suggesting that a client may have waived a nonwaivable cause of action. [289] Many investment advisers, however, continue to include such clauses in their advisory contracts.

The staff has used § 206 to regulate the method by which investment advisers can aggregate client orders for the purchase and sale of securities. [290] The staff has also used § 206 to hold investment advisers accountable for failing to disclose a number of practices and issues, including market timing and late trading arrangements, conflicts of interest, violations of codes of ethics, principal transactions, fees and allocations of expenses. [291]

The staff has even addressed the matter of time limitations on the ability of an advisory client to terminate its

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contract. In *Robert D. Brown Investment Counsel, Inc.*, the staff stated that a provision in an advisory contract permitting clients to terminate only on the contract anniversary date was not consistent with the adviser's fiduciary duty, since the provision would require a client to accept and pay for services even when the services were unsatisfactory. [292]

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At least one court has refused to terminate an advisory contract on the basis of fraud and violation of fiduciary duty in the context of a complex transaction that was carefully negotiated for the protection of many interested parties. [293] While the court agreed that the adviser owed a fiduciary duty to the plaintiffs and as an equitable principle a party to whom a fiduciary duty is owed may terminate its relationship with that fiduciary as of right, notwithstanding contractual provisions that provide otherwise, it held that "carefully negotiated, highly specific rights should not be overridden by a court armed only with general equitable principles, particularly at the behest of entities who may not be the only ones to whom the fiduciary is obligated and who may not have the greatest economic stake in the matter." [294]

In addition to the practices addressed in responses to requests for no-action relief and enforcement actions, the SEC is also authorized to address specific acts or practices that violate § 206 through rulemaking. [295] The SEC has exercised this authority by adopting rules, applicable to registered investment advisers only, that govern compliance programs, advertising practices, custody of client funds and securities, client solicitations and disclosure of an adviser's disciplinary history. [296] Again, the SEC staff has taken the position that a foreign adviser need not, subject to satisfaction of certain conditions, comply with these rules with respect to its non-U.S. clients. [297]

[1] Advertisements

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Rule 206(4)-1 under the Advisers Act prescribes limits on the ability of registered investment advisers to advertise. [298] In addition to including a general prohibition against the use of any advertisement "which contains any untrue statement of a material fact, or which is otherwise misleading," [299] the rule contains a number of specific proscriptions. The principal matter covered by the rule is an adviser's advertisement of its investment results. The rule prohibits a registered adviser from referring, directly or indirectly, to past "specific recommendations" [300] of the adviser that were or would have been profitable for any person, unless the adviser satisfies the conditions of the rule. Those conditions require that the adviser set out or offer to furnish a list of all recommendations made by the adviser for the most recent 12-month period that contains a cautionary legend and specifies: (i) the name of the security, (ii) the recommendation and related details, such as the market price of the security when recommended, (iii) the price at which the recommendation was to be followed and (iv) the current market price of the security. [301]

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In addition to satisfying these conditions, performance data must also not be so misleading as to violate the general antifraud prohibition of the rule. [302] The SEC staff has repeatedly stated that information concerning performance would be misleading:

> if it implies something about, or is likely to cause an inference to be drawn concerning, the experience of advisory clients, the possibilities of a prospective client's having an investment experience similar to that which the performance data suggest was enjoyed by the adviser's clients, or the adviser's competence, when there are additional facts which the adviser knew or ought to have known, which if also disclosed would prevent the implication from arising or the

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inference from being drawn. [303]

An advertisement thus may not, for example, include performance figures for a "nonrepresentative" sample of accounts or provide comparisons of an adviser's performance with any other index, unless the differences between the adviser's performance as presented and the index are explained in the presentation. [304] The staff has also questioned the use of advertisements showing percentage gains over time as presenting a misleading view of actual gains realized

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(particularly in the case of low-priced securities), the use of a hypothetical portfolio [305] and the use of performance data that does not reflect deductions for all charges for advisory fees and brokerage and other commissions. [306] The staff has, however, taken a no-action position with respect to disclosure of gross performance results to be presented to certain sophisticated clients (including high net worth individuals, pension funds and institutional clients) in "one-on-one" client presentations, if the adviser makes certain disclosures to the client concerning its fees. [307] The staff has also taken a narrow no-action position with respect to disclosure of gross performance results if the adviser also presents net performance results with equal prominence in a format designed to facilitate ease of comparison and the advertisement is not otherwise misleading. [308]

The staff has likewise taken no-action positions with respect to newly registered investment advisers that present performance information for accounts managed by another advisory entity so long as the persons responsible for investment management of those accounts at the other advisory entity are the same persons who will be responsible for investment management at the new firm. Such positions are typically based upon representations that:

- the person or persons who manage accounts at the current adviser were also those primarily responsible for achieving the prior performance at the other adviser;
- the accounts managed at the predecessor advisory entity are similar to the accounts currently under management;

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- all similarly managed accounts are included in the performance information; and
- the advertisement discloses that the performance results were from accounts managed at another entity. [309]

Rule 206(4)-1 also prohibits the use of any advertisement that refers, directly or indirectly, to any testimonial concerning the adviser or any of its services [310] or that states that any service will be provided free of charge unless the service will in fact be furnished free of charge and without any condition or obligation. [311] Finally, under the rule an adviser may not in any advertisement state that any graph, chart, formula or other device can, in and of itself, be used to determine which securities to buy or sell or when to buy or sell them or can assist any person in making those determinations, unless the limitations of the device in question are also set out. [312]

[2] Custody of Client Funds and Securities

A registered investment adviser that has custody of client funds or securities is subject to special limitations prescribed in Rule 206(4)-2 under the Advisers Act, which prohibits the adviser from taking any action with respect to

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a client's property unless the conditions of the rule are satisfied. [313] The SEC staff has taken the position that

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the rule's requirements are not applicable to the non-U.S. clients of a foreign adviser, subject to the adviser's compliance with certain conditions. [314]

"Custody" for purposes of Rule 206(4)-2 means "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them." [315] Rule 206(4)-2 also includes the following examples of activities that constitute custody:

- possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless the adviser receives them inadvertently and returns them to the sender promptly but in any case within three business days of receiving them; [316]
- any arrangement (including a general power of attorney) under which the adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the adviser's instruction to the custodian; [317] and

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- any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives the adviser or its supervised person legal ownership of or access to client funds or securities. [318]

The SEC amended the custody rules in 2009 to increase the obligations of advisers holding client assets. [319] An adviser is deemed to have custody of any client assets held directly or indirectly by a "related person" in connection with advisory services provided by the adviser to the client. [320] A "related person" for purposes of Rule 206(4)-2 means any person, directly or indirectly, "controlling or controlled by" or that is "under common control with" the adviser. [321]

To comply with Rule 206(4)-2, a registered adviser who has custody of client funds and securities must maintain them with a "qualified custodian." "Qualified custodians" under Rule 206(4)-2 include the types of financial institutions that clients and advisers ordinarily use for custodial services, such as banks and savings associations and registered broker-dealers. [322] The term also includes registered futures commission merchants in the case of security futures or other securities incidental to transactions in commodity futures and options thereon, and foreign financial institutions that customarily hold customer assets, so long as the customer assets are held in segregated customer accounts. [323]

The adviser must have a reasonable belief that the qualified custodian provides account statements at least quarterly to the adviser's clients whose funds and securities the custodian holds. [324] If a client does not wish to receive

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custodial reports directly, it may choose to have an "independent representative" receive account statements on its behalf. [325]

The rules require that advisers with custody of client assets undergo a surprise examination at least once during each calendar year by an independent public accountant to verify client assets. [326] However, an adviser will not be subject to the surprise examination requirement if it is deemed to have custody of client assets either (i) solely as a result of its authority to deduct advisory fees from client accounts, [327] or (ii) solely because of custody by a related person from whom it is "operationally independent." [328] The accountant must notify the SEC within one business day of the finding of any material discrepancies during the course of the examination. [329]

An adviser or a related person that maintains client funds as a qualified custodian is subject to additional restrictions, including a requirement to obtain within six months of becoming the qualified custodian and each year thereafter an internal control report by independent public accountants. [330]

Advisers need not comply with the custody rules with respect to clients that are registered investment companies. [331] Advisers also need not comply with the notice to clients and account statement requirements of

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the rule and are deemed to have complied with the surprise independent verification of the client assets for which the adviser has custody with respect to any pooled investment vehicle that (i) is audited at least annually and (ii) distributes its audited GAAP financial statements to all limited partners (or other beneficial owners) within 120 days of the end of its fiscal year. [332]

[3] Client Solicitation

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For many years, the SEC staff took the position that paid client solicitation was a practice so fraught with conflicts of interest that it was *per se* fraudulent and not susceptible of cure through disclosure. [333] Such arrangements were approved by the staff in no-action letters only in cases where the solicitor was an employee or otherwise under the control of a registered adviser. [334] With the adoption of Rule 206(4)-3 under the Advisers Act, the SEC clarified its approach to payment of referral fees, which the rule prohibits except in limited circumstances upon compliance with various disclosure and supervisory obligations set out in the rule. Rule 206(4)-3 is available only to registered investment advisers and, accordingly, would be unavailable to an adviser not otherwise subject to registration. [335] The SEC staff has taken the position that the rule's requirements are not applicable to the non-U.S. clients of an adviser located outside the United States, subject to the adviser's compliance with certain conditions. [336] The rule also does not apply to payments made to a broker or other person paid to solicit investors in a fund. SEC guidance made clear that Rule 206(4)-3 applies to an adviser's solicitation of *clients*, not investors. [337] The rule would also not apply to a referral program where the individuals who access the program are provided with a list of randomly selected advisers and the annual charge is a flat fee unrelated to the number of referrals to, or clients obtained by, the adviser. [338]

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Rule 206(4)-3 applies only to payment of cash referral fees and would not extend, for example, to compensation paid in the form of directed brokerage. [339] Such compensation would continue, in the absence of relief to the contrary, to be governed by the earlier positions of the staff finding such arrangements to be severely restricted, if not altogether prohibited, under the antifraud provisions of the Advisers Act.

[4] Disclosure of Disciplinary History

Although the Advisers Act imposes no special requirements concerning competence or financial responsibility of investment advisers, Part 2 of Form ADV does require a registered adviser to disclose to its clients any material financial, legal or disciplinary events. [340] Such disciplinary disclosure is subject to the "Brochure Rule" discussed in § 16.05. Any subsequent reportable events must be communicated promptly to all existing clients. If an adviser has custody of client funds and securities, it must also inform the client of any matter that could impair its ability to meet contractual commitments.

[5] Proxy Voting

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Rule 206(4)-6 under the Advisers Act addresses an adviser's fiduciary obligation to its clients when the adviser has authority to vote their proxies. [341] The rule provides that it is a "fraudulent, deceptive or manipulative act, practice or course of business" within the meaning of § 206(4) of the Advisers Act for a registered investment adviser to exercise voting authority with respect to client securities unless:

- the adviser has adopted and implemented written policies and procedures that are reasonably designed to ensure that the adviser votes proxies in the best interest of its clients and that describe how the adviser addresses material conflicts between its interests and those of its clients with respect to proxy voting; [342]

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- the adviser describes its voting procedures to its clients and provides copies on request; and
- the adviser discloses to its clients how they may obtain information on the adviser's vote.

[6] "Pay to Play" Regulations

Following a number of scandals in which investment advisers allegedly made campaign contributions to elected officials or others with the intention of influencing their selection of public pension fund asset managers, the SEC adopted new rules effectively banning the influence of so-called "pay to play" practices by investment advisers, significantly curtailing an adviser's ability to make political contributions to elected officials who have a decision making role over public pension fund assets. [343]

Rule 206(4)-5 under the Advisers Act directly prohibits an investment adviser from receiving any compensation for advisory services provided to a government entity, including any public pension plan, for two years after the

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advisory firm or certain of its executives or employees makes a contribution to certain elected officials, candidates or political action committees. [344] The rule encompasses donations made to any "official" (*e.g.*, an incumbent, candidate, or successful candidate for elective office in a U.S. state or political subdivision of a state) with a responsibility for or influence over the selection of an investment adviser. [345] There is, however, a *de minimis* exception for contributions up to $350 per candidate per election, if the donor is eligible to vote for the candidate, or up to $150, if the donor is ineligible. [346] Furthermore, investment advisers are prohibited from "bundling" political contributions, which means soliciting or coordinating contributions from others on behalf of an elected official or political action committee. [347]

Lastly, Rule 206(4)-5 prohibits an investment adviser from hiring a third-party placement agent, such as a consultant, solicitor or other intermediary, to attempt to obtain government business on its behalf, unless the third party is itself an SEC-registered investment adviser or broker-dealer subject to similar "pay to play" regulations. [348]

The SEC has adopted a few amendments to the recently enacted pay to play rules in response to the Dodd-Frank Act:

- The scope of the pay to play rules has been expanded to cover Exempt Reporting Advisers and foreign private advisers; and
- The rule adds municipal advisers to the categories of "regulated persons" who are permitted to solicit advisory business from government entities on their own behalf and on behalf of other advisers (*i.e.*, third-party solicitation). [349]

[7] Compliance Programs

Rule 206(4)-7 under the Advisers Act requires all registered investment advisers to create and maintain compliance programs. [350] In particular, the rule requires advisers to:

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- adopt and implement policies and procedures designed to prevent violations of the federal securities laws;
- review the policies and procedures at least annually for adequacy and effectiveness of implementation and maintain records of the reviews in accordance with the recordkeeping rules under the Advisers Act; and
- designate a chief compliance officer responsible for administering the policies and procedures.

While the rule does not require compliance programs to contain any specific elements, the following issues, at a

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minimum, should be addressed to the extent that they are applicable to the adviser:

- portfolio management processes (*e.g.*, processes for allocating investment opportunities and maintaining consistency of portfolios with clients' investment objectives);
- trading practices (*e.g.*, procedures for best execution, soft dollar arrangements and allocating aggregated trades among clients);
- proprietary trading by the adviser and personal trading by supervised persons;
- accuracy of disclosures to investors, clients and regulators (including account statements and advertisements);
- safeguarding client assets;
- accurate creation and protective storage of records;
- marketing advisory services (including the use of solicitors);
- processes used to value client holdings and assess client fees based on those valuations;
- safeguarding client privacy; and
- business continuity plans. [351]

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Compliance policies and procedures of advisers need not be contained in one document. In addition, entities that are registered as both investment advisers and broker-dealers are not required under Rule 206(4)-7 to have separate compliance policies and procedures for their advisory and broker-dealer businesses.

[8] Code of Ethics

Rule 204A-1 under the Advisers Act requires all registered investment advisers to adopt and enforce a code of ethics detailing standards of conduct for advisory personnel. [352] An adviser's code of ethics must include the following minimum provisions:

- standards of business conduct that reflect the fiduciary obligations of the adviser and its supervised employees;
- requirements to comply with federal securities laws;
- reporting of personal securities transactions conducted by "access persons" and review of such transactions; [353]

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- safeguards for material nonpublic information about client transactions;
- pre-approval of certain transactions;
- reporting of code violations; and
- review and enforcement of the code by the adviser's chief compliance officer, to whom personal securities transaction reports will be submitted. [354]

Footnotes

280 Section 206 of the Advisers Act provides that it is unlawful for any investment adviser using U.S. jurisdictional means:

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> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
>
> (3) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative.

281 *The National Mutual Group* (avail. Mar. 8, 1993); *see also Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994); *Mercury Asset Management* (avail. Apr. 16, 1993); *Unibanco* (avail. July 28, 1992). *See also* Hedge Fund Release, 69 Fed. Reg. 72,054, 72,073 n. 221 (Dec. 10, 2004). ("… [T]he adviser does have a fiduciary duty to provide those [offshore] clients with full and fair disclosure of conflicts of interest….We would not apply section 206(3)'s restrictions to an offshore adviser's principal transactions with offshore clients.").

282 SEC Release No. IA-2653 (Sept. 24, 2007).

283 *See* § 11.04[2].

284 *See* § 11.04[2].

285 *See*, *e.g.*, *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963). *But see SEC v. Steadman*, 967 F.2d 636 (D.C. Cir. 1992) (holding that *scienter* is required under § 206(1) of the Advisers Act).

286 *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11 (1979); *see also* § 16.12.

287 *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

288 *See*, *e.g.*, *Neuberger & Berman* (avail. Mar. 30, 1987); Letter from Alan Rosenblat to Morton Klevan (June 22, 1989); *see also National Association of Investors Corp.* (avail. Oct. 16, 1992). An exception to the general rule against dual fees also exists for investments of uninvested cash balances in affiliated money market funds, provided the client consents thereto. *Neuberger & Berman* (avail. May 29, 1984); *E.F. Hutton & Co., Inc.* (avail. Nov. 17, 1983); *see also WestAmerica Investment Co.* (avail. Nov. 26, 1991) (dual fees permitted in connection with "wrap fee" program, where client would pay advisory fee directly to adviser and indirectly through investments in mutual funds that were selected by adviser but managed by other, unaffiliated advisers).

289 *See, e.g., First National Bank of Akron* (avail. Feb. 27, 1976); SEC Release No. IA-58 (Apr. 18, 1951).

290 The staff has agreed to permit aggregation if (i) the practice of aggregating orders will be fully disclosed in the adviser's Form ADV and separately to each of the adviser's existing clients and (ii) no advisory client, including those clients in which the adviser or person associated with the adviser has a direct or indirect beneficial interest, will be favored by the adviser over any other client, and each client who participates in an aggregated order will participate at the average share price, with all transaction costs shared on a *pro rata* basis. *SMC Capital, Inc.* (avail. Sept. 5, 1995); *see also SEC v. Moran*, 922 F. Supp. 867, 885–86 (S.D.N.Y. 1996) (concluding that the defendant violated § 206 of the Advisers Act by allocating stock to his personal and family accounts at a lower price than that paid by his clients).

291 *See, e.g., In re JPMorgan Chase Bank, N.A. and J.P. Morgan Securities LLC*, SEC Release No. IA-4295 (Dec. 18, 2015) (failure to disclose conflict in investing client funds in firm's proprietary products); *In re JH Partners, LLC*, SEC Release No. IA-4276 (Nov. 23, 2015) (failure to disclose adviser's loans that were senior interests to fund clients' portfolio companies); *In re Fenway Partners, LLC, et al.*, SEC Release No. IA-4253 (Nov. 3, 2015) (failure to disclose change in fee arrangements that ended an offsetting arrangement, thereby increasing fees); *In re Guggenheim Partners Investment Management, LLC*, SEC Release No. IA-4163 (Aug. 10, 2015) (failure to disclose a loan from a client to an executive of the adviser in violation of code of ethics); *In re Parallax Investments, LLC, et al.*, SEC Release No. IA-4159 (Aug. 6, 2015) (failure to disclose or receive consent for principal transactions); *In re Banc of America Capital*

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Management, LLC, SEC Release No. IA-2355 (Feb. 9, 2005) (market timing and late trading); *In re Columbia Management Advisors, Inc.*, SEC Release No. IA-2531 (Feb. 9, 2005) (market timing and late trading).

292 *Robert D. Brown Investment Counsel, Inc.* (avail. July 19, 1984). The *Brown* letter is by its terms limited to restrictions on termination of advisory contracts for the provision of advice and services tailored to the investment objectives of particular clients, and the staff has not addressed whether the same conclusion would be reached, as a result of an adviser's fiduciary obligations or otherwise, in the case of an advisory contract for the provision of impersonal services. *See also BISYS Mutual Fund Asset Allocation Program* (avail. Sept. 2, 1999) (expressing the view that, although the imposition of fees upon termination of an advisory relationship may be inconsistent with the adviser's fiduciary duty, a contingent fee paid to an adviser by a client for services previously rendered to the client would not violate § 206 solely because such fee was payable upon the termination of a client's investment in the program, if at all); *Constellation Financial Management LLC* (avail. Jan. 9, 2003) (reaching the same conclusion as in BISYS Mutual Fund letter in a substantively similar contingent fee scenario); *supra* Notes 252–254 and accompanying text.

293 *Beacon Hill CBO II, Ltd. v. Beacon Hill Asset Management Limited Liability Company*, 249 F. Supp. 2d 268 (S.D.N.Y. 2003).

294 *Beacon Hill CBO II, Ltd. v. Beacon Hill Asset Management Limited Liability Company*, 249 F. Supp. 2d 268, 275 (S.D.N.Y. 2003).

295 § 206(4) of the Advisers Act.

296 *See* SEC Release No. IA-2204 (Dec. 17, 2003); SEC Release No. IA-1633 (May 15, 1997); *see also* SEC Release No. IA-1406 (Mar. 16, 1994) (proposing rules regarding suitability of investment advice). Although no further action has been taken with respect to this proposed rulemaking regarding suitability, the SEC has considered recommendations of unsuitable investments to constitute a breach of an adviser's fiduciary duty in certain circumstances. *See In the Matter of Grey Financial Group, Inc.*, SEC Release No. IA-4094 (May 21, 2015).

297 *The National Mutual Group* (avail. Mar. 8, 1993); *see also Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994); *Mercury Asset Management* (avail. Apr. 16, 1993); *Unibanco* (avail. July 28, 1992); Hedge Fund Release.

298 Rule 206(4)-1(b) defines "advertisement" as including:

> any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers (1) any analysis, report, or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (2) any graph, chart, formula or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (3) any other investment advisory service with regard to securities.

Rule 204-2 under the Advisers Act requires advisers to maintain all advertisements, as well as supporting materials (*e.g.*, with respect to performance data included in any advertisement), for a period of five years from the end of the fiscal year in which the advertisement was published or otherwise disseminated.

299 Rule 206(4)-1(a)(5) under the Advisers Act.

300 In this regard, in 1977 the SEC staff stated its position that the recommendations referred to in the rule are recommendations made by the adviser as an adviser during a period of not less than one year in which the adviser was either registered as an investment adviser or, if the adviser was not registered because of an

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applicable exemption from registration, a period during which the adviser made his recommendations for compensation. *John Warner Seder* (avail. June 10, 1977). Thus, the rule would not be complied with by the furnishing of information about the adviser's personal transactions and those of his family trust. *John Warner Seder* (avail. June 10, 1977); *see also Conway Asset Management, Inc.* (avail. Jan. 27, 1989).

301 Rule 206(4)-1(a)(2) under the Advisers Act. The SEC staff has stated that it would not recommend enforcement action under the rule where an adviser discussed specific securities bought and sold in periodic reports if: (i) the selection criteria were objective and nonperformance based, (ii) the same selection criteria would be used for each quarter for each particular investment category, (iii) reports would not discuss the amount of profit or loss of any particular security recommended by the adviser and (iv) the adviser maintained certain records relating to the selected securities. *Franklin Management, Inc.* (avail. Dec. 10, 1998).

302 In addition to the SEC's requirements under the Advisers Act, FINRA-member broker-dealers distributing marketing material on behalf of hedge funds must comply with NASD Rule 2210, which governs members' communications with the public, even if a nonmember, such as a hedge fund adviser, prepared the marketing material. *See also* Interpretive Letter from Gary L. Goldsholle, NASD, to Michael D. Udoff, Securities Industry Association (Oct. 2, 2003) (interpretive guidance concerning the sale of hedge funds and NASD Rule 2210).

303 *See*, *e.g.*, *Dow Theory Forecasts, Inc.* (avail. Aug. 26, 1983) and letters cited therein; *see also Clover Capital Management, Inc.* (avail. Oct. 28, 1986) (recognizing that whether an advertisement is misleading may also depend on the sophistication of the prospective client).

304 *See*, *e.g.*, *In re Harvest Financial Group, Inc.*, SEC Release No. IA-1155 (Feb. 21, 1989); *Covato/Lipsitz, Inc.* (avail. Oct. 23, 1981). In *Clover Capital Management, Inc.*, the SEC staff enumerated a nonexclusive list of 11 specific practices relating to advertisements of model or actual results that in its view would be deemed to be inappropriate under Rule 206(4)-1(a)(5), including failure to disclose: (i) the effect of material market or economic conditions on the results presented, (ii) the extent to which results reflected reinvestment of earnings, (iii) limitations inherent in model results or (iv) that the adviser's clients experienced investment performance materially different from that portrayed in the model. *Clover Capital Management, Inc.* (avail. Oct. 28, 1986); *see also Investment Company Institute* (avail. Aug. 24, 1987). Whether a successor to an adviser may use the adviser's performance data may also raise an issue under Rule 206(4)-1(a)(5). *Great Lakes Advisors, Inc.* (avail. Apr. 3, 1992).

305 *Donaldson, Lufkin & Jenrette Securities Corp.* (avail. Mar. 2, 1977); *S.H. Dike & Co., Inc.* (avail. Apr. 20, 1975); *see also Morrill-Stanfill & Co.* (avail. Apr. 13, 1978).

306 *See*, *e.g.*, *Investment Company Institute* (avail. Aug. 24, 1987) (confirming that although advisory fees must be reflected, custodian fees for safe-keeping client funds and securities need not be reflected); *In the Matter of Bond Timing Services, Inc.*, SEC Release No. IA-920 (July 23, 1984) (administrative proceeding for failure of investment adviser to include in advertisements of annualized returns information regarding advisory fees, sales loads and transfer fees); *Morrill-Stanfill & Co.* (avail. Apr. 13, 1978) (stating that account performance figures not reflecting commissions, advisory fees and other expenses and charges may convey an impression or give rise to an inference concerning the experience of existing accounts that is misleading); *see also Securities Industry Association* (avail. Nov. 27, 1989) (providing temporary no-action relief permitting deduction of a model fee from advertisements of historical net performance data).

307 *Investment Company Institute* (avail. Sept. 23, 1988); *see also Anametrics Investment Management* (avail. May 5, 1977) (among the factors relevant in determining whether an advertisement is false or misleading is the sophistication of the prospective client).

308 *Association for Investment Management and Research* (avail. Dec. 18, 1996); *see also J.P. Morgan Investment Management Inc.* (avail. May 7, 1996) (adviser may advertise the composite performance of accounts for which it employs a particular investment strategy by deducting a model fee equal to the highest fee charged to any account employing that strategy during the performance period).

309 *See Horizon Asset Management, LLC* (avail. Sept. 13, 1996); *Bramwell Growth Fund* (avail. Aug. 7, 1996).

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The SEC staff has also taken the position that § 206 of the Advisers Act would not prohibit mutual funds from including in their prospectuses, advertisements or sales literature information about the performance of private accounts or other registered investment companies with the same adviser that have similar investment objectives, policies and strategies, as long as the information was not presented in a misleading manner or as a substitute for the funds' own performance. *See Nicholas-Applegate Mutual Funds* (avail. Feb. 7, 1997); *ITT Hartford Mutual Funds* (avail. Feb. 7, 1997); *GE Funds* (avail. Feb. 7, 1997). The SEC staff has stated that it would not recommend enforcement action under § 206 if a newly registered open-end investment company used performance results from an existing class of shares of a separate investment company in its prospectus, advertisements or sales literature, where such shares were spun off to the newly registered entity pursuant to a reorganization. *Janus Adviser Series* (avail. Aug. 28, 2000).

310 Rule 206(4)-1 under the Advisers Act; *see also Multi-Financial Securities Corp.* (avail. Nov. 9, 1995); *Gallagher and Associates, Ltd.* (July 10, 1995); *Amherst Financial Services* (avail. May 23, 1995). The SEC staff has held that a partial client list that merely identifies certain clients of an investment adviser is not a testimonial. *Cambiar Investors, Inc.* (avail. Aug. 28, 1997). In addition, the staff has indicated that an investment adviser rating system would not be subject to enforcement under Rule 206(4)-1(a)(1), where the system does not emphasize favorable or ignore unfavorable responses, the rating represents the responses in a fair manner, the questionnaire is unbiased in presentation and the rating system operator does not perform any subjective analysis of the results. *See DALBAR, Inc.* (avail. Mar. 24, 1998).

311 Rule 206(4)-1(a)(4) under the Advisers Act.

312 *See*, *e.g.*, *S.H. Dike & Co., Inc.* (avail. Apr. 20, 1975).

313 Voluntary registration under the Advisers Act will subject the adviser to all of the requirements of Rule 206(4)-2 under the Advisers Act. *Brighton Pacific Realty Asset Management* (avail. Feb. 10, 1992).

314 *The National Mutual Group* (avail. Mar. 8, 1993); Hedge Fund Release.

315 Rule 206(4)-2(d)(2) under the Advisers Act.

316 In amending Rule 206(4)-2, the SEC made clear that an adviser has custody when it has possession of client funds or securities, even briefly. *See* SEC Release No. IA-2176 (Sept. 25, 2003); *see also New England Asset Management Corp.* (avail. May 1, 1976) (custody exists where an adviser received client funds and securities on opening an advisory account, even though the funds were immediately turned over to a custodian); *Piedmont Financial Company, Inc.* (avail. May 30, 1990); *Denver Investment Advisers* (avail. Jan. 10, 1986). The staff has also found custody to exist where an adviser did not generally retain physical possession of client property but received nominal amounts of client funds as a result of interest rate changes on commercial paper. *Omni Management Corp.* (avail. May 10, 1979).

317 An adviser authorized to deduct advisory fees or other expenses directly from a client's account has access to, and therefore has custody of, the client funds and securities in that account. SEC Release No. IA-2176 (Sept. 25, 2003). Note, however, that for purposes of Form ADV, an adviser that has custody solely because it deducts advisory fees or other expenses may answer "no" to Item 9 of the Form, which asks whether the adviser has custody of client funds or securities. SEC Release No. IA-2176 (Sept. 25, 2003).

An adviser's authority to issue instructions to a broker-dealer or a custodian to effect or to settle trades does not constitute custody. SEC Release No. IA-2176 (Sept. 25, 2003); *see also Piette and Associates, Ltd.* (avail. Sept. 17, 1981) (custody will not result if an adviser is authorized to effect client transactions only on a "delivery versus payment" basis). The SEC staff has determined that an adviser does not have custody solely by reason of its use of a registered clearing agency, such as The Depository Trust Company, where client securities are transferred into nominee name in denominations reflecting their respective ownership interests in a security. *Gardner and Preston Moss, Inc.* (avail. Feb. 18, 1983); *see also Newton Growth Fund* (avail. June 13, 1984).

318 Rule 206(4)-2(d)(2) under the Advisers Act.

319 SEC Release No. IA-2968 (Dec. 30, 2009).

320 Rule 206(4)-2(d)(2) under the Advisers Act.

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321 Rule 206(4)-2(d)(7) under the Advisers Act.

322 Rule 206(4)-2(d)(6) under the Advisers Act. The adviser must notify the client in writing of the qualified custodian's name, address and the manner in which the client's funds or securities are maintained, as well as changes to this information. Rule 206(4)-2(a)(2) under the Advisers Act.

323 Rule 206(4)-2(d)(6) under the Advisers Act. The rule contains special provisions for custody of mutual fund shares and privately offered uncertificated securities. *See* Rule 206(4)-2(b)(1) and (2). In the case of the former, an adviser may use a mutual fund transfer agent in lieu of a qualified custodian. In the case of the latter, an adviser is excepted from the rule if ownership of the securities is recorded only on the books of the issuer (or a transfer agent) in the name of the client and transfers are subject to prior consent of the issuer or the holders of the issuer's outstanding securities. This exception applies for privately offered uncertificated securities held for the account of a limited partnership only if the limited partnership is audited annually and its audited financial statements are distributed to its investors as described in the rule. *See* SEC Release No. IA-2176 (Sept. 25, 2003).

324 Rule 206(4)-2(a)(3) under the Advisers Act.

325 Rule 206(4)-2(a)(7) under the Advisers Act. An "*independent representative*" means a person that acts for the advisory client, is not in a control relationship with the adviser and does not have, and has not had within the past two years, a material business relationship with the adviser. Rule 206(4)-2(d)(4) under the Advisers Act. With respect to pooled investment vehicles for which the adviser acts as general partner (or in a similar capacity), the rule requires that account statements be sent directly to the investors in the vehicle.

326 Rule 206(4)-2(a)(4) under the Advisers Act.

327 Rule 206(4)-2(b)(3) under the Advisers Act.

328 Rule 206(4)-2(b)(6) under the Advisers Act. An adviser is presumed not to be "operationally independent" from a related person unless certain conditions are met: (i) client assets in custody of the related person may not be subject to claims of the adviser's creditors, (ii) adviser personnel may not have authority over the client assets of which the related person has custody, (iii) advisory personnel and personnel of the related person who have access to client advisory assets may not be under common supervision, and (iv) advisory personnel may not hold any position with the related person or share premises with the related person. Rule 206(4)-2(d)(5) under the Advisers Act.

329 Rule 206(4)-2(a)(4)(ii) under the Advisers Act.

330 Rule 206(4)-2(b)(6) under the Advisers Act.

331 Rule 206(4)-2(b)(5) under the Advisers Act.

332 Rule 206(4)-2(b)(4) under the Advisers Act.

333 *See*, *e.g.*, *Argus Securities Management Corp.* (avail. July 1, 1971).

334 *See*, *e.g.*, *Rhodes, King, Ruman & Farber* (avail. Nov. 2, 1972); *Mericka & Co., Inc.* (avail. July 28, 1972).

335 Rule 206(4)-3 under the Advisers Act generally provides that a registered investment adviser may pay a cash referral fee to a person who is not subject to a statutory disqualification specified in § 203 of the Advisers Act (or exempted from application of the disqualification) pursuant to a written agreement that, in the case of an unaffiliated solicitor or an adviser providing other than impersonal advisory services: (i) describes the solicitor's activities and related compensation, (ii) contains an undertaking by the solicitor to perform its activities in accordance with the adviser's instructions and the requirements of the Advisers Act, and (iii) requires the solicitor to deliver to any prospective client a copy of the adviser's "brochure" (*see* § 16.05) and a separate disclosure document describing the solicitor's relationship with the adviser. An adviser relying on the rule is also required to keep certain records relating to such arrangements and to disclose such arrangements in its "brochure." Upon application to the SEC, the requirement that the solicitor not be subject to certain statutory disqualifications may in appropriate circumstances be waived. *See, e.g., Oppenheimer & Co.* (avail. June 5, 1992); *see also Merchants Capital Management* (avail. Oct. 4, 1991) (no-action relief denied where required written contract would not be executed by each soliciting employee).

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336 *The National Mutual Group* (avail. Mar. 8, 1993); Hedge Fund Release.

337 *See Mayer Brown LLP* (avail. July 28, 2008).

338 *International Association for Financial Planning* (avail. June 1, 1998); *see also National Football League Players Association* (avail. Jan. 25, 2002) (Rule 206(4)-3 would not apply to the party arranging and operating a program whereby individuals were provided with a list of pre-screened investment advisers that were charged only a flat fee for participation in the program).

339 *See supra* Note 116; § 16.09. *But see Lincoln National Investment Management* (avail. Mar. 26, 1992) (in granting no-action relief under Rule 206(4)-3 with respect to solicitors not receiving cash compensation, SEC staff relied in part on representation that no noncash compensation would be paid to solicitors).

340 When the SEC released its new Form ADV requirements, it withdrew Rule 206(4)-4 under the Advisers Act, which required an adviser to disclose its disciplinary history, because it was duplicative of the new Form ADV requirements. SEC Release No. IA-3060 (July, 28, 2010). Rule 206(4)-4 created a rebuttable presumption that various events were "material" within the meaning of the rule. Included among those events were: (i) regulatory proceedings before any federal or state agency if the adviser or a management official of the adviser was found to have been involved in a violation of securities, commodities, banking, insurance or real estate laws and was the subject of an agency order denying, suspending or revoking authority to act or associate with an investment-related business or significantly limiting investment-related business activities or to have caused another entity to lose its license or to have been involved in such a violation, (ii) certain proceedings before self-regulatory organizations, and (iii) certain criminal and civil actions determined adversely to the defendant, including actions relating to fraud, wrongful taking of property, bribery, forgery, counterfeiting and extortion. Other events not specifically identified in Rule 206(4)-4 could have also subjected the adviser to a reporting obligation, although the staff generally declined to provide any guidance in this area. *See*, *e.g.*, *Whitaker Capital Management* (avail. June 7, 1990); *Douglas Capital Management, Inc.* (avail. Jan. 11, 1988). The staff has also required persons receiving cash payments for soliciting clients on behalf of a registered investment adviser to disclose remedial sanctions to which they are subject. *See*, *e.g.*, *Dougherty & Company LLC* (avail. Mar. 21, 2003).

341 SEC Release No. IA-2106 (Jan. 31, 2003); *see also In re Deutsche Asset Management, Inc.*, SEC Release No. IA-2160 (Aug. 19, 2003) (Order finding that an investment adviser had violated § 206(2) of the Advisers Act by failing to disclose to its clients a material conflict of interest before it voted the clients' proxies in favor of the merger of Hewlett-Packard Company and Compaq Computer Corporation).

342 The SEC did not adopt any specific policies or procedures, nor did it provide a list of approved procedures. Rather, recognizing that investment advisory activities are "varied," Rule 206(4)-6 permits advisers the flexibility to develop procedures suitable to their businesses and the conflicts they face. SEC Release No. IA-2106 (Jan. 31, 2003).

343 SEC Release No. IA-3043 (July 1, 2010).

344 Rule 206(4)-5(a)(1) under the Advisers Act. Note that the prohibition under this rule can apply in certain cases to a newly hired employee and contributions made up to six months prior to the employee being hired.

345 Rule 206(4)-5(f)(5) and (6) under the Advisers Act.

346 Rule 206(4)-5(b)(1) under the Advisers Act.

347 Rule 206(4)-5(a)(2)(ii) under the Advisers Act.

348 Rule 206(4)-5(a)(2)(i) under the Advisers Act.

349 SEC Release No. IA-3221 (June 22, 2011).

350 SEC Release No. IA-2204 (Dec. 17, 2003). A separate rule adopted in the same release imposes a similar requirement on registered investment companies.

351 SEC Release No. IA-2204 (Dec. 17, 2003). Currently, as noted above, the SEC has stated in guidance that investment advisers should address business continuity planning as part of their compliance programs to the extent that it is applicable to the adviser. In June 2016, the SEC issued a notice of proposed rulemaking

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that would impose business continuity plan and transition plan requirements on investment advisers. *See* SEC Release No. IA-4439 (June 28, 2016). If enacted, the proposed new Rule 206(4)-4 would require registered investment advisers to adopt business continuity plans with certain prescribed components. The plans would be required to address critical internal and third-party operations and systems, data protection, alternate physical locations, and communications procedures. Transition plans would be required to include policies and procedures to safeguard client assets and information, information on the corporate governance and material financial resources of the adviser, and an assessment of legal issues implicated by a transition.

In addition, although the SEC has not amended the compliance program rule to explicitly require that an adviser adopt policies regarding cybersecurity, the SEC has been increasingly focused on the importance of cybersecurity as a compliance matter for investment advisers issuing guidance recommending that funds and advisers consider conducting periodic assessments of cybersecurity threats, developing a strategy to prevent, detect, and respond to such threats, and preparing written policies and procedures including training and guidance to officers and employees to implement the strategy. *See* SEC, Division of Investment Management, Cybersecurity Guidance, IM Guidance Update 2015-02 (Apr. 2015).

352 SEC Release No. IA-2256 (July 2, 2004).

The SEC adopted in the same release corresponding amendments to the recordkeeping requirements of Rule 204-2 under the Advisers Act, Form ADV and the code of ethics requirements of Rule 17j-1 under the Investment Company Act. *See* Rule 204-2(a)(12)–(13) under the Advisers Act and Form ADV, Part 2. Recordkeeping requirements under the Advisers Act are discussed in § 16.11.

353 An "access person" is defined under Rule 204A-1(e)(1) as a supervised person who has access to non-public information regarding any client's purchase or sale of securities, is involved in making securities recommendations to clients or who has access to such recommendations that are nonpublic. The definition also includes a presumption that all directors, officers and partners of a firm will be presumed to be access persons if the firm's primary business is providing investment advice. Rule 204A-1(e)(1) under the Advisers Act.

The access persons of an adviser that is required to have a code of ethics pursuant to both Rule 204A-1 under the Advisers Act and Rule 17j-1 under the Investment Company Act (*i.e.*, an adviser or sub-adviser to a registered investment company) will not be required to report under Rule 17j-1 regarding their personal securities holdings to the extent that any such report will duplicate information required by Rule 204-2. Rule 17j-1(d)(2)(iv) under the Investment Company Act.

354 Rule 204A-1 under the Advisers Act. Supervised employees of an adviser must acknowledge in writing that they have received a copy of the adviser's code of ethics. Rule 204A-1 under the Advisers Act.

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U.S. Regulation of the International Securities and Derivatives Markets, § 16.09, "SOFT DOLLAR" ARRANGEMENTS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 16.09 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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As a fiduciary, an investment adviser must obtain the "best execution" for a transaction effected on behalf of an advisory client. In connection with the abolition of fixed brokerage commissions for exchange transactions pursuant to amendments to the Exchange Act adopted in 1975, [355] concern arose about fiduciaries paying more than the lowest available brokerage commissions. Under general fiduciary principles prohibiting a fiduciary from using trust assets to benefit himself, it is questionable whether an investment adviser would be permitted to pay commissions in excess of the lowest available unless it could demonstrate that any services it received were of corresponding value to the account in question. In addition, there was concern that even where, for example, research services purchased with commission dollars were for the benefit of the account that paid the commissions, the transaction could be viewed as for the benefit of the fiduciary since the use of commissions to pay for such services relieved the fiduciary of the need to develop or pay for such services itself. [356] To alleviate these concerns, in 1975 Congress also adopted § 28(e) of the Exchange Act, which provides a limited safe harbor for fiduciaries that "pay up" in order to obtain brokerage or research services. [357] In addition to permitting in certain circumstances

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the practice of "paying up," and permitting a fiduciary to pay amounts for brokerage and research that (if determined in good faith) are "reasonable" (rather than the lowest available), the safe harbor obviates the need for an adviser to demonstrate that a particular client's commission dollars were used to obtain services directly benefiting that client. [358]

Registered investment advisers are required to disclose on Form ADV their brokerage selection practices, including the circumstances surrounding any "soft dollar" arrangements in which they engage, even if the arrangements would fall within the scope of § 28(e). [359] While a detailed discussion of the impact of

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§ 28(e) on activities of advisers and other fiduciaries and of broker-dealers is beyond the scope of this book, some of the basic principles of the safe harbor as interpreted by the SEC are worth enunciating. [360]

First, the safe harbor is applicable only if the services provided constitute brokerage or research services. The SEC describes "brokerage services" as products and services that relate to the execution of a trade, from the point at which the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution through the point at which funds or securities are delivered or credited to the advised account. [361] "Research services" consist solely of advice, analysis and reports that have substantive intellectual or informational content. [362] The 2006 release confirms that research services related to the market for securities, trade analytics, advice on market color and execution are eligible for the safe harbor. The release also explains that market, financial, economic and similar data could also be eligible for the safe harbor, provided that the data relate to the subject matters set forth in the safe harbor (*e.g.*, data concerning the value of securities or concerning issuers or industries). Physical items (*e.g.*, computer hardware) and mass-marketed publications will not be eligible for the safe harbor.

Second, this safe harbor has been interpreted by the SEC to require that the service provide lawful and appropriate assistance to the adviser in the discharge of its responsibilities. The SEC has also stated that

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whether the test is satisfied requires a fact-intensive inquiry and has generally refused to provide specific

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guidance in this area. [363] An adviser may rely on the safe harbor only if it exercises discretion with respect to the accounts whose commission dollars are being used to obtain the brokerage or research services. As a result, in the case of a pension fund or trust the trustees of which have delegated investment discretion to an adviser, the safe harbor would be available to the adviser, although not to the trustees of the underlying account if they attempted to direct to which brokers the adviser should send business. [364]

Third, the adviser must make a "good faith determination" that the commission to be paid is "reasonable" in relation to the value of the brokerage or research services to be obtained. If the soft dollar arrangement has been negotiated on an arm's-length basis, this standard ordinarily does not present any issues. If, on the other hand, an adviser intends to pay a higher rate of commission to an affiliated broker-dealer, the adviser may be subject to a heightened burden of proof to demonstrate the *bona fides* of its determination. [365]

Finally, § 28(e) requires that the broker-dealer or exchange member provide the research to the adviser. The SEC has stated that research prepared by third parties but provided to the fiduciary by the broker in the transaction falls within the purview of the section if the broker itself has a direct obligation to pay for the research and does not merely reimburse the adviser for the adviser's own expenses and the broker controls and is familiar with the types of research provided to the adviser. However, the SEC commenced a private investigation of, and obtained consents to remedial action (albeit without admissions of wrongdoing) from, investment advisers acting as fiduciaries and participating broker-dealers in a situation where the broker-dealers paid a portion of their commissions received from the fiduciaries to a third party. The third-party administered accounts for fiduciaries and provided services selected by the fiduciaries directly to them. Fees owing to the third party could be paid by the fiduciary either by way of directed commission dollars to the executing broker (who in turn would pay the third party) or in cash paid directly to the third party by the fiduciary. The broker executing the trade was not involved in and indeed did not know which services were selected. The SEC viewed this arrangement as involving impermissible "give-ups" by broker-dealers in return for the direction of brokerage by fiduciaries rather than the permissible providing of brokerage

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and research services. [366] The SEC has also stated that § 28(e) is available to an adviser that obtains research from an introducing broker that clears its transactions through an executing broker only if there is a legitimate correspondent relationship between the two brokers. An introducing broker that does no more than provide research and direct brokerage to an executing broker would not satisfy this test. [367]

In its 1990 correspondence with the Department of Labor, [368] the SEC determined that the § 28(e) safe harbor is applicable only in the case of "commissions" paid—that is, where the broker, dealer or exchange member acts as agent—and not in the case of "mark-ups" or "mark-downs" payable in connection with principal transactions. As a result of the SEC's interpretation, transactions conducted in the over-the-counter market, which are typically executed on a principal basis, including most transactions in debt securities, are not within the scope of § 28(e). Moreover, the SEC clarified that transactions in exchange-listed equity securities are covered by the safe harbor only to the extent that the broker acts as agent and would not be covered if the broker filled the customer order using securities from its inventory. The correspondence also confirmed that § 28(e) is applicable only to transactions in "securities" within the meaning of the Exchange Act, thus excluding transactions in futures and commodity options from safe harbor coverage. [369] In a subsequent no-action letter, the SEC confirmed that safe harbor coverage is available to transactions in fixed-income securities conducted on an agency basis. [370]

Footnotes

355 § 6(e) of the Exchange Act.

356 SEC Release No. 34-23170 (Apr. 23, 1986).

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357 Section 28(e) of the Exchange Act provides in pertinent part that:

> No person using the mails, or any means or instrumentality of interstate commerce, in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law unless expressly provided to the contrary by a law enacted by the Congress or any State subsequent to the date of enactment of the Securities Acts Amendments of 1975 solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion.

The CFMA amended § 28(e) to provide that the provisions of § 28(e) do not apply to transactions in security futures products. § 28(e)(4) of the Exchange Act.

358 Securities Acts Amendments of 1975, Report of the Senate Comm. on Banking, Housing and Urban Affairs to Accompany S. 249, S. Rep. No. 75, 94th Cong., 1st Sess., 71 (1975). Notwithstanding the availability of § 28(e), special issues may be raised in the case of investment companies registered under the Investment Company Act, *see* SEC Release No. 34-23170 (Apr. 23, 1986), and if the account is a pension plan, additional limitations may be imposed under ERISA.

359 *See* Form ADV, Part 2, Item 12; *see also Kingsley, Jennison, McNulty & Morse*, SEC Admin. Proc. File No. 3-7446 (Nov. 14, 1991). When the SEC overhauled Part 2 of Form ADV, it did not change the substance of the disclosure related to "soft dollar" arrangements. The SEC's rules in response to the Dodd-Frank Act require disclosure of conflicts related to "soft dollar" arrangements in Part 1 of Form ADV in addition to Part 2. SEC Release No. IA-3221 (June 22, 2011). In addition, an adviser that is also a broker-dealer is required to make certain disclosures in its customer confirmations about its soft dollar and payment for order flow practices. See Rule 10b-10 under the Exchange Act. In 1998, the SEC undertook an investigation of soft dollar practices and published its findings in a report entitled INSPECTION REPORT ON THE SOFT DOLLAR PRACTICES OF BROKER-DEALERS, INVESTMENT ADVISERS AND MUTUAL FUNDS (Sept. 22, 1998).

In 1995, the SEC proposed a rule and form under the Advisers Act that would require each registered adviser that has the discretion to direct client brokerage transactions and receives services other than execution in exchange for that brokerage to provide its clients with an annual report that would contain information about its use of client brokerage. The report would disclose for the adviser's most recently completed fiscal year: (i) the 20 brokers to which the adviser directed the largest amounts of commissions, (ii) the three largest execution-only brokers utilized by the adviser, (iii) the aggregate amount of commissions directed by the adviser to each broker listed and the percentage of the adviser's total discretionary brokerage this amount represents, (iv) the average commission rate paid to each broker listed, and (v) for each broker other than an execution-only broker, information concerning products or services obtained from the broker. The report would also disclose the percentages of the adviser's total commissions that are directed to execution-only brokers, to other brokers and at the request of clients. The report would require information only about the adviser's use of client brokerage on an aggregate basis. *See* SEC Release No. IA-1469 (Feb. 14, 1995). No further action has been taken with respect to this proposed rulemaking.

In 2004, the NASD Mutual Fund Task Force submitted recommendations to the SEC regarding

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improvements in the transparency of mutual fund costs and distribution arrangements, including with respect to mutual fund portfolio transaction costs and soft dollar arrangements. The Mutual Fund Task Force recommended that the SEC narrow the types of research services that may be obtained with soft dollars to brokerage services described in § 28(e)(3) of the Exchange Act and the "intellectual content" of research (*i.e.*, not the means by which such content is provided). *See* NASD Mutual Fund Task Force, *Report of the Mutual Fund Task Force on Soft Dollars and Portfolio Transaction Costs* (Nov. 11, 2004).

360 In 2006, the SEC issued an interpretive release to address developments in industry practices and technology since its last major interpretive release in 1986. SEC Release No. 34-54165 (July 18, 2006). The 1986 interpretive release regarding § 28(e) of the Exchange Act set out the SEC's views regarding the nature of brokerage and research services within the safe harbor, the purchase by fiduciaries from brokers of research prepared by third parties (so-called "*third-party research*"), the disclosure obligations of investment advisers regarding soft dollar arrangements, special requirements applicable to soft dollar arrangements where the account for which the fiduciary is acting is an investment company registered under the Investment Company Act and a number of other matters. SEC Release No. 34-23170 (Apr. 23, 1986). That release replaced an earlier release that covered some of the same subjects, but had a more restrictive standard for brokerage and research services falling within the safe harbor. SEC Release No. 34-12251 (Mar. 24, 1976). In 2008, the SEC issued additional proposed guidance to boards of directors of registered investment companies to assist them in fulfilling their fiduciary responsibilities with respect to overseeing fund advisers' satisfaction of "best execution" obligations, including the use of brokerage commissions. SEC Release No. 34-58264 (July 30, 2008). In addition, the SEC has issued a large number of no-action letters providing guidance regarding various issues raised under § 28(e) of the Exchange Act.

361 SEC Release No. 34-54165 (July 18, 2006).

362 SEC Release No. 34-54165 (July 18, 2006).

363 Securities Acts Amendments of 1975, Report of the Comm. on Banking, Housing and Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess., 71 (1975); *see also* SEC Release No. 34-54165 (July 18, 2006); SEC Release No. 34-23170 (Apr. 23, 1986).

364 *See Foley & Lardner* (avail. Dec. 3, 1976). Similarly, "directed brokerage" arrangements, whereby a person other than the investment adviser routes trades to a particular broker, are outside the safe harbor. *See* SEC Release No. 34-23170 (Apr. 23, 1986).

365 SEC Release No. 34-23170 (Apr. 23, 1986); *see also* SEC Release No. 34-54165 (July 18, 2006).

366 SEC Release No. 34-16679 (Mar. 19, 1980).

367 *See*, *e.g.*, *Data Exchange Securities* (avail. May 20, 1981).

368 *See* Letter from Richard Ketchum, Director, SEC Division of Market Regulation, to Charles Lerner, Director of Enforcement, Pension and Welfare Benefit Administration (July 25, 1990).

369 Section 28(e) does not apply to transactions in security futures products. *See supra* Note 360.

370 *See Carolina Capital Markets, Inc*. (avail. July 30, 2013).

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U.S. Regulation of the International Securities and Derivatives Markets, § 16.10, ASSIGNMENT OF ADVISORY CONTRACTS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 16.10 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The Advisers Act prohibits an adviser from entering, extending or renewing any advisory contract that fails to prohibit assignment without the consent of the client. [371] This requirement can be of considerable importance in planning overall corporate strategy for a group of affiliated companies, since the most routine of corporate reorganizations theoretically constitutes an assignment. The

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SEC staff has taken the position, however, that an adviser located outside the United States is not subject to the requirement in the case of its non-U.S. clients, subject to the satisfaction of certain conditions. [372]

"Assignment" is defined under the Advisers Act to include "any direct or indirect transfer or hypothecation of an investment advisory contract by the assignor or of a controlling block of the assignor's outstanding voting securities." [373] Change in the ownership of an adviser can thus constitute an assignment that triggers a client consent requirement. [374] Where partnerships are concerned, the death, withdrawal or admission to partnership of persons representing a minority of the partners having only a minority interest in an adviser will not constitute an assignment. [375]

Recognizing that the purpose of the prohibition is to prevent "trafficking" in advisory contracts in order to protect clients from having new or different

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investment advisers imposed upon them without their knowledge, [376] the SEC adopted Rule 202(a)(1)-1 under the Advisers Act. The rule provides that "a transaction which does not result in a change of actual control or management" of an adviser will not constitute an assignment under § 202(a)(2) of the Advisers Act. The rule essentially codifies prior staff no-action advice in a variety of corporate reorganization transactions, in which the staff has taken the position that no assignment will result if: (i) subsequent to the transfer, the new advisory entity will have the same directors, officers, advisory and other professional support staff, (ii) the business of the adviser will continue to be conducted in the same manner, and (iii) persons having ultimate control of the new adviser are the same as those controlling the transferor, which would include, in the case of publicly held companies, a shifting base of public owners. [377] With the adoption of Rule 202(a)(1)-1, the SEC indicated that it will no longer respond to inquiries as to whether a specific transaction is within the rule. [378]

When consent to an assignment is required, it is the general position of the staff that mere failure of the client to object to the assignment is not sufficient to constitute consent and, moreover, can constitute a fraudulent and deceptive practice in violation of the Advisers Act antifraud provisions. [379] Indeed, the staff has

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stated that an adviser's failure to describe to the client the arrangements that will be made if the client fails to consent to the assignment also constitutes a fraudulent and deceptive practice. [380]

In *Funds Inc. Investment Advisory Co.*, the staff refused to grant no-action relief where, in connection with a proposed spin-off of the shares of a registered adviser, the adviser proposed to notify its clients that (i) the spin-off could constitute an assignment requiring client consent, (ii) advisory services would continue for a period of 30 days after such notice, and (iii) in the absence of written notice to the contrary after such period, the advisory

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client "will be considered to wish to continue the relationship." [381] The staff explained that it had insufficient facts to conclude that the 30-day period was reasonable in those circumstances. [382] Although relief was refused, and the staff reaffirmed its position that silence is generally insufficient to constitute consent, the staff also explained that it generally raises no question if the customer is informed that the prospective assignee would continue the advisory services of the assignor for a specified reasonable period of time and that if the customer continues to accept such services without objection during the specified period, the assignee could, on that basis, assume the customer's consent to the assignment. [383]

The staff did not specify any guidelines as to the length of period that it might consider "reasonable," but suggested that the determination of the reasonableness of a given period would depend on the circumstances.

Footnotes

371 § 205(a)(2) of the Advisers Act. The Advisers Act also prohibits an adviser organized as a partnership from entering into, extending or renewing any advisory contract that fails to provide that the adviser will notify the client of any change in the membership of the partnership. § 205(a)(3) of the Advisers Act. The staff has held, however, that an adviser organized as a limited partnership does not need to include in its advisory contracts a provision obligating it to notify its clients whenever there is a change in the identity of the adviser's limited partners. *The Ayco Company, L.P.* (avail. Dec. 14, 1995).

It is important to note that while § 205(a)(2) prohibits an adviser from entering into an advisory contract that fails to prohibit assignment without the client's consent, it does not prohibit an adviser's assignment of an advisory contract without client consent. Thus, the assignment of an advisory contract without client consent could constitute a breach of the advisory contract or, in egregious circumstances, a breach of the adviser's fiduciary duty, but would not be a violation of § 205(a)(2). *American Century Cos., Inc.* (avail. Dec. 23, 1997); *see also JPMorgan Chase; Bear Stearns Asset Management I* (avail. Mar. 16, 2008) (revised July 14, 2008).

372 *The National Mutual Group* (avail. Mar. 8, 1993); *see also Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994); *Mercury Asset Management* (avail. Apr. 16, 1993); *Unibanco* (avail. July 28, 1992); Hedge Fund Release. Nevertheless, where a non-U.S. adviser's contracts with its non-U.S. clients provide for client consent to assignments—even if the provision was included solely for purposes of compliance with § 205(a)(2) of the Advisers Act—the adviser should comply with the contractual provision.

373 § 202(a)(1) of the Advisers Act. The permissibility of sub-advisory contracts is subject to § 15(a) of the Investment Company Act, which provides that no person may serve as an investment adviser to a registered fund except pursuant to a written contract approved by a majority vote of the fund's shareholders. The SEC staff has agreed not to recommend enforcement action, however, where a new advisory contract was created from a pre-existing contract or fees were reallocated between the primary adviser and a sub-adviser, provided that the new contract or arrangement did not constitute a material change. *See*, *e.g.*, *Wells Fargo Bank, N.A.* (avail. Mar. 31, 1998).

374 The SEC has stated, however, that "the transfer or issuance of a block of stock in connection with a merger involving two issuers generally would not by itself cause an assignment of the advisory contracts of their advisory subsidiaries, for purposes of the Investment Company Act or the Advisers Act, unless (1) a person who had control of either issuer prior to the transaction does not have control of the surviving entity after the transaction, (2) a person who did not have control of either issuer prior to the transaction gains control of the surviving entity, or (3) the transaction results in an advisory subsidiary being merged out of existence." *Dean Witter, Discover & Co; Morgan Stanley Group Inc.* (avail. Apr. 18, 1997). But the SEC has informally cast doubt on the application of this no action letter beyond its facts, suggesting a narrow view of the change of control provisions. *See JPMorgan Chase; Bear Stearns Asset Management I* (avail. Mar. 16, 2008); Adviser and Broker-Dealer Study.

375 § 202(a)(1) of the Advisers Act.

376 SEC Release No. IA-1034 (Sept. 9, 1986); *see also* SEC Release No. IC-10809 (Aug. 6, 1979).

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377 In *Investors Research Corp.*, for example, the staff granted no-action relief in the context of a proposed share exchange by affiliated companies, one of which was a registered adviser, such that the ownership interests of shareholders in each company would be the same. *Investors Research Corp.* (avail. Sept. 10, 1984). In addition, the adviser planned to continue to manage the portfolios of its clients using the same management and professional staff. The purpose of the reorganization was to "arrange the corporate structure in a manner which will assure the continuity and stability of the management of the enterprise both during the lifetime of [the principal stockholder] and at his death." *Investors Research Corp.* (avail. Sept. 10, 1984); *see also Nikko International Capital Management Co., Ltd.* (avail. June 1, 1987) (assumption by majority-owned subsidiary of parent's sub-advisory agreement was within Rule 202(a)(1)-1); *Equitable Life Assurance Society of the United States* (avail. Jan. 11, 1984) (incorporation of unincorporated advisory division did not result in assignment). *But see United Asset Management Corp.* (avail. Nov. 2, 1981) (refusing to agree that transfers, each of less than a controlling block of voting securities of an adviser's parent, did not constitute an "assignment" since such transfers, if coordinated, could result in transfer of a controlling interest).

378 SEC Release No. IA-1034 (Sept. 9, 1986); *Zurich Insurance Company, Scudder Kemper Investments, Inc.* (avail. Aug. 31, 1998) (whether change in control or management occurred as a result of a merger between two financial services providers, where no material change in services, fees, board of directors or executive committee would result, could be determined under Rule 202(a)(1)-1, but staff took no position as to whether the merger itself might involve a change in control or management).

379 *See*, *e.g.*, *Funds Inc. Investment Advisory Co.* (avail. Mar. 3, 1972); *In the Matter of Bridwell & Co., Inc.*, SEC Release No. IA-180 (Dec. 18, 1964). *But see Equitable Life Assurance Society of the United States* (avail. Jan. 11, 1984) (although counsel opined that no assignment would result from incorporation of unincorporated division of company, notice to certain accounts was provided and, if client did not notify company of intent to terminate contract, company would assume consent to transfer to newly incorporated division).

380 *Funds Inc. Investment Advisory Co.* (avail. Mar. 3, 1972).

381 *Funds Inc. Investment Advisory Co.* (avail. Mar. 3, 1972).

382 *Funds Inc. Investment Advisory Co.* (avail. Mar. 3, 1972).

383 *Funds Inc. Investment Advisory Co.* (avail. Mar. 3, 1972).

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U.S. Regulation of the International Securities and Derivatives Markets, § 16.11, MAINTENANCE OF BOOKS AND RECORDS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 16.11 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The Advisers Act and the SEC's related regulations impose detailed recordkeeping requirements on registered investment advisers. [384] Included among the records that the adviser must maintain are:

- financial ledgers (including trial balances and internal audit papers), checkbooks, bank statements, cancelled checks and the like;

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- detailed trade orders, client instructions regarding transactions, trade confirmations and all other written communications relating to the placing or execution of any order;
- paid and unpaid bills;
- records of discretionary accounts managed by the adviser and all related powers of attorney granted to the adviser by its clients;
- copies of all advisory and related contracts;
- copies of all notices, advertisements and the like recommending the purchase or sale of a specific security;
- copies of the adviser's statements satisfying the "Brochure Rule";
- any records or documents necessary to demonstrate the calculation of performance in any advertisement circulated to ten or more persons; [385]
- a copy of the adviser's code of ethics, records of code of ethics violations and any actions taken as a result of those violations, and supervised employees' written acknowledgements of having received the adviser's code of ethics; [386]
- securities holding reports and securities transaction reports of the adviser's access persons and related records; [387] and
- records pertaining to the adviser's compliance with restrictions on political contributions pursuant to Rule 206(4)-5 under the Advisers Act, including documentation of direct or indirect political contributions made by the adviser or any of its "covered associates." [388]

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Under the Private Fund Advisers Act and the related SEC rules, Exempt Reporting Advisers are required to maintain records of certain information with respect to the funds they manage. [389]

An adviser that renders "investment supervisory" or "investment management" services is also required to keep records showing separately for each client the securities purchased and sold, the date, amount and price of each purchase and sale and the current positions held in the client's account. [390] An adviser that has custody of client funds and securities is subject to additional requirements, including a requirement to maintain a separate ledger account for each client showing all purchases, sales, receipts and deliveries of securities, as well as details concerning the prices of transactions. [391]

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Subject to satisfaction of certain conditions, a foreign adviser need not comply with all of the recordkeeping requirements of the Advisers Act in the case of its non-U.S. clients. [392] A foreign adviser must, in any event, maintain at a designated place within the United States correct, complete and current copies of the books and records maintained under the Advisers Act, unless the adviser files a written undertaking to furnish the SEC upon demand with copies of any required books and records and in fact provides such material at its own expense within 14 days subsequent to a written demand of the SEC. [393] In addition, where a foreign adviser's parent or affiliates provide the adviser with research, staff or other

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advisory services, or services relating to transactions effected by the adviser on behalf of its clients, the SEC staff has taken the position that the parent or affiliates must comply with certain of the recordkeeping requirements under the Advisers Act in order to avoid registration under the Advisers Act. [394]

Footnotes

384 § 204 of the Advisers Act and Rule 204-2 thereunder. In 2001, the SEC amended Rule 204-2 to permit electronic retention of required books and records. *See* SEC Release No. IA-1945 (May 24, 2001). The SEC staff has suggested that it may soon consider how to modernize the books and records rule requirements in light of, among other things, developments in recordkeeping technology. *See* Andrew J. Donohue, Director, SEC Division of Investment Management, Remarks at the Tenth Annual Investment Adviser Compliance Best Practices Summit (Mar. 21, 2008).

385 Rule 204-2(a) under the Advisers Act. The SEC has indicated in no-action relief that advisers can facilitate examinations of performance claims if they maintain (i) custodial or brokerage statements that confirm the accuracy of the account statements and other internally generated documents and (ii) reports prepared by an independent auditor that verify performance claims. *See Jennison Associates LLC* (avail. July 6, 2000).

Investment advisers, whether or not registered, may also have reporting requirements to the SEC under provisions of the U.S. securities laws not tied to the Advisers Act. For example, advisers having investment discretion for institutional investors that in the aggregate, together with the adviser's proprietary holdings, hold more than $100 million of publicly traded equity securities designated by the SEC pursuant to § 13(f) of the Exchange Act are required to file quarterly reports on Form 13F. Rule 13f-1 under the Exchange Act. In addition, advisers with investment discretion over accounts holding more than 5% of a class of voting equity securities of an issuer that is registered under the Exchange Act are required to make filings on Schedule 13D or 13G. *See* § 6.02[2].

386 Rule 204-2(a)(12) under the Advisers Act.

387 Rule 204-2(a)(13) under the Advisers Act.

388 Rule 204-2(a)(18) under the Advisers Act.

389 *See* §§ 404, 407 and 408 of the Private Fund Advisers Act; SEC Release No. IA-3221 (June 22, 2011); § 16.03[3][d].

390 Rule 204-2(c) under the Advisers Act. "Investment supervisory services" is defined in § 202(a)(13) of the Advisers Act as the "giving of continuous advice as to the investment of funds on the basis of the individual needs of each client," and the SEC has described "investment management services" as the "management of accounts where either the individual needs of the client are not considered or where the management services are not continuous." SEC Release No. IA-1000 (Dec. 3, 1985), 50 Fed. Reg. 49,835, 49,838 (Dec. 5, 1985). All of the records required to be maintained under the Advisers Act must be preserved in an easily accessible place for at least five years from the end of the fiscal year during which the last entry was made, and during the first two of these years they must be maintained in an office of the investment adviser. Even subsequent to the termination of an adviser's business, the Advisers Act requires retention of the corporate records (including such documents as the minute books, share certificate books and bylaws of an adviser organized in corporate form) for a period of at least three years. Records may, however, be maintained on microfilm or by computer. *See* Rule 204-2(g) under the Advisers Act. In certain circumstances, principally

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investment adviser subscriptions to electronic document provider services, records may even be maintained solely on the computer system of a third-party document provider. *See Disclosure Incorporated* (avail. Aug. 22, 1996); *First Call Corporation* (avail. Sept. 6, 1995); *Oppenheimer Management Corporation* (avail. Aug. 28, 1995).

391 Rule 204-2(b) under the Advisers Act.

392 *The National Mutual Group* (avail. Mar. 8, 1993); Hedge Fund Release.

393 Rule 204-2(j)(3)(i) under the Advisers Act specifies that such undertaking be in the following form:

> The undersigned hereby undertakes to furnish at its own expense to the [SEC] at its principal office in Washington, DC, or at any Regional Office of [the SEC] specified in a demand for copies of books and records made by or on behalf of [the SEC], true, correct, complete and current copies of any or all, or any part, of the books and records which the undersigned is required to make, keep current or preserve pursuant to any provision of any rule or regulation of the [SEC] under the Investment Advisers Act of 1940. This undertaking shall be suspended during any period when the undersigned is making, keeping current, and preserving copies of all said books and records at a place within the United States in compliance with Rule 204-2(j) under the Investment Advisers Act of 1940. This undertaking shall be binding upon the undersigned and the heirs, successors and assigns of the undersigned, and the written irrevocable consents and powers of attorney of the undersigned, its general partners and managing agents filed with the [SEC] shall extend to and cover any action to enforce same.

394 *Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994); *Kleinwort Benson Investment Management Ltd.* (avail. Dec. 15, 1993); *Mercury Asset Management* (avail. Apr. 16, 1993); *Unibanco* (avail. July 28, 1992).

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U.S. Regulation of the International Securities and Derivatives Markets, § 16.12, ENFORCEMENT

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 16.12 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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[1] SEC Enforcement

The Advisers Act, as amended by the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, [395] provides for broad SEC enforcement powers. These include:

- authority to bring suit to enjoin any actual or threatened violation of the Advisers Act by any person, including persons aiding and abetting any such violation and certain supervisory personnel;
- subpoena power to compel the production of witnesses and documents;
- authority to order a party to cease and desist from further violations;
- power to require an accounting and disgorgement of profits; and

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- authority to bar an investment adviser convicted of securities fraud from associating with other investment advisers. [396]

Both administrative and civil fines can be imposed by the SEC in amounts ranging up to $178,156 in the case of a natural person or $890,780 in the case of any entity. [397] In addition, violators are subject to criminal prosecution by the Department of Justice upon referral by the SEC, with potential penalties in the case of willful violations of up to five years in prison and/or a fine of up to $10,000. [398]

[2] Private Right of Action

The Advisers Act does not expressly provide for a private right of action by advisory clients to sue for damages resulting from an adviser's violations of the Advisers Act. [399] For many years a legal controversy existed as to whether such a private right could properly be implied under certain provisions of the Advisers Act—particularly under the antifraud provisions of § 206 of the Advisers Act. [400] The controversy was settled in 1979 with the U.S. Supreme Court's decision in *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*. [401] In that case, the Court found an implied private right of action for rescission and restitution of fees under an advisory agreement under § 215 of the Advisers

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Act, [402] but declined to recognize an implied private right of action for additional damages under § 206. The Court reasoned that in declaring in § 215 that contracts made in violation of the Advisers Act were void, Congress "intended that the customary legal incidents of voidness would follow, including the availability of a suit for rescission or for an injunction against continued operation of the contract, and for restitution." [403] Section 206, on the other hand, "simply proscribes certain conduct, and does not in terms create or alter any civil liabilities," [404] and thus provides no basis for inferring a damages remedy. [405]

[3] SEC Oversight

Registered investment advisers are also subject to SEC oversight. Under § 204 of the Advisers Act, the SEC has

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the authority to make such "reasonable, special, or other examinations by representatives of the SEC as it deems necessary or appropriate in the public interest or for the protection of investors." The SEC staff uses risk-based methodologies to identify activity that may warrant examination and thus to determine which registered investment advisers will be subject to routine examinations in a given year. [406] In particular, the staff divides all registered investment advisers into two groups—high-risk and low-risk—based on certain criteria. [407] In 2008 the SEC staff indicated that it would "zero in" on (i) firms that are of such size that, if anything went wrong, a significant number of investors would be affected, (ii) firms and areas within firms where compliance controls or supervision appears to be weak, and (iii) firms that are involved in activities that may present increased compliance risk, if not controlled adequately, such as dealing in structured products and illiquid securities. [408] Since 2015, SEC staff has aggregated and analyzed data concerning all registrants to identify activity that may warrant examination, identifying operational red flags, such as firms with aberrant swings in reported assets under management, changes in key individuals, business activities, and affiliates, and other possible indicia of heightened risk. [409]

In response to market turmoil and the effect of a significant number of Ponzi schemes and other fraudulent activities detected during the 2008 financial crisis, the SEC has implemented significant improvements to its surveillance efforts. As a result of the SEC's efforts to improve its risk-based methodologies, there was a significant increase in the number of firms identified by the SEC as "high-risk" by 2009. [410] The SEC missed its goal of examining "high-risk" advisers at least once every three years for the three-year period ending in 2013. [411] However, it exceeded its goals for the percentage of all advisers examined in both 2014 and 2015. [412]

In 2012, the SEC completed the restructuring of its enforcement division and launched a reorganization of its inspection unit with the intention of more aggressively and effectively spotting violations and pursuing fraud. As a result of the enforcement division restructuring, the SEC created specialized units to concentrate on high-priority areas of enforcement, one of which focuses on asset management (hedge funds and investment advisers). [413] In 2010, the SEC Office

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of Inspector General conducted an investigation into the SEC's response to Robert Allen Stanford's alleged Ponzi scheme and delivered a report recommending certain changes. [414] In light of the report's recommendations, the SEC implemented changes regarding the agency's leadership, its internal procedures and its culture of collaboration and continues to consider additional reforms as necessary for effective investor protection. [415]

In 2010, the staff generally sought to examine each registered investment adviser in the high-risk group once every three years. Registered investment advisers that were rated in the low-risk category did not receive routine examinations on a regularly scheduled basis. Instead, the firms within the low-risk group were subject to cause examinations resulting from tips, complaints and referrals and special purpose reviews such as risk-targeted examination sweeps and risk assessment reviews. [416] In 2013, the SEC conducted routine inspections of advisers with high-risk profiles (the examined "high-risk" advisers have assets under management that represent approximately 25% of the overall assets under management for currently registered advisers). The SEC examined 9% of the entire population of registered advisers in 2013. The percentage of advisers examined each year generally decreased over the period 2004–2013. While 18% of advisers were examined in 2004, only 8–9% of advisers were examined in each of 2011, 2012 and 2013. [417] However, the trends reversed in 2014 and 2015, when the SEC increased its percentage of advisers examined and exceeded its planned percentage. [418] In March 2016 the SEC's Office of Inspector General reviewed the Office of Compliance Inspections and Examinations ("OCIE")'s goals for investment adviser examination coverage, concluding that OCIE's risk-based examination prioritization was key to meeting the SEC's examination

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goals, and that OCIE has worked to increase its exam coverage. [419] The report recommended that OCIE improve by considering metrics other than the percentage of investment advisers examined each year. [420]

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Footnotes

395 Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990).

396 § 203(f) of the Advisers Act. The D.C. Circuit has held that this authority allows the SEC to bar an investment adviser from associating with both registered and unregistered investment advisers. *Teicher v. SEC*, 177 F.3d 1016 (D.C. Cir. 1999), *cert. denied*, 529 U.S. 1003 (2000).

The SEC is also empowered to adopt rules, regulations and orders concerning payments to investors, rates of interest, periods of accrual and other matters appropriate to the implementation of an order for an accounting and disgorgement of profits. § 203(j) of the Advisers Act.

397 §§ 203(i)(2) and 209 of the Advisers Act; SEC Release No. IA-1596 (Nov. 1, 1996); *see*, *e.g.*, *SEC v. Moran*, 944 F. Supp. 286 (S.D.N.Y. 1996). The maximum amount of the civil monetary penalties that may be assessed under the Advisers Act is periodically adjusted for inflation. *See* SEC Release No. IA-4437 (June 27, 2016) (interim final rule effective Aug. 1, 2016), to be codified at 17 C.F.R. § 201.1001. Settlements for Advisers Act violations involving multiple violations can exceed the statutory maximum civil monetary penalty limits. *In the Matter of Banco Espirito Santo S.A.*, SEC Release No. IA-3304 (Oct. 24, 2011), for example, a Portuguese bank agreed to pay approximately $5,000,000 to settle claims that the bank provided investment advice to U.S. persons without registering with the SEC as an investment adviser.

398 § 217 of the Advisers Act.

399 Nor, according to at least one case, is there any private right of action for aiding and abetting a violation of the Advisers Act. *Mekhjian v. Wollin*, 782 F. Supp. 881 (S.D.N.Y. 1992).

400 *See*, *e.g.*, *Wilson v. First Houston Investment Corp.*, 566 F.2d 1235 (5th Cir. 1978), *cert. vacated and rem'd*, 444 U.S. 959 (1979); *Abrahamson v. Fleschner*, 568 F.2d 862 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978).

401 *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11 (1979).

402 Section 215 of the Advisers Act provides:

> (a) Any condition, stipulation, or provision binding any person to waive compliance with any provision of [the Advisers Act] or with any rule, regulation, or order thereunder shall be void.
>
> (b) Every contract made in violation of any provision of [the Advisers Act] and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of any provision of [the Advisers Act], or any rule, regulation, or order thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, regulation, or order, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision.

403 *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11, 19 (1979); *see also Payne v. Wood*, No. 94-1230, 1995 U.S. App. LEXIS 22551, at *17–18 (6th Cir. 1995).

404 *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11, 19 (1979); *see also Goldstein v.*

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Malcolm G. Fries & Assoc., Inc., 72 F. Supp. 2d 620, 625 (E.D. Va. 1999) (holding that no private right of action exists for violations of § 206 of the Advisers Act).

405 The U.S. District Court for the District of Massachusetts has held that a 1990 amendment to the Advisers Act, made pursuant to the Securities Law Enforcement Remedies Act, did not create a private right of action under § 206. *Filson v. Langman*, No. 99-30021-FHF, 2002 U.S. Dist. LEXIS 22036 (D. Mass. Nov. 13, 2002).

406 *See* SEC, 2007–2015 Annual Reports.

407 SEC, 2013 Annual Report.

408 *See* Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, Remarks at the Private Fund Compliance Forum (May 6, 2014); Lori A. Richards, Director, SEC Office of Compliance Inspections and Examinations, Remarks at the Tenth Annual Investment Adviser Best Practices Summit (Mar. 20, 2008).

409 *See* Andrew J. Donohue, Chief of Staff, Remarks at NRS 30th Annual Fall Investment Adviser and Broker-Dealer Compliance Conference (Oct. 14, 2015).

410 SEC, 2009 Annual Report.

411 SEC, 2013 Annual Report.

412 SEC, 2015 Annual Report.

413 SEC, 2010 Annual Report. For 2016 the SEC identified the following examination priorities: (i) protecting retail investors and investors saving for retirement, including focus on exchange traded funds, branch offices, fee selection and reverse churning, variable annuities, and public pension advisers; (ii) assessing market-wide risks, including cybersecurity; and (iii) using data analytics to identify signals of potential illegal activity, including to find recidivist representatives, to examine AML programs, and to identify breaches of fiduciary obligations with respect to promotion of new products. Other initiatives not among the enumerated priorities but referred to in OCIE's document included examinations of municipal advisors, never-before-examined entities, and private fund advisers. *See* SEC, Office of Compliance Inspections and Examinations, Examination Priorities for 2016 (Jan. 11, 2016).

414 *See* SEC Office of Inspector General, Report of Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme (Mar. 31, 2010).

415 Press Release, SEC, Statement from Chairman Shapiro on OIG Report 526: "Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme" (Apr. 16, 2010); *see also* SEC, 2013 Annual Report.

416 Adviser and Broker-Dealer Study, SEC, 2010 Annual Report. The SEC's risk-based examination approach reflects an effort to make the most efficient use of its limited resources. *See* U.S. Government Accountability Office, GAO-02-302, SEC Operation—Increased Workload Creates Challenges 11 (2002) ("SEC's resource constraints contributed to bottlenecks in the examination and inspection area as workload grew."). From 2004 to 2010, the number of SEC registered investment advisers has increased significantly while SEC resources committed to examination of advisors has declined, increasing reliance on the risk-based approach. Adviser and Broker-Dealer Study.

417 Advisers and Broker-Dealer Study. In 2010, the SEC conducted approximately 1,083 examinations overall. In each year from 2004 to 2008, the SEC conducted over 1,300 examinations. After decreasing in 2010 and 2011, the number of overall examinations increased to just over 1,400 in 2013. *See* SEC, 2013 Annual Report.

418 SEC, 2014 Annual Report; SEC, 2015 Annual Report (SEC planned to examine 9% of advisers but examined 10% each year).

419 SEC, Office of Inspector General, OCIE's Management of Investment Adviser Examination Coverage Goals, Draft Report No. 533 (Mar. 10, 2016).

420 SEC, Office of Inspector General, OCIE's Management of Investment Adviser Examination Coverage Goals, Draft Report No. 533 (Mar. 10, 2016).

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U.S. Regulation of the International Securities and Derivatives Markets, § 16.13, INSIDER TRADING ACT AND PERSONAL TRADING

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 16.13 (11th and 12th Editions 2014-2017)
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Investment advisers (other than investment advisers specifically exempted from registration under § 203(b) of the Advisers Act) are subject to Section 204A of the Advisers Act, [421] which imposes liability on firms and individuals who supervise [422] or employ persons who are found to have violated the insider trading prohibitions contained in the Advisers Act or the Exchange Act. [423] Pursuant to amendments made to the Exchange Act, liability under the Insider Trading Act can take the form of civil penalties of $1.425 million or more or SEC disciplinary action. [424] In addition, the Insider Trading Act also creates an express private right of action for damages against supervisory personnel, as well as against violators of the act's provisions. [425]

The Advisers Act requires an adviser to implement written policies and procedures to prevent the misappropriation and misuse of material nonpublic information by the adviser or its associated persons. [426] Neither the Advisers Act nor its legislative history provides specific guidance as to the appropriate scope

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of such procedures, [427] which will of course depend on the nature of the adviser's business and its affiliations (if any) with a registered broker-dealer. At a minimum, however, such procedures should include identification of specific personnel to monitor dissemination of information and ongoing monitoring of the procedures and establishment of reporting and other mechanisms to aid in detection of insider trading violations. These mechanisms may include, for example, employee education, certifications from employees that they have reviewed and understood the policies and procedures, the use of restricted lists, watch lists and information barriers to isolate certain of the entity's operations, other proprietary and employee trading restrictions to limit transactions in securities concerning which the entity is in possession of material nonpublic information, blackout periods to prevent "trading ahead" of clients based on the adviser's research recommendations and limitations on the dissemination of sensitive information. [428]

In addition to policies and procedures required to prevent insider trading, the Advisers Act also imposes recordkeeping requirements on registered advisers with respect to trading by "access persons." [429] Records under these provisions must be maintained for prescribed periods and are subject to inspection by the SEC at any time that the SEC deems necessary or appropriate in the public interest or for the protection of investors. [430] In particular, registered advisers are required to keep a record of the names of their access persons, the securities holdings and transaction reports made by access persons and records of

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decisions approving access persons' acquisition of securities in initial public offerings and limited offerings (*i.e.*, offerings exempt from registration under § 4(a)(2) or § 4(a)(6) of the Securities Act or Regulation D under the Securities Act). [431] Advisers to investment companies registered under the Investment Company Act are subject to special rules governing the conduct of their employees. Trading practices of such advisers and their personnel have been the subject of public and industry scrutiny favoring increased limitations on the ability of such persons to engage in securities transactions that may result in conflicts of interest with their investment company clients. [432]

Footnotes

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421 *See* Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988); *see also* § 15(g) of the Exchange Act (analogous provision applicable to broker-dealers).

422 *See* § 203(e)(6) of the Advisers Act, which provides that a failure to supervise will not be deemed to have occurred if:

> (A) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and (B) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

423 *See* §§ 14.07[1][b] and 14.08.

424 § 21A of the Exchange Act; 17 C.F.R. § 201.1004 and Table IV to Subpart E of Part 201.

425 § 20A of the Exchange Act. Whether an individual constitutes a "supervisor" for these purposes "depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue." *In the Matter of George J. Kolar*, SEC Release No. 34-46127 (June 26, 2002) (citing *In the Matter of John H. Gutfreund*, SEC Release No. 34-31554 (Dec. 3, 1992)).

426 Section 204A of the Advisers Act provides in pertinent part that every investment adviser, other than those specifically exempted from registration under § 203(b) of the Advisers Act,

> [S]hall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to prevent the misuse in violation of [the Advisers Act or the Exchange Act], or the rules or regulations thereunder, of material, nonpublic information by such investment adviser or any person associated with such investment adviser.

427 As reported in the U.S. House of Representatives,

> [T]he Committee expects that institutions subject to the requirements of this provision will adopt policies and procedures appropriate to restrict communication of nonpublic information and to monitor its dissemination, such as restraining access to files likely to contain such information; providing continuing education programs concerning insider trading; restricting or monitoring trading in securities relating to which the firm's employees possess nonpublic information; and vigorously monitoring and reviewing trading for the account of the firm or individuals.

H.R. Rep. 910, 100th Cong., 2d Sess., 21, 22 (1988).

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428 For a more complete discussion of these procedures and mechanisms and of responses to the requirements of the Insider Trading Act applicable to both broker-dealers and advisers, see §§ 14.07[1][b] and 14.08.

429 *See supra* Note 353.

430 § 204 of the Advisers Act.

431 Rule 204-2(a)(13) under the Advisers Act. Section 4(a)(2) of the Securities Act and Regulation D thereunder are discussed in Chapter 7.

432 *See, e.g.*, Investment Company Institute, REPORT TO THE DIVISION OF INVESTMENT MANAGEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION, IMPLEMENTATION OF THE INSTITUTE'S RECOMMENDATIONS ON PERSONAL INVESTING (Apr. 21, 1995).

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U.S. Regulation of the International Securities and Derivatives Markets, § 16.14, STATE REGULATION

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 16.14 (11th and 12th Editions 2014-2017)
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As described in § 16.02[1][a], the Coordination Act, together with the Private Fund Advisers Act, provides for a division in supervisory responsibility with respect to investment adviser regulation between the SEC and the state securities regulatory authorities—with small advisory firms under state supervision and large advisory firms under SEC supervision. The Private Fund Advisers Act created a new category of "mid-sized" advisers with assets under management [433] of between $25 million and $100 million that generally may not register with the SEC unless the adviser would be required to register with 15 or more states or is an adviser to a registered investment company or a business development company. [434] The Advisers Act gives the SEC primary responsibility for the regulation of advisers that remain registered with the SEC by preempting certain state laws with respect to those advisers. The states may not impose their own registration requirements on such SEC-registered advisers or "supervised persons" of such advisers, although states may license, register or otherwise qualify any investment adviser representative that has a place of business located within that state. [435] Those advisers with less than $25 million in assets under management and mid-sized advisers will be subject to state regulation and must continue to register with their home state and any other state where they may conduct business.

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Each state of the United States, as well as the District of Columbia and Puerto Rico, has the authority to require that persons who provide investment advisory services, whether from or to persons within that state or jurisdiction, register with the appropriate state or local authorities. [436]

Generally, all states and other jurisdictions that regulate investment advisory operations require that an adviser consent to service of process within the state or jurisdiction for state securities law violations. In addition, certain states impose minimum capital requirements, which may not be satisfied through the posting of a bond or the maintenance of insurance. These requirements are usually applicable only to advisers with custody of client funds or securities. [437] The majority of states require that the adviser post a surety bond or otherwise maintain professional liability insurance with respect to its operations. However, the Advisers Act provides that the states may not impose recordkeeping, minimum net capital and bonding requirements on an adviser that differ from those imposed by the state where it maintains its principal office and place of business. [438] Many states also require that persons employed by registered investment advisers be separately registered as agents or representatives. [439] The Advisers Act further provides that the states may require those investment adviser representatives who are employed by SEC-registered investment advisers but have a place of business in the state to register under the state's securities laws. [440] In addition, the Advisers Act sets forth a *de minimis* standard whereby states may not require registration of any adviser that does not have a place of business in the state and has fewer than six clients in the state during the previous 12-month period. [441]

The Coordination Act preserved the authority of the states to require SEC-registered advisers to file with the state (for notice purposes) any documents filed with the SEC, together with a consent to service of process and filing fee, [442] and the Private Fund Advisers Act and related SEC rules do not alter this authority of the states. The states retain their authority to investigate and bring enforcement actions with respect to fraud claims against advisers and their associated persons. [443]

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Most state Regulation D erives from the Uniform Securities Act (1956), adopted at one time or another, in whole or in part, by 37 jurisdictions, and its successor, the Revised Uniform Securities Act. As both of these acts were preempted in part by NSMIA, the Uniform Securities Act (2002) was drafted and approved by the National Conference of Commissioners on Uniform State Laws as a "new" Uniform Securities Act. [444] The North American Securities Administrators Association (the "NASAA") has also provided a model form of regulation for investment advisers consisting of a set of administrative rules incorporating many of the federal securities law requirements. Although most states have adopted some version of the foregoing models, many state legislatures and securities authorities have adjusted the model provisions in light of their own regulatory schemes, as state regulation can vary substantially from jurisdiction to jurisdiction. SEC rulemaking has, however, created a central registration procedure through the Investment Advisers Registration Depositary ("IARD") for filings of state-registered advisers. [445] The SEC has re-programmed the IARD system to function under the Private Fund Advisers Act regime, but the IARD will still serve as a database for SEC-registered and state-registered advisers. [446]

Notwithstanding the substantial variations that can exist among state investment adviser regulations, most state initiatives closely follow the federal scheme. Form ADV has been, for example, the uniform form of application used for registration under the laws of most states, although a number have required supplementary information. [447] In addition, most state securities statutes provide for exclusions and exemptions from registration requirements, which in some cases are broader than those provided under the Advisers Act. For example, the definition of "investment adviser" under the Uniform Securities Act (1956)

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excludes "savings institutions" and "trust companies" in addition to those entities covered by the similar provision contained in § 202(a)(11)(A) of the Advisers Act. Another example is the elimination by a number of states of the requirement, in connection with the exclusion for broker-dealers, [448] that the advisory activities be "solely incidental" to the broker-dealer's securities trading business. [449] Moreover, the definition of "investment adviser" in many state statutes provides for an "institutional" exclusion for advisers that do not have any place of business within the state and only advise "financial institutions," which would generally include banks, thrifts, investment companies and insurance companies. [450] Nevertheless, states that have adopted the Revised Uniform Securities Act or the Uniform Securities Act (2002) have eliminated the "institutional adviser" and the *de minimis* exclusions from the definition of investment adviser and treated such advisers as being exempt from registration. As in the case of the federal liability provisions, the effect of the change is to bring such advisers within the ambit of state antifraud provisions applicable to all advisers, regardless of registration status. [451]

State substantive regulation of investment advisers generally incorporates all of the requirements applicable to advisers under the Advisers Act. Currently, the most significant difference between federal and state regulation of advisers relates to compensation: most states have not updated applicable regulations to permit the limited performance-based compensation arrangements permitted under Rules 205-1, 205-2 and 205-3 under the Advisers Act. [452] In addition, those states that have used the NASAA-proposed regulations as a basis for their regulatory scheme impose certain additional restrictions, including prohibitions against an adviser's engaging in trading that is excessive in size or frequency in view of the financial resources and character of a client's account. [453] Such states may also require that an adviser have reasonable grounds to believe that a recommendation is suitable for a client, on the basis of information furnished by the client after reasonable inquiry concerning the client's investment objectives, financial situation and needs. Finally, as in the case of current federal regulation, many states do not provide for any express private right of action for damages against investment advisers, although the Uniform Securities Act (2002) creates such a right.

Footnotes

433 R-AUM is used for purposes of determining whether an adviser is a "mid-sized" adviser. *See* § 16.03[3][a][i] for discussion of R-AUM.

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434 The addition of the mid-sized adviser category was the principal change the Private Fund Advisers Act made to the regime imposed by the Coordination Act. The Private Fund Advisers Act also changed references in the related sections from "principal place of business" to "principal office and place of business," but otherwise left the Coordination Act regime intact.

435 § 203A(b)(1) of the Advisers Act.

436 Currently, the only state that does not regulate investment advisory activities is Wyoming.

437 *See*, *e.g.*, CAL. CORP. CODE § 25237, CAL. CODE REGS. tit. 10, § 260.237.2; CONN. GEN. STAT. § 36b-5(c), CONN. AGENCIES REGS. § 36b-31-9c; FLA. STAT. § 517.12, FLA. ADMIN. CODE ANN. r.69W-600.016; KY. REV. STAT. ANN. § 292.330, 808 KY. ADMIN. REGS. 10:200; WASH. REV. CODE ANN. § 21.20.060, WASH. ADMIN. CODE § 460-24A-170; WIS. STAT. § 551.406, WIS. ADMIN. CODE DFI-SEC 5.02.

438 §§ 222(b) and 222(c) of the Advisers Act.

439 *See*, *e.g.*, GA. CODE ANN. § 10-5-33; R.I. GEN. LAWS § 7-11-203.

440 § 203A(b)(1) of the Advisers Act.

441 § 222(d) of the Advisers Act.

442 §§ 307(a) and 307(b) of the Coordination Act.

443 § 203A(b)(2) of the Advisers Act.

444 The Uniform Securities Act (2002) has been adopted by Hawaii, Idaho, Indiana, Iowa, Kansas, Maine, Minnesota, Missouri, Oklahoma, South Carolina, South Dakota, Vermont, Wisconsin and the U.S. Virgin Islands.

445 SEC Release No. IA-1897 (Sept. 12, 2000). All states are required to accept filing of Forms ADV and ADV-W (the form used to withdraw an adviser registration) through the IARD. Most states have adopted legislation and/or regulations that require state-registered advisers to use the IARD. *See also* § 16.04.

446 SEC Release No. IA-3221 (June 22, 2011). The SEC envisions the IARD as a tool to identify whether particular advisers meet the requirements to register with the SEC under the Private Fund Advisers Act and related SEC rules.

447 The SEC has adopted rules overhauling Form ADV. The new Form ADV requires additional information, in particular with respect to advisers to private funds, and a reorganization of information provided in order to standardize presentation of information across all advisers. *See* §§ 16.04, 16.05. States that adopted the SEC's Form ADV prior to the Private Fund Advisers Act have generally adopted the amended Form ADV. The NASAA has also adopted amendments to its model rules to reflect SEC changes to the brochure rule and Form ADV.

448 § 202(a)(11)(C) of the Advisers Act.

449 *See, e.g.*, N.J. STAT. ANN. § 49:3-49(g); 70 PA. STAT. ANN. § 1-102.

450 *See* N.J. STAT. ANN. § 49:3-49(g); 70 PA. STAT. ANN. § 1-102.

451 *See* § 16.03[2].

452 The Revised Uniform Securities Act contains no prohibition on performance-based compensation, and the NASAA's regulations permit performance-based fees that are calculated essentially as provided in Rule 205-3 under the Advisers Act.

453 *See*, *e.g.*, IOWA ADMIN. CODE r. 191-50.38(502); MONT. ADMIN. R. 6.10.402; OR. ADMIN. R. 441-205-0145.

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U.S. Regulation of the International Securities and Derivatives Markets, § 16.15, ANTI-MONEY LAUNDERING COMPLIANCE

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1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 16.15 (11th and 12th Editions 2014-2017)
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Investment advisers have not traditionally been regulated as "financial institutions" under the Bank Secrecy Act of 1970 (the "BSA") [454] and therefore have not been subject to anti-money laundering compliance regulations issued by the Financial Crimes Enforcement Network ("FinCEN"). [455] In May 2003, FinCEN issued a proposal to require certain investment advisers that offer asset management services to adopt an anti-money laundering program under the USA Patriot Act. [456] While the 2003 proposal was withdrawn in October 2008, in August 2015, FinCEN again issued a notice of proposed rulemaking that would impose anti-money laundering ("AML") compliance obligations on investment advisers under the BSA. The proposed AML regulations would require registered investment advisers to establish an AML program consistent with the requirements of the BSA, including risk-based policies, procedures and controls; independent testing; designation of an AML compliance officer or committee, and appropriate employee training. It would also require advisers to file suspicious activity reports and currency transactions reports. [457] The proposed AML regulations would not subject investment advisers to the customer due diligence rules applicable to broker-dealers and others summarized in § 14.07[4][e]. However, subsequent rulemaking is expected to extend these requirements to investment advisers.

Footnotes

454 Bank Secrecy Act of 1970, Pub. L. No. 91-508, 84 Stat. 1118 (1970).

455 However, investment advisers have been and continue to be subject to criminal anti-money laundering laws.

456 *See* FinCEN, Anti-Money Laundering Programs for Investment Advisers, 68 Fed. Reg. 23,646 (May 5, 2003); FinCEN, Withdrawal of the Notice of Proposed Rulemaking; Anti-Money Laundering Programs for Investment Advisers, 73 Fed. Reg. 65,568 (Nov. 4, 2008).

457 FinCEN, Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, 80 Fed. Reg. 52,680 (Sept. 1, 2015).

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