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Regulation of Investment Advisers by the U.S. Securities and Exchange Commission

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March 2017

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Note to Reader

I have designed this outline to be both a synthesis of regulation of advisers by the SEC, primarily under the Advisers Act, as well as a tool to identify and access legal and regulatory precedents. If you are reading an electronic version of this outline, you can use its many hyperlinks to view the authorities cited.

Statutes cited in the outline may be found at the SEC Securities Laws website. Rules cited may be found at the U.S. Government Printing Office Electronic Code of Federal Regulations. Links to source documents are provided by Brightline Solutions™.

I update this outline frequently, so please visit the Proskauer Rose LLP web site to download the most recent version. If you identify an error or believe I have missed an important point or precedent, feel free to contact me at rplaze@proskauer.com.

Regulation of Investment Advisers by the U.S. Securities and Exchange Commission[1]

I. Introduction

Money managers, investment consultants, and financial planners are regulated in the United States as "investment advisers" under the U.S. Investment Advisers Act of 1940 ("Advisers Act" or "Act") or similar state statutes. This outline describes the regulation of investment advisers by the U.S. Securities and Exchange Commission ("SEC").

The Advisers Act is the last in a series of federal statutes intended to eliminate abuses in the securities industry that Congress believed contributed to the stock market crash of 1929 and the depression of the 1930s. The Act is based on a congressionally-mandated study of investment companies, including consideration of investment counsel and investment advisory services, carried out by the SEC during the 1930s.[2] The SEC's report traced the history and growth of investment advisers and reflected the position that investment advisers could not properly perform their function unless all conflicts of interest between them and their clients were removed. The report stressed that a significant problem in the industry was the existence, either consciously or, more likely, unconsciously, of a prejudice by advisers in favor of their own financial interests.

The SEC's report culminated in the introduction of a bill that, with some changes, became the Advisers Act. The Act, as adopted, reflects congressional recognition of the delicate fiduciary nature of the advisory relationship, as well as Congress' desire to eliminate, or at least expose, all conflicts of interest that might cause advisers, either consciously or unconsciously, to render advice that is not disinterested.[3]

The outline that follows is divided into five sections, each of which addresses a different question: Who is an "investment adviser?" Which investment advisers must register with the SEC? Who must register under the Act? How does an investment adviser register under the Act? What are the requirements applicable to an investment adviser registered under the Act?

II. Who is an Investment Adviser?

A. Definition of Investment Adviser

Section 202(a)(11) of the Act defines an investment adviser as any person or firm that:

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[1] This outline provides general information on the subject matter discussed, does not necessarily reflect the views of Proskauer Rose LLP or any of its clients, and should not be relied upon for legal advice on any matter. Mr. Plaze was formerly Deputy Director of the Division of Investment Management, U.S. Securities and Exchange Commission.

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

[3] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 189, 191-192 (1963).

- for compensation;
- is engaged in the business of;
- providing advice to others or issuing reports or analyses regarding securities.

A person must satisfy all three elements to fall within the definition of "investment adviser."[4] In an extensive interpretive release, the SEC staff has explained how the Act applies to financial planners, pension consultants, and other persons who, as a part of some other financially related services, provide investment advice.[5] Published in 1987, Advisers Act Release No. 1092 represents the views of the SEC Division of Investment Management, which is primarily responsible for administering the Act. Courts accord this release substantial deference when applying the Advisers Act.[6]

1. *Compensation.* The term "compensation" has been broadly construed. Generally, the receipt of any economic benefit, whether in the form of an advisory fee, some other fee relating to the total services rendered, a commission, or some combination, satisfies this element.[7] It is not necessary that a client "pay a discrete fee specifically earmarked as payment for investment advice."[8] The compensation element is satisfied even if payments cover only the cost of the services.[9] And it doesn't matter

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4 In addition to statutory provisions, SEC-adopted rules, court decisions, and SEC releases, this outline cites numerous SEC staff letters, which reflect the current views of the staff of the application of the Advisers Act. These letters are informal staff advice and do not have the force of law. *See* *NYCERS v. SEC*, 45 F.3d 7, 12-13 (2d Cir. 1995). They do, however, "represent the views of persons who are continuously working with the provisions of the statute involved," and thus are frequently relied on by interested persons to provide guidance on the applications of the Act. *See* 17 CFR 202.1(d). The SEC staff generally permits third parties to rely on no-action letters to the extent that their facts and circumstances are substantially similar to those described in the underlying request for no-action. *See* *Informal Guidance Program for Small Entities*, Advisers Act Rel. No. 1624 (Mar. 27, 1997) at n.20.

5 *Applicability of the Advisers Act of 1940 to Financial Planners, Pension Consultants, and Other Persons Who Provide Others with Investment Advice as a Component of Other Financial Services*, Advisers Act Rel. No. 1092 (Oct. 8, 1987) ("Release 1092").

6 *See, e.g.*, *U.S. v Miller, 833 F.3d 274 (D.C. Cir., Mar. 15, 2016)* ("We defer to [Release 1092] because of the SEC's expertise and the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control." (internal cites and quotes omitted)).

7 *Id.; see also* *Kenisa Oil Company*, SEC Staff No-Action Letter (May 6, 1982); *SEC v. Fife*, 311 F. 3d 1 (1st Cir. 2002) (a person provides advice for compensation if it understands that successful investment will yield it a commission); *U.S. v. Manyu Ogale*, 2010 U.S. App. Lexis 9636 (11th Cir. 2010) (per curiam) (adviser to hedge fund who uses investor's money to pay personal expenses receives compensation); *Alexander V. Stein*, Advisers Act Rel. No. 1497 (June 8, 1995) (a person who fraudulently converts client funds to its own use receives compensation).

8 *U.S. v. Elliott*, 62 F.3d 1304, 1311 (11th Cir. 1995).

9 *CFS Securities Corp.*, SEC Staff Letter (Feb. 27, 1987); *Touche Holdings, Inc.*, SEC Staff Letter (Nov. 30, 1987).

whether the person receiving the advice or another person is paying the compensation."[10]

2. *Engaged in the Business.* A person must be engaged in the business of providing advice. This does not have to be the sole or even the primary activity of the person. Factors used to evaluate whether a person is engaged are: (i) whether the person holds himself out as an investment adviser; (ii) whether the person receives compensation that represents a clearly definable charge for providing investment advice; and (iii) the frequency and specificity of the investment advice provided.[11] Generally, a person providing advice about specific securities will be "engaged in the business" unless specific advice is rendered only on a rare or isolated occasion.[12]

   Holding Out. The SEC staff views a person as holding himself out as an adviser if he advertises as an "investment adviser," investment manager or financial planner, uses letterhead indicating activity as an investment adviser, or maintains a telephone listing or otherwise lets it be known that he will accept new advisory clients,[13] hires a person to solicit clients on his behalf,[14] or makes information about itself generally available on the Internet.[15]

   Non-U.S. Advisers and the Internet. The SEC does not view an adviser that uses the Internet to be holding itself out as an investment adviser if (i) the web site includes a prominent disclaimer making it clear to whom the site materials are (or are not) directed; and (ii) the adviser implements procedures reasonably designed to guard against directing information about its advisory services to U.S. persons.[16]

3. *Advising about Securities.* A person clearly meets the third element of the statutory test if he provides advice about specific securities, such as stocks, bonds, mutual

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[10] Release 1092.

[11] Release 1092, *supra* note 5.

[12] For instance, the SEC staff would not view an employer providing advice to an employee in connection with an employer-sponsored employee benefit program to be in the business of providing advice; *see* *Letter to Olena Berg, Assistant Secretary, Department of Labor* (Feb. 22, 1996). *See also* *Zinn v. Parrish*, 644 F.2d 360 (7th Cir. 1981) at 364 ("isolated transactions with a client as an incident to the main purpose of his management contract to negotiate football contracts do not constitute engaging in the business of advising others on investment securities").

[13] *See, e.g.*, *George J. Dippold*, SEC Staff No-Action Letter (May 7, 1990); *William Bloor*, SEC Staff No-Action Letter (Feb. 15, 1980); *Richard J. Shaker*, SEC Staff No-Action Letter (Aug. 1, 1977); *Al O'Brien Associates*, SEC Staff No-Action Letter (Oct. 6, 1973).

[14] Advisers Act Rel. No. 688 (July 15, 1979) at n.9. *See also* *Lamp Technologies, Inc.*, SEC Staff No-Action Letter (May 29, 1997) (investment adviser not "holding itself out generally to the public as an investment adviser" solely by virtue of posting information about certain private funds (*e.g.*, hedge funds) on a password-protected website accessible only by accredited investors).

[15] *Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information*, Advisers Act Rel. No. 1562 (May 9, 1996).

[16] *Statement of the Commission Regarding the Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore*, Advisers Act Rel. No. 1710 (Mar. 23, 1998).

funds, limited partnerships, and commodity pools. The SEC staff has stated that advice about real estate,[17] coins, precious metals, or commodities is not advice about securities.[18] The more difficult questions arise with less specific advice, or advice that is only indirectly about securities. Advice about securities includes:

a. advice about market trends;[19]

b. advice about the selection and retention of other advisers;[20]

c. advice about the advantages of investing in securities versus other types of investments (*e.g.*, coins or real estate);[21]

d. providing a selective list of securities even if no advice is provided as to any one security;[22]

e. advising about the value of securities;[23]

f. asset allocation advice; [24] and

g. advice about voting proxies.[25]

Discretionary Authority. An adviser managing client assets on a discretionary basis would be providing advice to its clients.[26] The Advisers Act does not distinguish

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17 *Brighton Pacific Realty Asset Mgmt. Co.*, SEC Staff Letter (Feb. 10, 1992). Many types of real estate investments, however, can be securities, such as investments in REITs (real estate investment trusts).

18 *Robert R. Champion*, SEC Staff No-Action Letter (Sept. 22, 1986).

19 *Dow Theory Forecasts*, SEC Staff No-Action Letter (Feb. 2, 1978). Thus, market-timing advice is advice about securities. *See* *Maratta Advisory, Inc.*, SEC Staff No-Action Letter (July 16, 1981).

20 *SEC v. Bolla*, 401 F. Supp. 43 (D.D.C. 2005), *aff'd. in relevant part*, *SEC v. Washington Investment Network*, 475 F.3d 392 (D.C. Cir. 2007); Release 1092, *supra* note 5; *FPC Securities Corp.*, SEC Staff No-Action Letter (Dec. 1, 1974).

21 Release 1092, *supra* note 5.

22 *RDM Infodustries, Inc.*, SEC Staff No-Action Letter (Mar. 25, 1996). The SEC staff takes the position that providing information about securities in a report does not constitute providing advice about the securities if: (i) the information is readily available to the public in its raw state; (ii) the categories of information presented 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 security. *See* *Media General Financial Services*, SEC Staff No-Action Letter (July 20, 1992). The letter notes that the staff does not believe that information is organized or presented in a manner suggesting the purchase, holding, or sale of securities, where the customer or subscriber, and not the information provider, selects the search criteria or requests that the service provide certain select information.

23 *Chaffe & Associates*, SEC Staff Letter (Jan. 4, 1985).

24 *Maratta Advisory, Inc.*, *supra* note 19. *See also* *SEC v. Bolla*, *supra* note 20.

25 *Concept Release on the U.S. Proxy System*, Advisers Act Rel. No. 3052 (July 14, 2012). In this release the SEC stated that the activities of proxy voting services made them investment advisers, subject to the Act (although many may not have a sufficient amount of assets to register), and requested comment on whether they should be required to register. No action has been taken by the SEC on this concept release.

between "investment advisers" and "investment fund managers" as do many non-U.S. jurisdictions.

Digital Advice. The Act applies to persons providing advice through human interaction as well as those providing digital advice through a web site via algorithms built into the programming of a "robo-adviser."[27]

Investment Banking. The SEC staff does not believe that the Act applies to persons whose activities are limited to advising issuers concerning the structuring of their securities offerings, even though such advice may technically be about securities.[28] Providing advice regarding the investment of the proceeds of the offering, however, may subject the person to the Act.[29]

4. *Advising Others.* A person is not subject to the Act if he is managing his own securities portfolio. Questions about whether a person advises "others" usually arise when a client is not a natural person. The SEC generally looks to whether there is an identity of interest between the adviser and the ultimate client.[30]

   a. A person managing a fund investing in securities, such as a mutual fund or a hedge fund, is advising others even where the person is the general partner with legal title to these assets.[31]

   b. A wholly-owned corporate subsidiary exclusively advising the parent or another wholly-owned corporate subsidiary would not generally be considered advising "others."[32]

   c. A member of an investment club who gives advice about securities in which the club invests may be advising others.[33]

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[26] *Abrahamson v. Fleschner*, 568 F.2d 862, 871 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978) ("These provisions [of the Advisers Act] reflect the fact that many investment advisers "advise" their customers by exercising control over what purchases and sales are made with their clients' funds."). The SEC takes the view that "each trade initiated by the adviser would constitute 'advice.'" *Suitability of Investment Advice Provided by Investment Advisers*, Advisers Act Rel. No. 1406 (Mar. 16, 1994) at n.12.

[27] The SEC staff has provided recent guidance on the fiduciary obligations of robo-advisers. IM Guidance Update No. 2017-02 (Feb. 2017).

[28] *See, e.g.*, *The Applicability of the Advisers Act of 1940 to Financial Advisors to Municipal Bond Issuers, Division of Investment Management*, SEC Staff Legal Bulletin No. 11 (Sept. 19, 2000); *The Knight Group*, SEC Staff No-Action Letter (Nov. 19, 1991); *Dominion Resources*, SEC Staff No-Action Letter (July 23, 1985).

[29] *Id.*

[30] *Touche Holdings, Inc.*, SEC Staff No-Action Letter (Nov. 30, 1987).

[31] *United States v. Ogale*, No. 09-11780, 2010 U.S. App. Lexis 9636 (11th Cir. 2010).

[32] *See Zenkyoren Asset Mgmt. of America Inc.*, SEC Staff No-Action Letter (June 30, 2011). .

[33] *See Rami Hofshi*, SEC Staff No-Action Letter (Feb. 26, 1973). The advice may be provided to the club or to the other members depending upon whether the advice was tailored to the needs of the members or the club.

Non-U.S. Clients. The SEC takes the position that a U.S. person providing advice exclusively to non-U.S. persons would still be subject to the Act.[34]

B. Exclusions from Definition

There are several exclusions from the investment adviser definition available to persons who presumably (or at least arguably) satisfy all three elements of the definition. A person eligible for an exclusion is not subject to *any* provisions of the Act.

1. *Banks and Bank Holding Companies.* This exclusion is generally limited to U.S. banks and bank holding companies.[35] The SEC staff has stated that the exclusion is not available to non-U.S. banks,[36] credit unions, and investment adviser subsidiaries of banks or bank holding companies.[37]

2. *Lawyers, Accountants, Engineers, and Teachers*. The professional exclusion is available only to those professionals listed, and only if the advice given is incidental to the practice of their profession.[38] Factors considered by staff to evaluate whether advice is incidental to a profession are: (i) whether the professional holds himself out as an investment adviser; (ii) whether the advice is reasonably related to the professional services provided; and (iii) whether the charge for advisory services is based on the same factors that determine the professional's usual charge.[39]

3. *Brokers and Dealers*. A broker or dealer that is registered with the SEC under the Securities Exchange Act of 1934 ("Exchange Act") is excluded from the Act if the

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Investment clubs may also be subject to the Investment Company Act. *See* *Frank Mason*, SEC Staff Letter (July 3, 1996).

[34] *See* Release 3221, *infra* note 90, at n.76. *Gim-Seong Seow*, SEC Staff No-Action Letter (Nov. 30, 1987) (domestic adviser that provides advice to non-U.S. clients must register (unless an exemption is available) if it uses any U.S. jurisdictional means in connection with its advisory business).

[35] Section 202(a)(11)(A). The term "bank" is defined in section 202(a)(2) of the Act. In 2001, the Act's definition of "investment adviser" was amended so that banks and bank holding companies are not eligible for this exclusion to the extent that they serve or act as an investment adviser to a registered investment company. However, 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, is deemed to be the investment adviser. (The phrase "separately identifiable department or division" is defined in section 202(a)(26)). The effect of this provision is to make the bank exclusion unavailable to banks advising registered investment companies.

[36] *Letter to Rep. William J. Hughes from Stanley B. Judd, Deputy Chief Counsel, Division of Investment Management*, SEC (June 4, 1980). *But see*, *American Express Bank International*, SEC Staff No-Action Letter (Jun. 2, 1987) (stating staff will not recommend enforcement action if a so-called "Edge Act corporation," which is established by a non-U.S. bank to engage in international banking transactions and regulated as a bank under the Federal Reserve Act, does not register as an investment adviser if it limits the services it provides to U.S. persons to non-U.S. securities).

[37] *First Commerce Investors, Inc.*, SEC Staff No-Action Letter (Jan. 31, 1991); *Southwest Corporate Federal Credit Union*, SEC Staff No-Action Letter (May 31, 1983).

[38] Section 202(a)(11)(B).

[39] Release 1092, *supra* note 5; *Henry S. Miller Companies of Dallas, Texas*, SEC Staff No-Action Letter (Feb. 21, 1975).

advice given is: (i) solely incidental to the conduct of its business as broker or dealer, and (ii) it does not receive any "special compensation" for providing investment advice.[40] The analysis is done separately for each account.

Solely Incidental. The SEC has stated that investment advice is "solely incidental" to brokerage services when the advisory services rendered are "in connection with and reasonably related to the brokerage services provided."[41] If advice is not "solely incidental," a broker-dealer is subject to the Advisers Act with respect to the account regardless of the form of compensation it receives.

In 2007, the SEC proposed a rule that identified two non-exclusive "situations" in which it would consider broker-dealers to not provide incidental advisory services:[42]

a. *Separate Contract of Fee for Advisory Services*. A broker-dealer that separately contracts or separately charges a customer for advisory services would provide non-incidental advice to that customer.

b. *Discretionary Investment Advice.* Broker-dealer discretionary accounts (unless discretion is granted on a temporary or limited basis) must be treated as advisory accounts.

While the rule was never adopted, the guidance is the most recent provided by the SEC.

Special Compensation. Generally, to avoid receiving "special compensation," a broker or dealer relying on this exclusion must receive only commissions, markups, or markdowns.[43]

a. *Bundled Fees.* The SEC has stated a broker-dealer that receives a fee based on a percentage of assets that compensates the broker-dealer for both advisory and brokerage services receives "special compensation."[44]

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40 Section 202(a)(11)(C). A broker-dealer may advertise or otherwise hold itself out as providing investment advice without loss of the broker-dealer exception if its advisory activities are limited to those within the exemption. *Elmer D. Robinson*, SEC Staff No-Action Letter (Jan. 6, 1986); *Elliott W. Smith*, SEC Staff No-Action Letter (Mar. 20, 1990). *Compare* with the exception, discussed above, for lawyers, accountants, etc.

41 *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Advisers Act Rel. No. 2376 (Apr. 12, 2005) ("Release 2376"), at note 44. *See also* *Thomas v. Metropolitan Life Insurance Company*, *infra* note 53.

42 *Interpretive Rule under the Advisers Act Affecting Broker-Dealers*, Advisers Act Rel. No. 2652 (Sept. 24, 2007) ("Release 2652").

43 *Townsend and Associates, Inc.*, SEC Staff No-Action Letter (Sept. 21, 1994). ***See*** S. Rep. No. 76-1775 at 22; H.R. Rep. No. 76-2639 at 28 (the term "investment adviser" was "so defined as specifically to exclude…brokers insofar as their advice is merely incidental to brokerage transactions for which they receive only brokerage commissions"). The SEC staff has expressed the view that broker-dealers that do no more than receive referral fees for referring clients to an investment adviser are not receiving special compensation. *Koyen, Clarke & Associates*, SEC Staff No-Action Letter (Nov. 9, 1986).

44 In Release 2376 the SEC adopted a rule that, among other things, deemed brokers charging asset-based brokerage fees (rather than commissions, mark-ups, or mark-downs) not to be investment advisers based solely

b. *Separate or Identifiable Charge.* The SEC has stated that a broker-dealer charges "special compensation" when it charges its customer a separate fee for investment advice, or when it charges its customers different commission rates, one with advice and one without, because the difference represents a clearly definable charge for investment advice.[45]

Brokerage Customers. The SEC has stated that a broker-dealer does not have to treat all of its brokerage customers to whom it provides some investment advice as advisory clients simply because it is registered under the Advisers Act. It must treat as an advisory client only those accounts for which it provides advice (*i.e.*, non-incidental advice) or receives compensation (*i.e*., special compensation) that subjects the broker-dealer to the Advisers Act.[46]

Hat-Switching. As noted above, the broker-dealer exception is applied separately to each customer account, so that a broker-dealer registered as an investment adviser need not treat all of its brokerage customers as advisory clients. May a broker-dealer provide advisory services to a client with an *advisory* account subject to the Advisers Act while at the same time providing incidental advice to the same customer's full-service brokerage account with respect to which it would not be subject to a fiduciary obligation (as well as restrictions on principal trading)? Or does a fiduciary relationship, once established with a client under the Advisers Act, extend to all of the client's accounts? The SEC staff issued one letter expressing the view that a broker-dealer may so limit its obligations to brokerage accounts of an advisory client, but only if the broker-dealer fully disclosed the nature of the change in the relationship.[47] The SEC later withdrew the letter without comment.[48]

Registration. Although it is not explicitly required by the statutory exemption, the SEC staff takes the position that the exemption, which is premised on the protections

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on their receipt of special compensation. The rule was vacated for other reasons by a federal court in March 2007. *Financial Planning Association v. SEC*, 482 F.3d (D.C. Cir. 2007) ("FPA v. SEC"). *See also* *National Regulatory Services*, SEC Staff No-Action Letter (Dec 2, 1992) at n.3; *Robert S. Strevell*, SEC Staff Interpretive Letter (Apr. 19, 1985).

45 *Final Extension of Temporary Exemption from the Advisers Act for Certain Brokers and Dealers*, Advisers Act Rel. No. 626 (Apr. 27, 1978) ("Release 626"). *See also* *Opinion of the General Counsel Relating to Section 203(b)(3) of the Advisers Act of 1940*, Advisers Act Rel. No. 2 (Oct. 28, 1940). (The SEC proposed to codify this interpretation in a rule. *See* *Release 2652*, *supra* note 42.) In contrast, a broker-dealer charging all clients the same commission for brokerage transactions while only providing some with investment advice is not receiving special compensation. *SEC v. National Executive Planners, Ltd*., 503 F. Supp. 1066 (M.D.N.C 1980).

46 Release 626 at section V, *supra* note 45. In 2007, the SEC proposed to codify this interpretation in a rule. *See* *Interpretive Rule under the Advisers Act Affecting Broker-Dealers*, *supra* note 45.

47 One administrative law judge opinion appears to agree. *Lawrence M. Labine*, Init. Dec. Rel. No. 973 (Mar. 2, 2016) ("It would be inconsistent with the remedial purposes of the Advisers Act to hold that [the adviser] could have "switched hats" and disclaimed the fiduciary duties of an adviser without giving notice to his clients.").

48 *See* Release 2652, *supra* note 42 at n.18. The issue of "hat switching" by broker-dealers and advisers played a role in the April 2015 consideration of fiduciary rules under ERISA by the Department of Labor in "The Effects of Conflicted Investment Adviser on Retirement Savings," President's Council of Economic Advisers (February, 2015).

afforded by regulation under the Exchange Act, is available only to a broker-dealer that is registered under the Exchange Act.[49]

a. *Broker-Dealer Agents*. The SEC staff has stated that an agent of a broker-dealer (not otherwise registered as a broker-dealer) who provides customers investment advice may also rely on the broker-dealer exception if she is: (i) giving advice within the scope of her employment with the broker-dealer; (ii) the advice is incidental to her employer's brokerage activities; and (iii) she receives no special compensation for her advice.[50]

b. *Non-U.S. Broker-Dealers*. One consequence of this implied registration requirement is that a non-U.S. broker-dealer lawfully operating in the U.S. as an unregistered broker-dealer could not provide investment advice incidental to its U.S. brokerage activities without registering as an adviser. The SEC has stated that its staff would look favorably on requests for no-action relief from an unregistered non-U.S. broker-dealer that otherwise qualifies for the broker-dealer exemption from the Advisers Act but is not registered as a broker-dealer in reliance on rule 15a-6 under the Exchange Act.[51] The staff has issued such letters, but so far only where the non-U.S. broker-dealer advisory activities were limited to furnishing research reports to U.S. institutional investors.[52]

Study on Fiduciary Obligations. Section 913 of the Dodd-Frank Act required the SEC to conduct a study to evaluate the differences between the fiduciary obligations of advisers under the Advisers Act and broker-dealers who also give advice but qualify for this exclusion (and may not, therefore, have such obligations[53]), and authorized the SEC to adopt rules to harmonize their application to retail investors.[54] In January 2011 the SEC submitted to Congress a study by its staff recommending that the SEC adopt a uniform fiduciary standard of conduct for broker-dealers and advisers "when providing personal investment advice about securities to retail customers."[55] The SEC has not yet proposed any rules under this provision.[56]

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49 *Citicorp*, SEC Staff No-Action Letter (Sept. 14, 1986).

50 *Brent Neiser*, SEC Staff No-Action Letter (Dec. 15, 1985).

51 *Registration Requirements for Foreign Broker-Dealers*, Exchange Act Rel. No. 27017 (July 11, 1989) at n.126, and accompanying text. Under rule 15a-6, a non-U.S. broker-dealer may, under certain conditions, effect transactions and provide research to certain institutional investors, intermediaries, and persons temporarily in the United States without registering under the Exchange Act.

52 *Charterhouse Tilney*, SEC Staff No-Action Letter (July 15, 1993); *James Capel*, SEC Staff No-Action Letter (Dec. 6, 1989); Citicorp, SEC No-Action Letter (Sept. 14, 1986).

53 *See, e.g.*, *Thomas v. Metropolitan Life Insurance Company*, CIV-07-0121-F (W.D. Okla. 2009) (broker-dealer not acting as an adviser with respect to purchasers of a variable life insurance contract does not have a fiduciary obligation to disclose conflicts arising as a result of the method of compensating sales personnel).

54 Section 211(g), as added by Section 913(g) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act").

55 *Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.*

4. *Publishers.* Publishers (both print and electronic media) are excluded from the Act, but only if the publication: (i) provides only impersonal advice (*i.e.*, advice not tailored to the individual needs of a specific client);[57] (ii) is "bona fide," (contains disinterested commentary and analysis rather than promotional material disseminated by someone touting particular securities); and (iii) is of general and regular circulation (rather than issued from time to time in response to episodic market activity).[58]

   Although the exception by its terms is limited to publications of general and regular circulation, the SEC staff has effectively extended it to books and other one-time publications.[59] Similarly, the staff has expanded the exemption to include not only publishers, but also columnists whose work appears in publications that qualify for the publishers exception.[60]

5. *Government Securities Advisers.* This exclusion is available to persons and firms whose advice is limited to certain securities issued by or guaranteed by the U.S. government.[61] The exception covers persons whose advice is limited to: (i) direct obligations of the Federal government (*e.g.*, U.S. Treasury obligations); (ii) securities subject to guarantees from the Federal government; and (iii) securities issued by or guaranteed by corporations whose securities are designated by the Secretary of the Treasury as exempt from the Exchange Act.[62]

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56 In 2013 the SEC issued a release requesting data on the costs and benefits on alternative approaches it could consider in exercising the new authority provided by Congress. *Duties of Brokers, Dealers, and Investment Advisers*, Advisers Act Rel. No. 3558 (Mar. 1, 2013).

57 The communications must be "entirely impersonal and do no develop into the kind of fiduciary, person-to-person relationships that . . . are characteristic of investment adviser-client relationships." "Factors that may be relevant to whether a newsletter may rely on the publishers' exemption include the existence of authority over the funds of subscribers; decision-making authority to handle subscribers' portfolios or accounts, or individualized, investment-related transactions with subscribers." *Weiss Research, Inc.*, *et al.*, Advisers Act Rel. No. 2525 (June 22, 2006) (newsletter publisher deemed to be an investment adviser providing personalized investment advice whose "auto-trading" program sent signals to broker-dealer, which automatically traded subscriber/customer securities consistent with signals).

58 Section 202(a)(11)(D). *See* *Lowe v. SEC*, 472 U.S. 181 (1985); *SEC v. Gun Soo Oh Park, A/K/A Tokyo Joe, and Tokyo Joe's Societe Anonyme Corp*., 99 F. Supp. 2d 889 (N.D. Ill. 2000). If a publisher voluntarily registers under the Act, or is required to register as a result of some other advisory activity, the adviser is subject to all of the provisions of the Act and SEC rules with respect to the publication. *See* Advisers Act Rel. No. 870 (July 15, 1983) ("Release 870"); *see also* *Vincent J. Cosentino*, SEC Staff No-Action Letter (Feb. 13, 1986).

59 *See*, *e.g*., *Gilbert L. Delugach*, SEC Staff No-Action Letter (Sept. 18, 1986).

60 *Donald E. Kendrick*, SEC Staff Letter (Oct. 30,1990). This approach is similar to the approach taken by the staff in the broker-dealer and professional exemptions discussed above. The availability of the exemption both to the columnist and the publisher of the publication is unclear, however, if a columnist were to provide personalized advice.

61 Section 202(a)(11)(E).

62 The SEC staff has stated that advice about repurchase agreements collateralized by U.S. government securities does not fall within the exception. *J.Y. Barry Arbitrage Mgmt., Inc*., SEC Staff No-Action Letter (Oct. 18, 1989). *See also* *Rauscher Pierce Refsnes, Inc.*, *et al*., Advisers Act Rel. No. 1863 (Apr. 6, 2000).

6. *Credit Rating Agencies*. This exclusion is available to any rating agency regulated under section 15E of the Exchange Act as a "nationally recognized statistical rating organization."[63]

7. *Family Offices*. A family office which manages the wealth and other affairs of a *single* family is excluded from the investment adviser definition if it: (i) provides investment advice only to family clients; (ii) is wholly-owned by family clients and exclusively controlled by family members and/or certain family entities; and (iii) does not hold itself out[64] to the public as an investment adviser.[65]

   a. *Family Clients.* The family office's clients generally may include family members and former family members; key employees and certain former key employees; any non-profit or charitable organization funded exclusively by family clients; any estate of a family member, key employee, or subject to certain conditions, certain family client trusts; and any company wholly-owned by and operated for the sole benefit of family clients.[66]

   b. *Family Members.* A family office's family members include all lineal descendants (including adopted children, stepchildren, foster children, and, in some cases, persons who were minors when a family member became their legal guardian) of a common ancestor (no more than 10 generations removed from the youngest generation of family members), and such lineal descendants' spouses or spousal equivalents.[67]

   c. *Key Employees*. Key Employees include certain investment professionals who, because of their position and experience, the SEC presumes are able to protect themselves. Key employees include executive officers, directors, trustees, general partners, or any person serving in a similar capacity for the family office or its affiliated family office, and certain employees who have participated in the investment activities of the family office or its affiliated family office for at least 12 months. They also include certain key employee investment entities through

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[63] Section 202(a)(11)(F) excluding rating agencies was added to the Act by the Credit Rating Agency Reform Act of 2006. Pub. L. No. 109-291, 120 Stat. 1327 (Sept. 29, 2006).

[64] *See infra* Section 0. of this outline for a discussion of "holding out."

[65] Rule 202(a)(11)(G)-1(b) (defining "family office" for purpose of section 202(a)(11)(G). Family offices that do not meet these conditions must register with the SEC unless another exemption is available. Rule 202(a)(11)(G)-1(e)(2). The SEC staff has issued FAQs that provide guidance on the application of the rule.

[66] Rule 202(a)(11)(G)-1(d)(4)..

[67] Rule 202(a)(11)(G)-1(d)(6). An appendix to the SEC release adopting the rule includes a chart illustrating how lineal descendants are determined. *Family Offices*, Advisers Act Rel. No. 3220 (June 22, 2011), Annex A. The SEC has issued exemptive orders to a few family offices permitting them to remain unregistered notwithstanding providing advice to a close family member not identified in the rule. *See, e.g.*, *Duncan Family Office*, Advisers Act Rel. No. 3867 (July 1, 2014) (notice) and 3882 (July 29, 2014) (order).

which key employees may invest in opportunities connected to the family office.[68]

d. *Multi-Family Offices*. The rule is *not* available to a family office that serves multiple families.[69] In this regard, the SEC staff has stated that if several unrelated families established separate family offices staffed with the same or substantially the same employees, such employees would be managing a de facto multifamily office, so that the family offices could not rely on the exclusion.[70]

8. *Governments and Political Subdivisions.* The Act does not apply to the U.S. government, state governments and their political subdivisions, and their agencies or instrumentalities, including their officers, agents, or employees acting in their official capacities.[71]

9. *Non-U.S. Advisers.* Non-U.S. advisers soliciting or advising U.S. persons are subject to the Act and must register under the Act unless eligible for one of the exemptions discussed below (*e.g.*, the "foreign private adviser" registration exemption).[72] The SEC does not accept "home state registration" of non-U.S. advisers in lieu of SEC registration.[73]

a. *U.S. Persons.* "U.S. persons" generally are (i) natural persons who reside in the U.S., (ii) partnership or corporation organized or incorporated in the U.S., (iii) any estate of which any executor or administrator is a U.S. person, (iv) any trust of which a trustee is a U.S. person, and (v) any discretionary account owned by a U.S. person and managed by a non-U.S. affiliate of the adviser.[74] An adviser must assess whether a person is "in the United States" at the time the person

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68 Rule 202(a)(11)(G)-1(d)(8). *See* *Key Employee Trusts Under the Family Office Rule.* IM Guidance Update, 2014-13 (Dec. 2014)

69 Advisers Act Rel. No. 3220, *supra* note 67.

70 *Peter Adamson III*, SEC Staff No-Action Letter (Apr. 3, 2012).

71 Section 202(b).

72 *See* Section III.B.3 of this outline for discussion of the foreign private adviser exemption.

73 On June 12, 2007, the SEC held a "roundtable discussion" at which the possibility of revising its approach to mutual recognition was discussed. The SEC press release concerning the roundtable stated that "selective mutual recognition would involve the SEC permitting certain types of foreign financial intermediaries to provide services to U.S. investors under an abbreviated registration system, provided those entities are supervised in a foreign jurisdiction under a securities regulatory regime substantially comparable (but not necessarily identical) to that in the United States."

74 The SEC has not adopted any definition of "U.S. person" of general applicability under the Act. In connection with implementing provisions of the Dodd-Frank Act, it adopted two new rules that define the term for purposes of two new exemptions by reference to Regulation S under the Securities Act of 1933, except with respect to discretionary accounts. *See* Rule 203(m)-1(d)(8) and 202(a)(30)-1(c)(3). In addition, the SEC uses this definition of "U.S. person" in Form PF (glossary) and Form ADV (glossary), both by reference to rule 203m-1.

becomes a client or, in the case of an investor in a private fund, each time the investor acquires securities issued by the fund.[75]

b. *Non-U.S. Activities of Registered Non-U.S. Advisers*. In a line of no-action letters beginning with Uniao de Bancos de Brasileiros ("Unibanco") in 1992, the SEC staff stated that it will not seek to apply the Advisers Act to a non-U.S. adviser that is registered with the SEC with respect to its non-U.S. clients.[76] Such an adviser is not, for example, required to deliver a brochure to its non-U.S. clients. This letter and its progeny made it feasible for non-U.S. advisers to directly enter the U.S. market and register with the SEC. Today, almost 700 non-U.S. advisers are registered with the SEC under the Advisers Act.

c. *U.S. Activities of Unregistered Non-U.S. Advisers.* The SEC staff has expressed the view that a non-U.S adviser providing advice to a non-U.S. person is not subject to the Act merely because it gives advice about securities issued by a U.S. company, conducts research in the United States or effects transactions in securities through U.S. broker-dealers.[77]

10. *Exemptive Authority*. SEC has authority to designate, by rule or order, other persons who are not within the intent of the definition of investment adviser.[78]

III. Which Investment Advisers Must Register Under the Advisers Act?

A firm that meets the definition of "investment adviser" (and is not eligible for one of the exclusions discussed above) must register with the SEC, unless it (i) is prohibited from registering under the Act because it is a smaller firm regulated by one or more of the states, or (ii) qualifies for an exception from the Act's registration requirement.[79] In contrast, an adviser precluded from registering with the SEC may be required to register with one or more state securities authorities. All advisers, registered or not, are subject to the Act's anti-fraud provisions.[80]

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75 Note to Rule 202(a)(30)-1(c)(3)(i).

76 *Uniao de Bancos de Brasilerios, S.A.*, SEC Staff No-Action Letter (July 28, 1992) ("Unibanco"); *Mercury Asset Mgmt.*, SEC Staff No-Action Letter (Apr. 16, 1993); *Kleinwort Benson Investment Mgmt. Ltd.*, SEC Staff No-Action Letter (Dec. 15, 1993); *Murray Johnstone Holdings Ltd.*, SEC Staff No-Action Letter (Oct. 7, 1994). To facilitate SEC monitoring the activities of a non-U.S. adviser that may affect its U.S. clients, the letters impose certain conditions, including recordkeeping requirements, discussed *infra* at note 648. The SEC has adopted the staff approach. Advisers Act Rel. No. 3222, *infra*, note 117 at n.515.

77 *Gim-Seong Seow*, *supra* note 34; *Double D. Mgmt.*, SEC Staff No-Action Letter (Dec. 30, 1982).

78 Section 202(a)(11)(H). *See, e.g.*, *International Bank for Reconstruction and Development and International Development*, Advisers Act Rel. Nos. 1955 (July 27, 2001) (notice) and 1971 (Sept. 4, 2001) (order) (declaring World Bank instrumentalities not to be investment advisers under the Act). Section 202(a)(11)(H) was designated as section 202(a)(11)(F) until 2006, and as 202(a)(11)(G) until 2010, when it was re-designated by the Dodd-Frank Act.

79 Section 203(a).

80 *See* *Transamerica Mortg. Advisors, Inc. v. Lewis*. 44 U.S. 11 (1979); *Teicher v. SEC*, 177 F.3d 1016, 1017-19 (D.C. Cir. 1999).

A. State/SEC Registration

Until 1996, most investment advisers were subject to regulation by both the SEC and one or more state regulatory agencies. The Act was amended in 1996 and again in 2010 to allocate regulatory responsibility between the SEC and the states.[81] Today, most small advisers and "mid-sized advisers" are subject to state regulation of advisers and are prohibited from registering with the SEC.[82] Most large advisers (unless an exemption is available) must register with the SEC.[83] State adviser laws are preempted for SEC-registered advisers.[84]

Most advisers prefer registration with the SEC because it permits them to avoid registration and regulation or their advisory activities by multiple state laws. In most cases, the choice is not the adviser's but is determined by application of 203A of the Advisers Act.

Regulatory Assets under Management. As discussed below, in many cases the registration obligations of an adviser will turn on the amount of its "regulatory assets under management," which is the sum of the value of all "securities portfolios for which the adviser provides continuous and regular supervisory or management services." An account is a "securities portfolio" if at least 50% of the value of the portfolio consists of securities or cash and cash equivalents. An adviser provides "continuous and regular supervisory or management services" when it has ongoing (i) discretionary management authority, or (ii) non-discretionary authority to select and recommend securities on behalf of a client and, if accepted, arrange or effect the purchase or sale.[85]

Principal Office and Place of Business. The application of the rules turn in many cases on the state in which the adviser has its "principal office and place of business," which is defined as the adviser's executive office from which the senior officers of the adviser directs, controls and coordinates the activities of the investment adviser.[86]

1. *Operation of Section 203A of the Advisers Act*

    a. *Small Advisers.* Advisers with less than $25 million of assets under management must register with and be regulated by states in which they do business (in

81 *National Securities Markets Improvements Act of 1996* ("NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416 (1996); Section 410 of Dodd-Frank Act, *supra* note 54. Most of the provisions amending the Advisers Act to allocate regulatory responsibilities between the SEC and state governments have been codified in section 203A.

82 Section 203A(a). Section 203A creates a *prohibition*, not an exemption. *Warwick Capital Mgmt., Inc.* Advisers Act Rel. No. 2694 (Jan. 16, 2008) (adviser sanctioned for, among other things, violating Section 203A for improperly registering with the SEC).

83 *See* Sections 203(a) (registration required).

84 203A(b) (preemption of state law).

85 Instruction 5.b of Instructions for Part 1A of Form ADV. The Instruction lays out several factors an adviser that does not have ongoing discretionary authority must consider when determining whether it has continuous and regular supervisory or management services.

86 Rule 203A-3(c).

accordance with state law) unless the state in which the adviser has its principal office and place of business has not enacted a statute regulating advisers.[87] Thus, unless an exemption is available (discussed below), a only small adviser with its principal office and place of business in Wyoming (which has not enacted a statute regulating advisers) may register with the SEC and avoid state regulation as an adviser. [88]

b. *Mid-Sized Advisers*. Advisers with between $25 million and $100 million of assets under management[89] are also subject to regulation in the states in which they do business if (i) the adviser is registered with the state where it has its principal office and place of business (*i.e.*, it has not taken advantage of an exemption from state registration), and (ii) the adviser is "subject to examination" by that state securities authority.[90] A mid-sized adviser with its principal office and place of business in New York or Wyoming is not "subject to examination" and therefore must register with the SEC, unless one of the exemptions discussed below is available.[91]

c. *Large Advisers*. Advisers with more than $100 million of regulatory assets under management must register with the SEC unless an exemption is available.

d. *Non-U.S. Advisers*. Advisers whose principal offices and places of business are outside the United States are treated as "large advisers" regardless of the amount

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87 Section 203A(a)(1) prohibits any adviser from registering with the SEC that is *regulated or is required to be regulated* in the state in which it maintains its principal office and place of business. The SEC interprets this provision to mean the prohibition applies only to an adviser that maintains its principal office and place of business in a state that has enacted an investment adviser statute. *Rules Implementing Amendments to the Advisers Act of 1940*, Advisers Act Rel. No. 1633 (May 15, 1997) ("Release 1633") at n.83 and accompanying text.

88 Wyoming recently adopted a "Uniform Securities Act," which regulates advisers in that state for the first time. By April 8, 2017, with certain exceptions, advisers that have less than $100 million of regulatory assets under management whose principal office and place is in Wyoming must register with the Wyoming Secretary of State and withdraw their registrations with the SEC. Wyo. Stat. Ann. § 17-4-403 (2016).

89 Section 410 of the Dodd-Frank Act raised the threshold for advisers to register with the SEC to $100 million of assets under management. An SEC rule provides that a mid-sized adviser *may* register when it acquires $100 million of assets under management and *must* register once it obtains $110 million of assets under management, unless some other exemption is available. Rule 203A-1(a)(1). Once registered with the SEC, a mid-sized adviser is not required to withdraw from SEC registration and register with the states until the adviser has less than $90 million of assets under management. *Id*. The rule is designed to prevent advisers "on the bubble" from having to frequently re-register in a different jurisdiction because of fluctuation in the number of clients or the value of client assets.

90 Section 203A(a)(2) prohibits a mid-sized adviser from registering with the SEC if the adviser is required to be registered as an adviser in the state where it has its principal office and place of business and is subject to examination by that state. *See Rules Implementing Amendments to the Advisers Act of 1940*, Advisers Act Rel. No. 3221 (June 22, 2011) ("Release 3221").

91 *See* Instructions for Item 2 of Part 1A of Form ADV; Division of Investment Management: Frequently Asked Questions ("FAQs") Regarding Mid-Sized Advisers.

of assets they have under management.[92] Accordingly, a non-U.S. adviser giving advice to U.S. persons[93] must register with the SEC (and may avoid registration with state regulators), unless an exemption from registration is available (in which case it may be subject to state registration requirements).[94]

2. *Exceptions to Prohibition*

Section 203A and SEC rules carve out several exceptions from the assets under management tests. In most cases, the exception operates to require a person eligible for the exemption to register with the SEC.

a. *Advisers to Investment Companies.* An adviser to an investment company registered under the Investment Company Act of 1940 ("Investment Company Act") must register with the SEC.[95] The exception is not available to an adviser that simply gives advice about investing in investment companies.[96]

b. *Advisers to Business Development Companies*. An Adviser with at least $25 million of assets under management that advises a company that has elected to be a business development company pursuant to section 54 of the Investment Company Act must register with the SEC.[97]

c. *Pension Consultants*. An adviser providing advisory services to employee benefit plans having at least $200 million of assets must register with the SEC (even though the adviser/consultant does not itself have those assets under management).[98]

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92 *See* Release 1633, *supra* note 87 at Section II.E. An adviser with a principal office and place of business outside the United States does not have a principal office and place of business in a U.S. state that regulates investment advisers.

93 *See supra* Section II.B.9 of this outline for a discussion of who is a "U.S. person."

94 *See* Section III.B.3 of this outline for discussion of exemption from registration for foreign private advisers.

95 Sections 203A(a)(1)(B) and 203A(a)(2)(A).

96 *See* Instructions for Item 2 of Part 1A of Form ADV.

97 Section 203A(a)(2)(A). *See also* Item 2.A.(6) of Part 1A of Form ADV.

98 Rule 203(A)-2(a). In May 2005, the SEC staff published a report detailing concerns with conflicts of pension fund consultants who help pension managers evaluate money managers. *See* *Staff Report Concerning Staff Examinations of Certain Select Pension Fund Consultants*. Subsequently, the SEC instituted an administrative proceeding against a pension consultant that breached its fiduciary obligations by failing to disclose conflicts of interest. *Yanni Partners, Inc*, Advisers Act Rel. No. 2642 (Sept. 4, 2007) (pension consultant held itself out to be "independent" of money managers sold subscriptions to data base to money managers it was evaluating).

d. *Related Advisers.* An adviser that controls, is controlled by, or is under common control with an SEC-registered adviser must register with the SEC if it has the same principal office and place of business.[99]

e. *Newly-Formed Advisers.* An adviser that is not registered, but has a reasonable expectation that it will be eligible for SEC registration within 120 days of registering, may register with the SEC.[100] This exemption was designed primarily (but not exclusively) for spin-offs of registered advisers where the client assets are expected to follow shortly thereafter.

f. *Multi-State Advisers*. An adviser that would otherwise be obligated to register with 15 or more states may register with the SEC.[101] This exemption was designed primarily (but not exclusively) for the large accounting firms which did business in many states, but managed client assets in none.[102]

g. *Internet Advisers.* An adviser that provides advice exclusively through an interactive website may register with the SEC.[103] This exception was designed for the predecessor of the modern digital adviser (or "robo-adviser") that in 1997, when the rule was adopted, did not have discretionary authority and therefore did not have any assets under management.

Exemptions (a-d above) are mandatory, *i.e.*, an adviser that qualifies *must* register with the SEC unless some other exemption is available. Others are, as a practical matter at least, voluntary, and an eligible adviser could choose whether to register with the SEC or the relevant states.

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[99] Rule 203A-2(b). The SEC considers an SEC-registered adviser to have the same principal office and place of business if the principal office of the related adviser is in the "proximate geographic area as the principal office of the registered adviser." Release 1633, *supra* note 87 at n.65.

[100] Rule 203A-2(c). An adviser relying on this exception must file an amendment to its Form ADV at the end of the 120 days indicating whether it has become eligible for SEC registration, or must withdraw its SEC registration. An adviser that expects to be eligible for SEC registration because of the amount of its assets under management must have $100 million or more of assets under management no later than 120 days after its registration is declared effective. *See* Instructions for Item 2 of Part 1A of Form ADV. The IARD system monitors for compliance with the 120 day filing requirement, and automatically generates emails to an adviser that claims this exemption but fails to update its Form ADV (as well as to the SEC staff).

[101] Section 203A(a)(2)(A); Rule 203A-2(d). *See* *Evans Barthelemy and Barthelemy Group LLC*, Advisers Act Rel. No. 3503 (Nov. 20, 2012) (instituting enforcement proceeding against adviser misstating state registration obligations on its Form ADV in order to assert availability of multi-state exemption). *See* *David Henry Disraeli*, Advisers Act Rel. No. 2686 (Dec. 21, 2007) (multi-state adviser exemption not available based on solicitation of clients in multiple states).

[102] *Exemption for Investment Advisers Operating in Multiple States*, Advisers Act Rel. No. 1733 (July 17, 1998).

[103] Rule 203A-2(e). *Exemption for Certain Investment Advisers Operating Through the Internet*, Advisers Act Rel. No. 2091 (Dec. 12, 2002). *See* *Retirehub, Inc.*, Advisers Act Rel. No. 3337 (Dec. 15, 2011) (adviser claiming exemption did not provide advice exclusively through an interactive web site).

3. *State Law Still Applicable to SEC-Registered Advisers*

Although state investment adviser statutes do not apply to SEC-registered advisers, other state laws, including other state securities laws, do apply. In addition, state laws may (and most state laws continue to) require an SEC-registered adviser to:

a. comply with state anti-fraud prohibitions;

b. provide the state regulator with a copy of its SEC registration;

c. pay state licensing and renewal fees; and

d. license persons giving advice on behalf of the adviser, but only if the person has a place of business in the state.[104]

4. *Federal Anti-Fraud Law Still Applicable to State-Registered Advisers*. The SEC continues to institute enforcement actions against state-registered advisers charging violations of section 206 of the Act.[105]

B. Exemptions from Registration

The Advisers Act provides several exemptions from registration. The exemptions are voluntary; advisers eligible for them can nonetheless register with the SEC.[106] State regulatory laws are pre-empted for advisers voluntarily registering with the SEC. Advisers relying on these exemptions (other than an adviser to a SBIC), may be required to register with one or more state securities regulator.[107]

1. *Intrastate Advisers*

Available to an adviser: (i) all of whose clients are residents of the state in which the adviser maintains its principal office and place of business; and (ii) that does not give

[104] SEC-registered advisers can comply with state requirements that they provide states with a copy of their registration (so-called "notice filings"), pay state registration fees, and license advisory personnel (in most states) through the electronic filing system (IARD) discussed below.

[105] *See, e.g.*, *James William Fuller*, Advisers Act Rel. No. 1842 (Oct. 4, 1999); *Robert Radano*, Advisers Act Rel. No. 2750 (June 30, 2008); *SEC v. Aaron Donald Vallett, LLC*, Lit. Rel. No. 21557 (June 16, 2010). Most of the anti-fraud rules adopted by the SEC pursuant to its authority under section 206(4) of the Act (and discussed below) are not applicable to state-registered advisers. Many states have, however, adopted similar rules.

[106] Persons who voluntarily register under the Advisers Act, in circumstances where their registration may not be required, are subject to all of the provisions and rules under the Advisers Act applicable to persons required to register. *See* Release 870, *supra* note 58. State regulatory law is not preempted for an adviser taking advantage of one of the exceptions from registration and thus the adviser may be required to register with one or more state securities regulators. *See* discussion of state preemption in Section III.B. of this outline.

[107] The states are precluded from requiring an adviser exempt from SEC registration from requiring an adviser to register that does not have a place of business in the state unless it has more than six clients during the preceding 12 months who reside in the state. Section 222(d) of the Act ("National De Minimis Standard").

advice about securities traded on any national exchange.[108] The Dodd-Frank Act made this exemption unavailable to an adviser that advises a private fund.[109]

2. *Advisers to Insurance Companies*

Available to an adviser whose only clients are insurance companies.[110]

3. *Foreign Private Advisers*

Available to an adviser that (i) has no place of business in the United States; (ii) has, in total, fewer than 15 clients in the United States and investors in the United States in private funds advised by the adviser; (iii) has aggregate assets under management attributable to these clients and investors of less than $25 million; and (iv) does not hold itself out generally to the public in the United States as an investment adviser.[111] An adviser relying on this exemption is not required to make any filing with the SEC.

The exemption for foreign private advisers was added by the Dodd-Frank Act and replaces the private adviser exemption (i.e., an exemption for any adviser with fewer than 15 clients), which was repealed. In implementing the new exemption, the SEC incorporated the "counting" and "holding out" rules that implemented the old exemption, discussed below.

a. *Place of Business in the United States.* A place of business in the United States is (i) an office located in the United States where the investment adviser regularly provides services, solicits, meets with or otherwise communicates with clients, and (ii) any location held out to the public as a place where the adviser conducts such activities.[112] It includes an office in which the adviser manages money or conducts research, but not one in which the adviser provides solely administrative services or back-office activities that are not "intrinsic to providing advisory services."[113]

b. *Calculating Assets Under Management.* In determining whether the $25 million threshold is met, an adviser must count only the value assets that are attributable

[108] Section 203(b)(1). The SEC staff takes the position that advice regarding investment companies involves advice about "listed securities" if the investment company invests in listed securities. *Roy Heybrock*, SEC Staff No-Action Letter (Apr. 5, 1982).

[109] Section 403(1).

[110] Section 203(b)(2). The SEC staff has interpreted the exemption to be available to a U.S. adviser that provides advice solely to a non-U.S. based insurance company. *TACT Asset Mgmt. Company*, SEC Staff No-Action Letter (Oct. 24, 2012).

[111] Section 203(b)(3) (exempting "any investment adviser that is a foreign private adviser"); Section 202(a)(30) (defining a "foreign private adviser"). Rule 202(a)(30)-1 defines the term "in the United States" by reference to the definitions of a "U.S. person" and the "United States" in Regulation S under the Securities Act. *See* discussion, *supra at* Section II.B.9 of this outline.

[112] Rule 202(a)(3)-1(c)(ii), which references rule 222-1(a).

[113] Release 3222, *infra* note 117 at Section II.C,4.

to (i) clients who are U.S. persons, and (ii) investors in private funds who are U.S. persons.

c. *Counting Clients and Investors*

(1) *Multiple Persons as a Single Client.* Rule 202(a)(30)-1 provides that the following can be considered a single client:[114]

(A) a natural person together with (i) any minor child of the natural person; (ii) any relative, spouse, spousal equivalent, or relative of the spouse or of the spousal equivalent of the natural person with the same principal residence; and (iii) all accounts or trusts of which the persons described above are the only primary beneficiaries; or

(B) a corporation, general or limited partnership, limited liability company, trust or other legal organization (or multiple organizations with identical ownership) to which the adviser provides advice based on its investment objectives rather than the individual investment objectives of its owners,[115]

(2) *"Look Through" Private Funds.* An adviser must count both its direct clients and each investor in any "private fund" it advises.

No Double Counting. An adviser (i) need not count a client as an investor if it also counts the investor as a client, and (ii) may treat as a single investor any person who is an investor in two or more of the adviser's private funds.[116]

Nominal Holders. An adviser may be required to also "look through" persons who are nominal holders of a security issued by a private fund to count the investors in the nominal holder when determining if the adviser qualifies for the exemption. For example, holders of the securities of any feeder fund in a master-feeder arrangement may be deemed to be the investors of the master fund.[117]

(3) *Non-U.S. Persons.* A client with whom the adviser had a pre-existing client relationship who relocates to the U.S. need not be counted as being "in the United States," even if the person has becomes a U.S. resident. In the case of

[114] The rule provides a non-exclusive safe harbor for counting clients for purposes of section 203(b)(3). *See* rule 202(a)(30)-1, at note to paragraphs (a) and (b).

[115] An adviser must count an owner (*e.g.*, a limited partner) as a client if it provides advice to that owner "separate and apart" from the advice provided to the entity. Rule 202(a)(30)-1(b)(1). *Cf. Latham & Watkins*, SEC Staff No-Action Letter (Aug. 24, 1998); *Burr, Egan, Deleage & Co., Inc*., SEC Staff No-Action Letter (Apr. 27, 1987).

[116] Rule 202(a)(30)-1(c)(5); and note to paragraph (c)(2).

[117] *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers*, Advisers Act Rel. No. 3222 (June 22, 2011) ("Release 3222") at Section II.C.2.

an investor in a private fund, however, whether, such person is "in the United States" must be tested each time the investor acquires a security issued by the private fund.[118]

d. *Holding Out.* The SEC staff views a person as holding himself out as an adviser if he advertises as an investment adviser or financial planner, uses letterhead indicating activity as an investment adviser, or maintains a telephone listing or otherwise lets it be known that he will accept new advisory clients,[119] or hires a person to solicit clients on his behalf. [120]

(3) *Participation in Non-Public Offerings*. Foreign private advisers will not be deemed to be holding themselves out generally to the public in the United States as an investment adviser solely because they participate in a non-public offering in the United States of securities issued by a private fund pursuant to an exemption from registration under the Securities Act of 1933.[121]

(4) *Use of the Internet.* An adviser using the Internet to provide information about itself ordinarily would be "holding itself out" as an adviser. However, the SEC has stated that it will not consider a non-U.S. adviser, including foreign private advisers, to be holding itself out as an adviser if:

(A) *Prominent Disclaimer.* The adviser's website includes a prominent disclaimer making it clear that its website materials are not directed to U.S. persons; and

(B) *Procedures.* The adviser implements procedures reasonably designed to guard against directing information about its advisory services to U.S. persons (*e.g.*, obtaining residency information before sending further information).[122]

(C)

4. *Charitable Organizations and Plans*

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[118] Rule 202(a)(3)-1, note to paragraph (c)(3)(i). Note that a foreign broker-dealer selling interests in a private fund to a non U.S. person while in the U.S. has available a similar exemption in rule 15a-6 under the Exchange Act, which is not available once the investor establishes residency in the U.S. *See* Rule 15a-6(a)(4)(iii).

[119] *See, e.g.*, *William Bloor*, SEC Staff No-Action Letter (Feb. 15, 1980); *Richard J. Shaker*, SEC Staff No-Action Letter (Aug. 1, 1977); *Al O'Brien Associates*, SEC Staff No-Action Letter (Oct. 6, 1973).

[120] Advisers Act Rel. No. 688 (July 15, 1979) at n.9. *See also* *Lamp Technologies, Inc.*, SEC Staff No-Action Letter (May 29, 1997) (investment adviser not "holding itself out generally to the public as an investment adviser" solely by virtue of posting information about certain private funds (*e.g.*, hedge funds) on a password-protected website that is accessible only by accredited investors).

[121] Rule 202(a)(30)-1(d).

[122] *Statement of the Commission Regarding Use of Internet Websites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore*, Advisers Act Rel. No. 1710 (Mar. 23, 1998) at section VI.

Available to an adviser that is a charitable organization or a charitable organization's employee benefit plan, including a trustee, officer, employee, or volunteer of the organization or plan to the extent that the person is acting within the scope of his employment or duties.[123]

5. *Commodity Trading Advisors*

   a. *Generally.* Available to any adviser that is registered with the U.S. Commodity Futures Trading Commission ("CFTC") as a commodity trading advisor ("CTA") and whose business does not consist primarily of acting as an investment adviser and that does not advise a registered investment company or a business development company.[124]

      This first exemption is of limited utility for many CTAs because, on its face, it requires the CTA's business to not consist primarily acting as an investment adviser at all times.[125]

   b. *Commodity Trading Advisors to Private Funds.* Available to any adviser registered with the CFTC as a commodity trading advisor that advises a private fund, provided that the adviser must register with the SEC if its business *becomes* predominantly the provision of securities-related advice.[126]

      This second exemption for CTAs was added by the Dodd-Frank Act, but it is unclear the extent to which it expands the existing exemption, which is also available to advisers to private funds that are commodities pools. The SEC staff has expressed a view that it is not available to an adviser to a private fund whose business was and is predominantly the provision of advice about securities (and thus did not become predominantly advice about securities after the enactment of the Dodd-Frank Act).[127]

6. *Private Fund Advisers*

Available to an adviser (i) solely to private funds that have less than $150 million in assets under management in the United States,[128] and (ii) one or more small business

[123] Sections 203(b)(4) and (5) were added by the *Philanthropy Protection Act of 1995*, Pub. L. No. 104-62, 109 Stat. 682 (1995). *See also* *Sisters of Mercy*, SEC Staff No-Action Letter (Oct. 1, 2009).

[124] Section 203(b)(6) (re-designated as 203(b)(6)(A) by the Dodd-Frank Act) was added by the *Commodity Futures Modernization Act of 2000*, Pub. L. No. 106-554, 114 Stat. 2763 (2000), which also amended the Act's definition of "security" in section 202(a)(18) of the Act to include certain "securities futures." The Act repealed the ban on single stock or narrow-based stock index futures and established a framework for shared jurisdiction over the trading of these instruments and market participants. *See* Exchange Act Rel. No. 44288 (May 9, 2001).

[125] The SEC staff has taken a different approach in determining whether a commodity pool is subject to the Investment Company Act. *See* *Peavey Commodity Futures Fund*, SEC Staff No-Action Letter (June 2, 1983).

[126] Section 203(b)(6)(B) of the Advisers Act (added by Section 403(4) of the Dodd-Frank Act).

[127] *See* Investment Management Staff Issues of Interest.

[128] Section 203(m)(1) of the Advisers Act and rule 203(m)-1.

investment companies (SBICs) (discussed below).[129] An adviser that has any other type of client is not eligible for the exemption.[130]

a. *Private Funds.* A "private fund" is an issuer of securities that would be an investment company "but for" the exceptions provided for in section 3(c)(1) or 3(c)(7) of the Investment Company Act.[131]

(1) Section 3(c)(1) is available to a fund that does not publicly offer its securities and has 100 or fewer beneficial owners of its outstanding securities.

(2) Section 3(c)(7) is available to a fund that does not publicly offer its securities and limits its owners to "qualified purchasers," which generally include natural persons who own at least $5 million in investments.[132]

General Solicitation. Private funds have typically relied on the safe harbor provided by Regulation D under the Securities Act of 1933 to offer their securities in "private placements," which precludes general solicitations, e.g., advertisements and other public statements.[133] In 2013, the SEC adopted amendments to Regulation D that permitted issuers including private funds, subject to certain conditions, to make general solicitations.[134] Most private funds continue to make traditional private placements without a general solicitation.

Bad Boy Restrictions. A private fund is disqualified from making an offering in reliance on section 506 of Regulation D if, among other persons, an investment adviser to a private fund issuer (or certain of its directors and officers) has engaged in certain "disqualifying conduct" during the past 10 years.[135] Most private funds making offerings in the United States rely on section 506.

Disqualifying conduct includes convictions within the last 10 years (in some cases 5 years) for securities fraud; being subject to certain injunctions or

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[129] Section 203(m)(2) was added in December 2015 by section 74002 of the Fixing America's Surface Transportation Act (FAST Act), Pub. L. No. 114-94, to treat SBICs as private funds for purpose of section 203(m) and to exclude the amount of assets of the SBICs in determining the $150 million limit. *See* IM Guidance Update No. 2016-03 (Mar. 2016). The provisions are self-executing and are available notwithstanding the provisions of rule 203(m)-1.

[130] Two nominally separate but related advisers may be considered to be one adviser (and their assets aggregated) if they do not operate sufficiently independent of one another. *See* discussion *infra* note 158.

[131] Section 202(a)(29) of the Advisers Act.

[132] The term "qualified purchaser" is defined in section 2(a)(51) of the Investment Company Act.

[133] Rule 506(b) under the Exchange Act. The SEC has published a brief summary of Regulation D.

[134] Securities Act Rel. No. 33-9415 (July 10, 2013). The SEC was required to adopt these amendments by section 201(b) of the Jumpstart Our Business Startups Act (JOBS Act), Pub. L. No. 112-106.

[135] Rule 506(d) under the Securities Act of 1933 *adopted in* Securities Act Rel. No. 9414 (July 10, 2013). The SEC was required to adopt these amendments by section 926 of the Dodd-Frank Act.

decrees by courts and regulators involving securities, banking, insurance of commodities activities; suspension or expulsion from membership by a self-regulatory organization (such as FINRA), etc.[136]

b. *Less than $150 million in AUM in the United States.* In determining whether it has less than $150 million in assets under management in the United States:

(1) *U.S. Advisers.* An adviser that has its principal office and place of business in the United States is deemed to manage all of its assets in the U.S. even if the adviser has offices outside the U.S. at which management activities take place.[137]

(2) *Non-U.S. Advisers.* An adviser with a principal office and place of business outside the United States may (i) must include only assets managed at a "place of business" in the U.S.,[138] and (ii) may exclude consideration of assets managed on behalf of non-U.S. clients. As a result a non-U.S. adviser may rely on the exemption if:

(A) *all* of its clients that are U.S. persons are private funds (even if some or all non-U.S. clients are not); and[139]

(B) management activities in the United States are limited to $150 million of private fund assets.[140]

Thus, a non-U.S. adviser's non-U.S. clients will not count in determining whether it qualifies for the private fund adviser exemption from registration as long as the assets of the non-U.S. clients are managed from *outside* the United States. Such an adviser can avail itself of the exemption regardless of the number of U.S. investors or the amount of assets they have invested. The exemption is available regardless of where the private fund is organized.

(3) *Calculating Private Fund Assets.* Generally, advisers must include the value of all private funds managed, including the value of any uncalled capital

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[136] Rule 506(d)(i).

[137] Rule 203(m)-1(b). The rule essentially reads the words "in the United States" language out of Section 203(m).

[138] The SEC has stated that whether assets are managed "in the United States" is an "inherently factual determination," but it does not consider providing research or conducting due diligence activities on potential investments to be managing assets of management decisions are made outside of the U.S. Release 3222, *supra* note 117 at 93. Back office services are also unlikely to be considered management activities.

[139] Similar to the foreign private adviser exemption, a "United States person" generally is a "U.S. person," as defined in Regulation S under the Securities Act, except that a discretionary or other fiduciary account also is a "United States person" if the account is held for the benefit of a United States person by a non-U.S. fiduciary who is a related person of the adviser. Rule 203(m)-1(d)(8), discussed, *supra,* Section II.B.9 of this outline.

[140] Rule 203(m)-1(b)(1) and (2). The term "place of business" has the same meaning as in the exemption for foreign private advisers, discussed above. Rule 203(m)-1(d)(2), discussed, *supra*, Section III.B.3. of this outline.

commitments.[141] Value is based on market value of those assets, or the fair value of those assets where market value is unavailable, and must be determined on a gross basis, *i.e.*, without deduction of any liabilities, such as accrued fees and expenses or the amount of any borrowing.[142]

(4) *Annual Assessment.* An adviser relying on the private fund exemption must assess annually whether it has $150 million or more of private fund assets under management. An adviser that meets or exceeds the $150 million threshold must register with the SEC.[143] However, accepting an engagement with a client that is not a private fund will cause the adviser to immediately lose the exemption and require it to be registered.

Advisers Act Lite. Alternatively, a non-U.S, adviser managing a private fund organized *outside of* the United States may register as an investment adviser under the Advisers Act. Most of the substantive provisions would be inapplicable to the adviser with respect to the private funds under the *Unibanco* line of SEC staff no-action letters.[144] This alternative permits the adviser to accept U.S. clients that are not private funds, *e.g.*, separate accounts, with respect to which the adviser would be subject to all of the provisions of the Advisers Act.

c. *Annual Reporting and Examination.* An adviser relying on the private fund adviser exemption must file an initial and annual report on Form ADV to the SEC[145] and is subject to examination. Other provisions of the Act and SEC rules applicable only to registered advisers do not apply.[146] *See* Appendix A. The SEC refers to these advisers as "exempt reporting advisers."

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[141] Form ADV: Instructions for Part 1A, instr. 5.b.(4). Proprietary assets, *i.e.*, those of the adviser or its principals may not be excluded. Form ADV: Instructions for Part 1A, instr. 5.b.(1).

[142] *Id*. The SEC has recognized that, although many advisers will calculate the fair value of their private fund assets in accordance with Generally Accepted Accounting Principles ("GAAP") or another international accounting standard, other advisers acting consistently and in good faith may utilize another fair valuation standard. Release 3222, *supra* note 117 at nn.364-365 and accompanying text. Consistent with this good faith requirement, the SEC expects that an adviser that calculates fair value in accordance with GAAP or another basis of accounting for financial reporting purposes will also use that same basis for purposes of determining the fair value of its regulatory assets under management. *Id*. at n.365.

[143] Rule 203(m)-1(c). A private fund adviser that had complied with all SEC reporting requirements applicable to an exempt reporting adviser, but reported in its annual updating amendment that fund assets exceeded $150 million, has up to 90 days after filing the annual updating amendment to apply for SEC registration, and may continue doing business as a private fund adviser during this time. General Instruction 15 to Form ADV.

[144] *Unibanco*, *supra* note 76. The fund rather than the investors in the fund would be treated as the client. *See* *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

[145] Rule 204-4. The report must be filed within 60 days of relying on the private fund adviser exemption. Only portions of Form ADV must be completed. General Instruction 13 to Form ADV. An exempt reporting adviser is not required to deliver a brochure to its clients. General Instruction 3 to Form ADV.

[146] The anti-fraud rules the SEC has adopted under section 206(4) of the Act do not apply to exempt reporting advisers other than rule 206(4)-5, which addresses political contributions by advisers providing advisory services to state and local governments. *See* rule 206(4)-5(a)(1) discussed in Section VI.B.5 of this outline.

7. *Venture Capital Advisers*

Available to an adviser that solely advises (i) one or more "venture capital funds" as defined by SEC rule (regardless of the amount of assets managed), and (ii) one or more SBICs (discussed below).[147]

a. *Venture Capital Fund*. To qualify as a "venture capital fund," a fund must be a "private fund"[148] that:

(1) represents to investors that the fund pursues a venture capital strategy;[149]

(2) does not provide investors with redemption rights;[150]

(3) holds no more than 20% of its assets in non-"qualifying investments" (excluding cash and certain short-term holdings); and

Qualifying investment generally means directly acquired investments in equity securities of private companies (generally, companies that at the time of investment have not made a public offering) that do not incur leverage or borrow in connection with the venture capital fund investment and distribute proceeds of such borrowing to the fund (*i.e.*, have not been acquired in a leveraged buy-out transaction).

(4) does not borrow (or otherwise incur leverage) more than 15% of the fund's assets, and then only on a short-term basis (*i.e.*, for no more than 120-days).[151]

b. *Non-U.S. Advisers.* The exemption is available to a non-U.S. adviser, but (unlike the private fund adviser exception) such an adviser may not disregard its non-U.S. advisory activities.[152] Thus, all of an adviser's clients, including non-U.S. clients, must be venture capital funds.[153]

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[147] Section 203(l) of the Advisers Act (added by the Dodd-Frank Act). The SEC adopted rule 203(l)-1 on June 22, 2011 to implement the section. *See* Release 3222, *supra* note 117. Section 203(l) was amended in 2015 by Section 74001 of the FAST Act, *supra* note 129, to treat a SBIC as a "venture capital fund" for purpose of section 203(l). *See* IM Guidance Update No. 2016-03, *supra* note 129.

[148] Rule 203(l)-1(a)(5). In addition, the fund cannot be registered under the Investment Company Act or have elected to be treated as a business development company as defined by that Act. Rule 203(l)-1(a)(5).

[149] Rule 203(l)-1(a)(1).

[150] Rule 203(l)-1(a)(4) (the rule permits exceptions in extraordinary circumstances).

[151] Rule 203(l)-1 contains a grandfathering provision for certain private funds that have sold their initial interests in the fund by December 31, 2010, provided that they have represented to their investors that they pursue a venture capital strategy and that they do not issue any interests to any person after July 21, 2011.

[152] Release 3222, *supra* note 117.

[153] Rule 203(l)-1 contains a note the effect of which is to permit a non-U.S. adviser to treat a non-U.S. fund it advises as a "private fund" even if the fund does not technically meet the Act's definition of a private fund because it is not relying on a statutory exemption from the Investment Company Act, but is rather relying on the lack of U.S. jurisdiction Release 3222, *supra* note 117.

c. *Annual Reporting and Examination.* An adviser relying on the venture capital adviser exemption must annually file a report on Form ADV to the SEC,[154] and is subject to examination. Other provisions of the Act and SEC rules applicable only to registered advisers do not apply. *See* Appendix A. The SEC also refers to these advisers as "exempt reporting advisers."

8. *Advisers to Small Business Investment Companies ("SBICs")*

SBICs, licensed by the Small Business Administration, are privately owned and managed investment firms that provide venture capital to small businesses from the SBIC's own capital and from funds which the SBIC is able to borrow at favorable rates through the federal government.[155]

IV. **Who Must Register Under the Advisers Act?**

A. The Advisory Firm

Although many individuals who are employed by advisers fall within the definition of "investment adviser," the SEC generally does not require those individuals to register separately as advisers with the SEC. The adviser's registration covers its employees *and* other persons under its control and supervision (*e.g.*, officers, independent contractors), provided that their advisory activities are undertaken on the adviser's behalf.[156]

B. Affiliates

1. *Integration of Affiliates*

The SEC takes the view that advisers and their affiliates cannot circumvent the disclosure and other requirements of the Act by separately organizing if they are operationally integrated, *i.e.*, have the same advisory personnel, capital structures, and investment decision-making functions.[157] For example:

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[154] Rule 204-2.

[155] Section 203(b)(7) (added by the Dodd-Frank Act). Advisers relying on this exemption are also exempt from state registration requirements. Section 203A(b)(1)(C), which was added in December 2015 by Section 75003 of the FAST Act, *supra* note 129.

[156] Advisers Act Rel. No. 688 (July 12, 1979) (persons associated with registered adviser need not separately register as investment advisers solely as a result of their activities as associated persons). *See also* *Kevin J. Hughes*, SEC Staff No-Action Letter (Dec. 7, 1983).

[157] Section 208(d) of the Act. The determination of whether an advisory business of two separately formed affiliates may be required to be integrated is based on the facts and circumstances. Release 3222, *supra* note 117. *See* *Richard Ellis*, SEC Staff No-Action Letter (Aug. 18, 1981); *Kenneth Leventhal & Co.*, SEC Staff No-Action Letter (Feb. 7, 1983). *See also* *Price Waterhouse*, SEC Staff No-Action Letter (July 16, 1987).

- An adviser managing $200 million of private fund assets could not simply reorganize as two separate advisers each of which purport to rely on the private fund adviser exemption from registration.[158]

- An adviser that utilized controlled limited partnership that are themselves investment advisers to manage a hedge fund, may be unable to avoid the obligations of the Advisers Act with respect to the hedge funds.[159]

2. *Participating Affiliates*

Under certain conditions, a non-U.S. adviser (a "participating affiliate") does not have to register under the Act if it provides advice to U.S. persons through an affiliate registered under the Advisers Act.[160] "Through an affiliate" means that all advice must be transmitted through the registered adviser.

A participating affiliate arrangements is typically structured in a "participating affiliate agreement" entered into between the two advisers the terms of which reflect the conditions set forth in the staff letters. The conditions include:

a. the unregistered adviser and its registered affiliate must be separately organized;

b. the registered affiliate must be staffed with personnel (located in the U.S. or abroad) who are capable of providing investment advice;

c. all personnel of the participating affiliate involved in U.S. advisory activities must be deemed "associated persons"[161] of the registered affiliate; and

d. the SEC must have adequate access to trading and other records of the unregistered adviser and to its personnel to the extent necessary to enable the SEC to monitor and police conduct that may harm U.S. clients or markets.[162]

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[158] Release 3222, *supra* note 117, at Section II.D. *See* *TL Ventures*, Advisers Act Rel. No. 3859 (June 20, 2014) (settled enforcement action alleging two exempt reporting advisers under common control were "operationally integrated" and thus were not eligible to rely on exemptions. The advisers shared employees, had significantly overlapping operations, cross-marketed services, and failed to have any policies and procedures designed to keep the entities separate).

[159] *Reid S. Johnson*, Advisers Act Rel. No. 4161 (Aug. 6, 2015) (adviser and managing members of pooled investment vehicles operated as single integrated adviser, having overlapping ownership and personnel, and did not observe corporate formalities or otherwise did not conduct themselves as separate entities).

[160] *See* *Unibanco*, *supra* note 76; *Mercury Asset Mgmt.*, SEC Staff No-Action Letter (Apr. 16, 1993) (first using the term "participating affiliates); *Kleinwort Benson Investment Mgmt. Ltd.*, SEC Staff No-Action Letter (Dec. 15, 1993); *Murray Johnstone Holdings Ltd.*, SEC Staff No-Action Letter (Oct. 7, 1994). *See also* Section II.C. of Release 3222 and Section III.B.3 of this outline regarding the exemption for foreign private advisers.

[161] *See* Section V.A.1 of this outline for the definition of "person associated with an investment adviser." As a result, the associated persons of the non-U.S. adviser would be subject to the registered adviser's code of ethics, including the provisions requiring reporting of personal securities transactions.

[162] *See id*. The adviser must undertake to have records requested by the staff translated into English.

Participating affiliate arrangements permit a non-U.S. adviser to enter the U.S. market by establishing a registered subsidiary in the United States that may draw upon advisory resources of its unregistered non-U.S. affiliates, which may including sharing personnel (often called "dual hatted" employees). In many respect, the non-U.S. personnel are treated as if they constituted an office of the registered adviser.[163]

3. *Umbrella Registration for Advisers to Private Funds*

Under limited conditions, an adviser ("Filing Adviser") to one or more private funds may file a single Form ADV on behalf of itself and multiple related advisers ("Filing Advisers"). The conditions are designed to limit umbrella registration to advisers that collectively operate a single business through multiple firms.[164]

Conditions for Use

a. The Filing Adviser and each Relying Adviser advise *only* (i) private funds, and (ii) parallel managed separate accounts, *i.e*., separately managed accounts that are eligible to invest in the private funds and pursue similar investment strategies.[165]

b. The Filing Adviser's principal office and place of business is in the United States. Accordingly, a non-U.S. adviser cannot have Relying Advisers.

c. Each Relying Adviser (as well as its employees and other persons acting on its behalf) is subject to the control and supervision of the Filing Adviser and is treated as an associated person of the Filing Adviser.

d. The advisory activities of each Relying Adviser are subject to the Advisers Act and each Relying Adviser is subject to examination by the SEC. As a result, Relying Advisers are not eligible for "adviser lite."[166]

e. The Filing Adviser and each Relying Adviser operate under a single code of ethics and set of compliance policies administered by a single chief compliance officer.

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[163] The SEC has affirmed the staff no-action positions. Release 3222, *supra* note 117, at Section II.D.

[164] Instruction 5 of the General Instructions to Form ADV, as amended. *Form ADV and Investment Advisers Act Rules*, Advisers Act Rel. No. 4509 (Aug. 25, 2016). In this release the SEC, among other things, amended Form ADV Instructions to codify staff interpretations that permitted joint registration of related advisory firms. *See* ERA FAQs. In addition, the SEC adapted Form ADV to joint registration. The rules are not effective until October 1, 2017.

Likewise, under certain circumstances, the Staff has indicated that an exempt reporting adviser may satisfy the Form ADV reporting obligations of one or more special purpose entities under its control..

[165] Data about "parallel managed accounts" are captured by Form PF, discussed *supra*, Section VI.B.13.a of this outline.

[166] Accordingly, non-U.S. advisers registering jointly with U.S. advisers cannot take advantage of the *Unibanco* letter and its progeny under which the SEC does not apply the substantive provisions of the Act with respect to non-U.S. clients of a non-U.S. adviser, including private funds organized in other jurisdictions.

Limitations

a. Umbrella reporting is not available to exempt reporting advisers, which are not registered under the Advisers Act. Nonetheless, exempt reporting advisers may use umbrella reporting for a Relying Adviser that is a special purpose entity.[167]

b. Each Relying Adviser must have an independent basis for registering with the SEC, *i.e.*, an adviser cannot "aggregate" assets under management of Relying Advisers in order to meet the $100 million RAUM threshold of Section 203A of the Advisers Act.

V. How Does an Investment Adviser Register Under the Advisers Act?

A. Procedure

Applicants for registration under the Act must file Form ADV with the SEC.[168] Within 45 days the SEC must grant registration or institute an administrative proceeding to determine whether registration should be denied.[169]

1. *Denial of Registration*. The SEC may deny registration if the adviser is subject to a "Statutory Disqualification," that is, if the adviser or any "person associated with the adviser" makes false or misleading statements in its registration application, has within the past 10 years been convicted of a felony, or if it has been convicted by a court or found by the SEC to have violated a securities-related statute or rule, or have been the subject of a securities-related injunction, or similar legal action.[170]

   Persons Associated with an Investment Adviser. These include employees (other than clerical employees) of the advisers as well as any persons who directly or indirectly control the investment adviser or are controlled by the adviser.[171] The SEC can deny registration if, for example, the parent company of an adviser has been convicted of securities fraud even if the adviser and its employees have not.

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[167] Advisers Act Rel. No. 4509, *supra* note 164. *See* FAQs on Form ADV and IARD (Mar. 2012). Although, the FAQ may suggest that all entities serving as general partners of private funds may be advisers required to register under the Act, s*ee* Thompson Advisory Group L.P. (Sept. 26, 1995).

[168] Form ADV can be found here.

[169] The SEC will respond to requests made for accelerating the date of registration. Requests should be made in the "free writing" portion of Schedule D.

[170] Sections 203(c)(2) and (e).

[171] Section 202(a)(17). For this purpose, a person associated with an adviser does not include a person under common control with the adviser, *i.e.*, a sister company. In this respect the SEC's authority to deny registration to an adviser is narrower than its authority regarding broker dealers. *Compare* Section 3(a)(18) of the Exchange Act (defining the term "person associated with a broker or dealer"). Form ADV and some SEC rules use the term "related person," which includes persons who are under common control with the adviser. *See*, *e.g.*, rule 206(4)-2(d)(7).

Non-U.S. Based Offenses. Statutory Disqualifications include convictions in non-U.S. courts, and by findings of violations by "foreign financial regulatory authorities" enforcing non-U.S. laws.[172]

2. *Qualifications.* There are no "fit and proper," educational or experience requirements for SEC registration as an investment adviser, although certain employees of the adviser may have to pass securities examinations in the states in which they have a principal place of business. Instead, advisers must disclose to clients the background and qualifications of certain of their personnel.[173]

B. Form ADV

Form ADV sets forth the information that the SEC requires advisers to provide in an application for registration. Once registered, an adviser must update the form at least once a year, and more frequently if required by instructions to the form.[174] Form ADV consists of two parts.[175]

1. *Part 1.* Part 1 is primarily for SEC use. It requires information about the adviser's business, ownership, clients, employees, business practices (especially those involving potential conflicts with clients), and any disciplinary events of the adviser or its employees. The SEC uses information from this part of the form to make its registration determination and to manage its regulatory and examination programs. Part 1 is organized in a check-the-box, fill-in-the-blank format.

2. *Part 2.* Part 2 is divided into Part 2A and Part 2B and sets forth information required in client brochures and brochure supplements.[176]

   Brochure Part 2A requires an adviser to prepare a narrative "brochure" that includes plain English disclosures of, among other things, the adviser's business practices, investment strategies, fees, conflicts of interest, and disciplinary information.[177] Part 2B requires an adviser to prepare a "brochure supplement" that contains information about each advisory employee that provides investment advice to its clients, including her educational background, business experience, other business activities, and disciplinary history. To satisfy the "brochure rule" (discussed below),[178] the adviser

[172] Sections 203(c)(2) and (e). Non-U.S. based offenses were added to section 203(e) in 1990 by the International Securities Enforcement Cooperation Act of 1990, Pub. L. No. 101-550, 104 Stat. 2713 (Nov. 15, 1990).

[173] Form ADV, Item 2 of Part 2B.

[174] Rule 204-1(a).

[175] Both Part 1 and Part 2A of the Form ADV are filed by registered advisers through the IARD system and are available to the public through the SEC's Investment Adviser Public Disclosure Website.

[176] In 2010 the SEC adopted extensive amendments to Part 2 of Form ADV. *See* Advisers Act Rel. No. 3060 (July, 2010) ("Part 2 Adopting Release"). For staff responses to FAQs about the amended Part 2, visit the SEC's website at ("Part 2 FAQs").

[177] Prior to the 2010 amendments, Part II of Form ADV was in a check-the-box, fill-in-the-blank format.

[178] Rule 204-3.

must deliver the brochure (and updates to that brochure) to its clients annually and the brochure supplement about a supervisory employee to a client at the time the employee begins to provide advisory services to that client.[179] In addition, the adviser must file its brochure, but not its brochure supplement, with the SEC to satisfy its registration requirements.[180]

C. Electronic Filing

All applications for registration as an adviser with the SEC must be submitted electronically through an Internet-based filing system called the Investment Adviser Registration Depository ("IARD").[181] The IARD is sponsored by the SEC and the North American Securities Administrators Association (NASAA), and operated by the Financial Industry Regulatory Authority ("FINRA"), the broker-dealer self-regulator.[182]

D. Public Availability

All current information from advisers' Form ADVs filed with the SEC is publicly available through the SEC website: www.adviserinfo.sec.gov.

E. Withdrawal of Registration

Advisers withdraw from registration by filing Form ADV-W.[183] An adviser may withdraw from registration because it: (i) ceases to be an investment adviser; (ii) is entitled to an exception from the registration requirements; or (iii) no longer is eligible for SEC registration (*e.g.*, it no longer has the requisite amount of assets under management).[184] The SEC also has the authority under section 203(f) of the Advisers Act to revoke the registration of an adviser under certain enumerated circumstances.

F. Successor Registrations

1. *Succession by Application.* An unregistered person that assumes and continues the business of a registered investment adviser (which then ceases to do business) may continue to rely on the registration of the investment adviser until its registration becomes effective by filing an application for registration within 30 days of the

[179] Rule 204-3(b)(3). For specific delivery requirements under the brochure rule, *see* Section VI.B.12 of this outline.

[180] Rule 203-1(a); Rule 204-1(b)(1).

[181] Rule 203-1(b). FINRA charges advisers filing fees to defray the cost of maintaining and operating the IARD. To pay the fees, advisers must establish and fund an account with FINRA before making a filing. *See* fee schedule.

[182] Rule 204-1(b). For information about electronic filing by advisers, including how to register, *see* http://www.sec.gov/IARD. FINRA operates the IARD system, but does not act as a self-regulatory organization with respect to investment advisers.

[183] Rule 203-2. Form ADV-W filings are made electronically through the IARD, and are effective immediately. There are no filing fees for Form ADV-W. Form ADV-W can be found here.

[184] Before withdrawing from registration, an adviser must arrange for the preservation of records it is required to keep under the Act. Rule 204-2(f).

succession.[185] This provision is designed to facilitate the transfer of business between two or more entities and to permit the successor to operate without interruption.[186]

2. *Succession by Amendment.* A succession resulting from a change in the place or form of organization, or composition of a partnership, *i.e.*, a succession that does not involve a change of control, may be completed by amending relevant provisions of the predecessor's Form ADV promptly after the succession.[187] This staff position is designed to deal with technical but not actual changes of control.

VI. What Are the Requirements Applicable to an Investment Adviser?

The Advisers Act does not provide a comprehensive regulatory regime for advisers, but rather imposes on them a broad fiduciary duty to act in the best interest of their clients. As the SEC explained:

> Unlike the laws of many other countries, the U.S. federal securities laws do not prescribe minimum experience or qualification requirements for persons providing investment advice. They do not establish maximum fees that advisers may charge. Nor do they preclude advisers from having substantial conflicts of interest that might adversely affect the objectivity of the advice they provide. Rather, investors have the responsibility, based on disclosure they receive, for selecting their own advisers, negotiating their own fee arrangements, and evaluating their advisers' conflicts.[188]

Advisers are subject to five types of requirements: (i) fiduciary duties to clients; (ii) substantive prohibitions and requirements; (iii) contractual requirements; (iv) recordkeeping requirements; and (v) administrative oversight by the SEC, primarily by inspection.

A. Fiduciary Duties to Clients

Fundamental to the Act is the notion that an adviser is a fiduciary. As a fiduciary, an adviser must avoid conflicts of interest with clients and is prohibited from overreaching or taking unfair advantage of a client's trust. A fiduciary owes its clients more than mere honesty and good faith alone. A fiduciary must be sensitive to the conscious and unconscious possibility of providing less than disinterested advice, and it may be faulted even when it does not intend to injure a client and even if the client does not suffer a

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[185] Section 203(g). *See* Instruction 4 to Part 1A of Form ADV; *Registration of Successors to Broker-Dealers and Investment Advisers*, Advisers Act Rel. No. 1357 (Dec. 28, 1992) (the provision in rule 203-1 referred to in Release 1357 that addressed successions was moved by the SEC to Instruction 4 to Form ADV in 2000). Item 4 of Form ADV asks whether the filing relates to a succession.

[186] A transfer of control of a controlling block of a corporate adviser's voting securities may result in an "assignment" of the advisory contracts, but it would not raise concerns regarding a succession. *See* *Staff Guidance Concerning Investment Adviser Reliance on Predecessor Registrations*, IM Guidance Update 2016-05 (Nov. 2016).

[187] *Id.*

[188] *See* *Amendments to Form ADV*, Advisers Act Rel. No. 2711 (Mar. 3, 2008).

monetary loss.[189] The landmark court decision defining the duties of a fiduciary is Justice Cardozo's opinion in *Meinhard v. Salmon,* in which he explains that:

> Many forms of conduct permissible in the workaday world for those acting at arm's length are forbidden by those bound by fiduciary ties. A fiduciary is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.[190]

These concepts are embodied in the anti-fraud provisions of the Advisers Act. As the Supreme Court stated in *SEC v. Capital Gains Research Bureau, Inc.*, its seminal decision on the fiduciary duties of an adviser under the Act, "[t]he Advisers Act of 1940 reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."[191]

The duty is not specifically set forth in the Act, established by SEC rules, or a result of a contract between the adviser and the client (and thus it cannot be negotiated away). Rather, fiduciary duties are imposed on an adviser by operation of law because of the nature of the relationship between the two parties.[192] It is made enforceable by section 206 of the Act,[193] which contains the Act's anti-fraud provisions, and incorporated indirectly into the Act in various provisions and disclosure requirements discussed below.[194]

Unlike Section 10(b) of the Exchange Act, Section 206 of the Act is not limited to fraud in connection with the purchase or sale of a security. Accordingly, once an advisory relationship is formed, the adviser's fiduciary obligation extends "to all services undertaken on behalf of the client."[195]

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[189] *SEC v. Capital Gains Research Bureau, Inc.*, *supra* note 3 at 191-192.

[190] *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928).

[191] *SEC v. Capital Gains Research Bureau, Inc.*, *supra* note 3 at 190-192.

[192] *See Arleen W. Hughes*, Exchange Act Rel. No. 4048 (Feb 18, 1948), *affd. sub. nom. Hughes v. SEC*, 174 F.2d 969 (May 9, 1949).

[193] *Transamerica Mortg. Advisors v. Lewis*, *supra* note 80 ("[T]he Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations."). An aggrieved client has no private right of action against the adviser under section 206. *Id.* Many courts, however, when dealing with private causes of action for breach of fiduciary obligations by investment advisers under state law apply standards developed under section 206 of the Advisers Act. *See Belmont v. MB Investment Partners, Inc., 708. F.3d 470* (3rd Cir. 2013).

[194] *See Morris v. Wachovia Securities, Inc.*, 277 F. Supp. 2d 622 (E.D. Va. 2003) ("§206(2) is more than an anti-fraud provision because it establishes fiduciary duties for investment advisers"). The scope of the fiduciary duties is determined by reference to federal court and administrative decisions rather than state common law analogies. *Laird v. Integrated Resources, Inc.*, 897 F.2d 826 (5th Cir. 1990) ("[B]ecause state law is not considered, uniformity is promoted.")

[195] *Proxy Voting by Investment Advisers*, Adv. Act Rel. No. 2106 (Jan. 31, 2003); Release 1092, *supr*a note 5 (Sections 206(1) and 206(2) "do not refer to dealings in securities but are stated in terms of the effect or potential

Several obligations flow from an adviser's fiduciary duties.

1. *Full Disclosure of Material Facts*. Under the Act, an adviser has an affirmative obligation of utmost good faith and full and fair disclosure of all facts material to the client's engagement of the adviser to its clients, as well as a duty to avoid misleading them.[196] Accordingly, the duty of an investment adviser to refrain from fraudulent conduct includes an obligation to disclose material facts to its clients whenever failure to do so would defraud or operate as a fraud or deceit upon any client.

   Material Facts. A fact is material under the Advisers Act if there is a substantial likelihood that a reasonable client would consider the information important.[197] The question of materiality under the Act (like other federal securities laws) is "an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor."[198]

   Conflicts of Interest. Disclosure of material facts is particularly pertinent whenever the adviser is faced with a conflict—or a potential conflict— of interest with a client. "The existence of a conflict of interest is a material fact which an investment adviser must disclose to its clients because a conflict of interest 'might incline an investment adviser – consciously or unconsciously – to render advice that was not disinterested.'"[199]

   Accordingly, an adviser must disclose all material facts regarding the conflict so that the client can make an informed decision whether to enter into or continue an advisory relationship with the adviser, or take some action to protect himself or herself against the conflict.[200] A sincere belief that the adviser with a conflict is acting solely in the interest of the client is insufficient to excuse full disclosure.[201]

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effect of prohibited conduct on the client"). *See also* *Timbervest, LLC, et al.*, Adv. Act Rel. No 4197 (Sept. 17, 2015) (SEC Opinion) ("Thus, once an investment advisory relationship is formed, the Advisers Act does not permit an adviser to exploit that fiduciary relationship by defrauding his client in any investment transaction connected to the advisory relationship.").

[196] *See* *Arleen W. Hughes*, *supra* note 192.

[197] Part 2 Adopting Release. at n. 35, *supra* note 176, *citing* *SEC. v. Steadman*, 967 F.2d 636, 643 (D.C. Cir. 1992).

[198] *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 445 (1976).

[199] *SEC v. K.W. Brown & Co.*, 555 F. Supp. 2d 1275, 1305 (S.D. Fla. 2007).

[200] Part 2 Adopting Release, *supra* note 176. *See also* *SEC v. Capital Gains Research Bureau, Inc.*, *supra* note 3 at 191-192 (1963).

[201] *See* *Feeley & Willcox Asset Mgmt. Corp*, Advisers Act Rel. No. 2143 (July 10, 2003) ("In practical terms, when clients receive a recommendation from their investment adviser, that recommendation must be coupled with disclosure regarding any financial interest the adviser. . . It is the client, not the adviser, who is entitled to make the determination whether to waive the adviser's conflict.").

Accounts for Which the Adviser Receives No Compensation. An adviser's fiduciary and other obligations under the Act extend to accounts it manages without compensation.[202]

Disciplinary Events and Precarious Financial Condition. Although not typically considered a conflict, the SEC has long considered that an adviser has an obligation to disclose to clients and prospective clients material facts about:

a. a financial condition of the adviser that is reasonably likely to impair the adviser's ability to meet contractual

b. commitments to clients;[203] and

c. certain disciplinary events of the adviser (and certain of its officers) occurring within the past 10 years, which are presumptively material.[204]

2. *Suitable Advice.* Advisers owe their clients a duty to provide only suitable investment advice. This duty generally requires an adviser to make a reasonable inquiry into the client's financial situation, investment experience and investment objectives, and to make a reasonable determination that the advice is suitable in light of the client's situation, experience and objectives.[205]

Institutional Clients. There is no exception to the obligation for institutional clients.[206] However, what is "suitable" for an institutional investor is often

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[202] Advisers Act Rel. No. 3222 at n.390 and accompanying text ("Although a person is not an 'investment adviser' for purposes of the Adviser 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)").

[203] Item 18 of Part 1A, Form ADV. This requirement is applicable to advisers that have discretionary authority with client accounts, or have custody of client assets, or require or solicit prepayment of more than $1,200 in fees per client, six months or more in advance.

[204] Form ADV: Item 11 of Part 1A, Item 9 of Part 2A, and Item 3 of Part 2B.

[205] *See* Advisers Act Rel. No. 1406 (Mar. 16, 1994), *supra note 26*. In this release, the SEC proposed a rule prohibiting advisers from giving clients unsuitable advice. Although the rule was never adopted, SEC staff believes that the rule would have codified existing suitability obligations of advisers and, as a result, the proposed rule reflects the current obligation of advisers under the Act. Suitability obligations do not apply to impersonal investment advice, and compliance with the obligation is evaluated in the context of a client's overall portfolio. *Id*. "Thus, inclusion of some risky securities in the portfolio of a risk-averse client may not necessarily be unsuitable." *Id*. The SEC has instituted enforcement actions against advisers that provided unsuitable investment advice. *See* *George E. Brooks & Associates, Inc*., Advisers Act Rel. No. 1746 (Aug. 17, 1998) (adviser failed to appropriately diversify, and effected unsuitable trades of speculative high risk stocks in, the discretionary accounts of customers with conservative investment objectives, many of whom were elderly and had little investment experience); *Philip A. Lehman*, Advisers Act Rel. No. 1831 (Sept. 22, 1999) (adviser recommended risky investment for customer's individual retirement account, despite customer's conservative investment objective and age).

[206] FINRA rule 2111 provides for an exception from a broker-dealer's suitability obligations for institutional customers that (i) are capable of independently evaluating risks; and (ii) affirmatively indicate that they are exercising independent judgment in evaluating the broker-dealer's recommendations.

determined by reference the investment objectives, strategy or restrictions set forth in the advisory contract, limited partnership agreement (or is otherwise disclosed to clients). The failure of an adviser to follow will be treated by the SEC as a violation of the anti-fraud provisions (and thus identical to a suitability violation).[207] In some cases, the SEC has looked to relevant laws governing investments by the client to determine the suitability of an investment.[208]

3. *Reasonable Basis for Recommendations*. An adviser's fiduciary duty includes a duty of care to clients, which requires that an adviser have a reasonable, independent basis for its recommendations.[209]

4. *Best Execution.* Where an adviser has responsibility to direct client brokerage, it has an obligation to *seek* best execution of clients' securities transactions.[210] In meeting this obligation, an adviser must seek to obtain the execution of transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances.[211] In assessing whether this standard is met, an adviser should consider the full range and quality of a broker's services when placing brokerage, including, among other things, execution capability, commission rate, financial responsibility, responsiveness to the adviser, and the value of any research provided. "The determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the [client]."[212]

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[207] *See, e.g., JH Partners, LLC,* Advisers Act Rel. No. 4276 (Nov. 23, 2015); *UBS Willow Mgmt., LLC,* Advisers Act Rel. No. 4233 (Oct. 16, 2015); *Top Fund Mgmt., Inc.*, Advisers Act Release No. 3526 (Dec. 12, 2012).

[208] *See* *Grey Financial Group, Inc.*, Advisers Act Release No. 4094 (May 21, 2015) (adviser recommended public pension fund clients invest in proprietary hedge funds that did not meet requirements of state pension law).

[209] *Larry C. Grossman and Gregory J. Adams*, Initial Decision Rel. No. 727 (Dec. 23, 2014) (adviser failed to "perform reasonable due diligence" before recommending hedge funds investing in Madoff feeder funds); *Baskin Planning Consultants, Ltd*., Advisers Act Rel. No. 1297 (Dec. 19, 1991) (adviser failed adequately to investigate recommendations to clients); *Alfred C. Rizzo*, Advisers Act Rel. No. 897 (Jan 11, 1984) (investment adviser lacked a reasonable basis for advice and could not rely on "incredible claims" of issuer). *See also* *Investment Adviser Due Diligence Process for Selecting Alternative Investments and Their Respective Managers*, National Examination Risk Alert, Vol. IV, Issue 1 (Jan 28, 2014).

[210] *Kidder Peabody & Co., Inc*., Advisers Act Rel. No. 232 (Oct. 16, 1968). *See also* rule 206(3)-2(c) (acknowledging adviser's duty of best execution of client transactions).

[211] This obligation is different from a broker-dealer's best execution obligation, which typically focuses on the price at which an order is executed and does not consider the broker's compensation, whereas an adviser's duty requires it to consider the total transaction cost to its client. The SEC has brought enforcement actions against advisers alleging failure to seek best execution. *Fidelity Mgmt. Research Company*, Advisers Act Rel. No. 2713 (Mar. 5, 2008); *Renberg Capital Mgmt., Inc*., Advisers Act Rel. No. 2064 (Oct 1, 2002); *Portfolio Advisory Services, LLC*, Advisers Act Rel. No. 2038 (June 30, 2002).

[212] *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, Exchange Act Rel. No. 23170 (Apr. 23, 1986) ("1986 Soft Dollar Release"). To fulfill this duty, an investment adviser should "periodically and systematically" evaluate the execution it is receiving for clients. *Id*. The scope of the duty evolves as changes occur in the market that give rise to improved execution, including opportunities to trade at more advantageous prices. *See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc*., 135 F.3d 266, 270-271 (3d Cir. 1998). *See also* *Jamison, Eaton & Wood, Inc*., Advisers Act Rel. No. 2129 (May 15, 2003).

a. *Interpositioning.* An adviser will generally not obtain best execution if it interposes a broker that does not make a market in the security when it could have avoided the unnecessary commission payments by dealing directly with market makers.[213]

b. *Mutual Funds.* The SEC has brought a recent enforcement action against an adviser for failure to obtain best execution where an adviser has selected higher cost classes of shares for clients, paying avoidable sales charges.[214]

c. *Directed Trades.* An adviser is relieved of its obligation to seek best execution when a client directs the adviser to use a particular broker. An adviser must disclose to the client that direction to trade securities with a particular broker may result in the inability of the adviser to obtain best execution or to efficiently aggregate client trades.[215] When the adviser receives some benefit from the direction of the trade, additional disclosure may be required.[216]

It is not uncommon for advisers to disclose that they will direct trades to an a broker-dealer "subject to best execution," in which case disclosure about the risk that the adviser may be unable to obtain best execution for the client are unnecessary.[217] Such advisers should establish and implement policies and procedures designed to seek best execution in a manner consistent with this undertaking.[218]

Use of Brokerage Affiliate. The Act does not prohibit advisers from using (or requiring that a client use) an affiliated broker to execute client trades.[219]

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213 *Delaware Mgmt. Company, Inc.*, Exchange Act Rel. No. 8128 (July 19, 1967).

214 *Manarin Investment Counsel, Ltd., et al.*, Advisers Act Rel. No. 3686 (Oct. 2, 2013); *Pekin Singer Stauss Asset Mgmt., Inc.*, Advisers Act Rel. No. 4126 (June 21, 2015). In a recent settlement, the SEC referred to the same practice as failing to disclose a conflict of interest. *Royal Alliance Associates, Inc.* Advisers Act Rel. No. 4351 (Mar 14, 2016). FINRA has fined member broker-dealers for similar conduct for violation of its "suitability" rule. *See* News Release, Dec. 19, 2005.

215 Item 12.A.3.a. of Part 2 of Form ADV ([E]xplain that you [the adviser] may be unable to achieve most favorable execution of client transactions. Explain that directing brokerage may cost clients more money. For example, in a directed brokerage account, the client may pay higher brokerage commissions because you may not be able to aggregate orders to reduce transaction costs, or the client may receive less favorable prices.)

216 *See* *Mark Bailey & Co.*, Advisers Act Rel. No. 1105 (Feb. 24, 1988) (adviser failed to disclose that it did not negotiate commissions on directed trades, and failed to disclose that the adviser would be in a better position to negotiate commissions in bunched transactions for non-directed trades, and violated anti-fraud provisions of Advisers Act); *Jamison, Eaton and Wood, Inc.*, *supra* note 212. *See also* Item 12.A.3.a. (If you and the broker-dealer are affiliated or have another economic relationship that creates a material conflict of interest, describe the relationship and discuss the conflicts of interest it presents.).

217 Item 12.A.3.b. of Part 2 of Form ADV.

218 *See*, *Goelzer Investment Mgmt.*, Advisers Act Rel. No. 3638 (July 31, 2013) (adviser failed to evaluate other brokers and misrepresented that use of an affiliate to effect trades would benefit clients paying lower commission rates).

219 *See* Item 12.A.3.a. of Part 2 of Form ADV (If you [the adviser] routinely recommend, request or require that a client direct you to execute transactions through a specified broker-dealer, describe your practice or policy.).

However, use of an affiliate involves a conflict of interest that must be disclosed to clients.[220] For example, use of an affiliated broker may give the adviser incentive to "churn" the account or to fail to seek to obtain best execution, and may result in violations of the adviser's fiduciary responsibilities to its clients unless it implements effective policies and procedures.[221]

Step-Outs. A step-out occurs when an adviser directs an executing broker-dealer to allocate (or "step out") all or part of a trade to another broker-dealer for clearance and settlement. Such a trade permits an adviser to accommodate a direction by a client to execute a trade (*e.g.*, to recapture brokerage) while obtaining best execution.[222]

Soft Dollars. Soft dollars is a term used to describe a variety of practices by which an adviser or other fiduciary causes a client to pay higher brokerage costs than might otherwise be available in order to obtain research or other products used to manage client assets. These practices were developed when brokerage rates were fixed by rules of the stock exchanges and served as a way for brokers to offer price discounts to larger traders, such as investment advisers. When fixed commissions were abandoned in 1975, Congress preserved the practice in Section 28(e) of the Securities Exchange Act.

Section 28(e) provides a safe harbor from liability for breach of fiduciary duties under state and federal law when advisers purchase brokerage and research products and services with client commission dollars under specified circumstances. In July 2006, the SEC issued a revised interpretation as to the scope of the safe harbor, including, for example, use of step-outs.[223]

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[220] *Folger Nolan Fleming Douglas Capital Mgmt., Inc.*, Advisers Act Rel. No. 2639 (Aug. 23, 2007) (adviser entered into agreements with clients to direct trades to affiliated broker without disclosing commission rates were twice as high as non-directed trades). *See also* Advisers Act Rel. 1092, *supra* note 5 (if an investment adviser recommends that a client effect transactions through its broker-dealer employer, the anti-fraud provisions of the Advisers Act require that the adviser make full disclosure of the nature and extent of all adverse interests, including the amount of any compensation the advisers will receive from its broker-dealer employer in connection such transactions); *Don P. Matheson*, SEC Staff No-Action Letter (Aug. 2, 1976) (investment advisers that are also broker-dealers or registered representatives have a duty to inform their investment advisory clients of their ability to seek executions of transactions recommended through other broker-dealers firms).

[221] *See, e.g.*, *A.R. Schmeidler & Co.*, Advisers Act Rel. No. 3637 (July 31, 2013) (adviser with authority to selected brokers to execute client transactions selected itself unless clients otherwise instructed without evaluating the implications on client execution); *Goelzer Investment Mgmt., Inc.*, Advisers Act Rel. No. 3638 (July 31, 2013) (same).

[222] *Inspection Report on the Soft Dollar Practices or Broker-Dealers, Investment Advisers And Mutual Funds* (Sept. 22, 1988) at V.3.

[223] *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, Exchange Act Rel. No. 34-54165 (July 18, 2006) ("2006 Soft Dollar Release"). The release superseded parts (but not all) of the 1986 Soft Dollar Release. In particular, the 2006 Soft Dollar Release does not replace Section IV of the 1986 Release, which discusses an investment adviser's disclosure obligations.

An adviser cannot "violate" section 28(e), and need not take advantage of the safe harbor it provides unless it is subject to statutory restriction on the use of client brokerage, e. g, under ERISA or the Investment Company Act.[224] Accordingly, if properly disclosed to clients, an adviser may use client brokerage for purposes other than those permitted by section 28(e).[225] Soft dollars arrangements present adviser with conflicts that arise from an adviser's receipt of a benefit (*e.g.*, research) that it would otherwise have to purchase with its own resources or produce itself in exchange for directing brokerage for a client.[226]

Under section 28(e), an adviser that exercises investment discretion may lawfully pay commissions to a broker at rates higher than those offered by other brokers, as long as the services provided to the adviser by the broker-dealer: (i) are limited to "research" or "brokerage"; (ii) constitute lawful and appropriate assistance to the adviser in the performance of its investment decision-making responsibilities; and (iii) the adviser determines in good faith that the commission payments are reasonable in light of the value of the brokerage and research services received.

a. *Research Services.* "Research" services generally include the furnishing of advice, analyses, or reports concerning securities, portfolio strategy and the performance of accounts, which means the research must reflect the expression of reasoning or knowledge relating to the statutory subject matter bearing on the investment decision-making of the adviser. The SEC does not believe that products or services with "inherently tangible or physical attributes" meet this test.

(1) Products or services generally falling within the safe harbor include traditional research reports, market data, discussions with research analysts, meetings with corporate executives; software that provides analysis of securities, and publications (other than mass-marketed publications).

(2) Products or services not within the safe harbor include computer hardware, telephone lines, peripherals; salaries, rent, travel, entertainment, and meals; software used for accounting, recordkeeping, client reporting, or other administrative functions; and marketing seminars and other marketing costs.

(3) Where a product or service has uses both inside and outside the safe harbor, the SEC believes that an adviser should make a reasonable allocation of the

[224] The safe harbor provided by Section 28(e) extends to other federal and state statutes that could otherwise restrict an adviser's ability to use of client commissions, *e.g*., Section 17(e)(1) of the Investment Company Act, which is discussed in Section VI.B.9.d of this outline below. The use by an adviser of investment company brokerage to acquire goods or services not within the safe harbor will violate Section 17(e)(1). *Parnassus Investments*, Initial Decision 131 (Sept. 3, 1998).

[225] The SEC requires advisers using client brokerage for products or services that do not qualify for the safe harbor in section 28(e) to provide more detailed disclosure to clients. *See* Note to Item 12.A.1.e. of Part 2 of Form ADV.

[226] *Dawson-Samburg Capital Mgmt., Inc.*, Advisers Act. Rel. No. 1889 (Aug. 3, 2000) (settled enforcement action alleging failure to disclose use of soft dollars to purchase goods and services outside the scope of Section 28(e)).

cost of the product or service according to its use and keep adequate books and records concerning allocations so as to be able to make the required good faith showing.[227]

b. *Brokerage Services.* "Brokerage" generally includes activities related to effecting securities transactions and incidental functions. According to the SEC, brokerage begins when the order is transmitted to the broker-dealer and ends when funds or securities are delivered to the client account.[228]

c. *Commissions*. The SEC interprets the safe harbor of section 28(e) as being *only* available for research obtained for commissions on agency transactions either on equity or debt securities,[229] and certain riskless principal transactions.[230]

d. *Third Party Research.* Research acquired with soft dollars can be provided by the broker with which the adviser trades or by a third party, such as an investment adviser.

Soft Dollar Credits. In a typical soft dollar arrangement, the broker will keep track of the amount of trading by issuing "soft dollar credits" that the adviser (or a client) can use to acquire research or other goods or services in what amounts to a barter arrangement. While the SEC has stated that soft dollar credits are assets of the client rather than the adviser,[231] it is not clear which client own the credits. This is because Section 28(e) permits soft dollar credits generated by the trading of one client to be used for the benefit of all or some of the adviser's clients whose trades generated the soft dollars.

e. *Disclosure Obligations.* Advisers are required to disclose to clients any soft dollar arrangements, regardless of whether the arrangements fall within the

[227] *See id*., 2006 Soft Dollar Release, at Section F, n. 148.

[228] *Id*.

[229] *See* *Carolina Capital Markets Inc.*, SEC Staff No-Action Letter (July 30, 2013).

[230] Exchange Act Rel. No. 45194 (Dec. 27, 2001) ("Release No. 45194"). In Release No. 45194, the SEC concluded with respect to riskless principal transactions that "[t]he term 'commission' in Section 28(e)…include[s] a markup, markdown, commission equivalent or other fee paid by a managed account to a dealer for executing a transaction where the fee and transaction price are fully and separately disclosed on the confirmation and the transaction is reported under conditions that provide independent and objective verification of the transaction prices subject to self-regulatory oversight." The SEC staff had previously interpreted the safe harbor as being available only to agency transactions. *Letter to Charles Lerner, Esq., Director of Enforcement, Pension and Welfare Benefit Administration, U.S. Department of Labor, from Richard Ketchum, Director, Division of Market Regulation, SEC* (July 25, 1990).

[231] *Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices*, Advisers Act Rel. No. 2763 (July 30, 2008). *See also* *In re Lehman Bros. Inc.*, 474 B.R. 139 (July 10, 2012) (soft dollar credits treated as unsecured claims of investors for purposes of Securities Investor Protection Act of 1970, 15 U.S.C. 78a).

section 28(e) safe harbor.[232] Failure to disclose the receipt of products or services purchased with client commission dollars may constitute a breach of fiduciary duties and/or violation of specific provisions of the Advisers Act and other federal laws.[233] Part 2 of Form ADV specifies the types of disclosures the SEC expects advisers to make regarding soft dollar arrangements.[234]

5. *Proxy Voting*. The SEC has stated that an adviser delegated authority to vote client proxies has a fiduciary duty to clients to vote the proxies in the best interest of its clients and cannot subrogate the client's interests to its own.[235]

B. Substantive Requirements (Advisers Act)

The Act contains other, more specific prohibitions designed to prevent fraud. In addition, the SEC has adopted several anti-fraud rules. Some of these provisions apply to all investment advisers (e.g., principal trade restrictions), while many apply only to registered advisers. *See* Appendix A.

1. *Client Transactions*

a. *Principal Transactions.* Section 206(3) of the Act prohibits an adviser (regardless of whether registered under the Act), acting as principal for its own account, from knowingly selling any security to or purchasing any security from a client for its own account, without disclosing to the client in writing the capacity in which it (or an affiliate) is acting and obtaining the client's consent before the "completion of the transaction."[236] The SEC staff has stated that notification and consent must

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[232] Form ADV, the registration form for advisers, requires that advisers disclose soft dollar arrangements. *See* Form ADV, Part 1A, Item 8; Part 2A, Item 12A.1. *See also* *SEC Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds* (Sept. 22, 1998).

[233] *See, e.g.*, *S Squared Technology Corporation*, Advisers Act Rel. No. 1575 (Aug. 7, 1996) (adviser's failure to disclose its receipt of benefits in exchange for direction of client brokerage violated section 206 of the Act); *Schultze Asset Mgmt.*, Advisers Act Rel. No. 2633 (Aug. 15, 2007) (adviser misrepresented to clients that it would restrict its use of soft dollars to cover only those expenses covered by section 28(e) when it used them to pay for operating expenses).

[234] Item 12 (Brokerage Practices).

[235] *Proxy Voting by Investment Advisers*, Advisers Act Rel. No. 2106 (Jan. 31, 2003). In this release, the SEC adopted rule 206(4)-6, which requires, among other things, each registered investment adviser that has voting authority over client securities to adopt and implement policies and procedures reasonably designed to ensure that client securities are voted in the best interest of clients. The SEC has instituted enforcement action against an adviser that failed to disclose to clients its conflicts before voting their shares in a hotly contested proxy fight. *Deutsche Asset Mgmt., Inc*., Advisers Act Rel. No. 2160 (Aug. 19, 2003). *See also* Section VI.B.6 of this outline.

[236] Section 206(3). The SEC interprets "completion of the transaction" to mean by settlement of the transaction. *See* *Interpretation of Section 206(3) of the Advisers Act of 1940*, Advisers Act Rel. No. 1732 (July 17, 1998) ("Release 1732"), at n.3. But the SEC believes that, in order for post-execution, pre-settlement consent to comply with section 206(3), the adviser must provide both sufficient disclosure for a client to make an informed decision, and the opportunity for the client to withhold consent. *Id*. While the notice must be in writing, the SEC staff has stated that oral consent is sufficient under the Act, but that written consent should be retained for evidentiary purposes. *Dillon, Read & Co.*, SEC Staff No-Action Letter (Aug. 6, 1975).

be obtained separately for each transaction, *i.e.*, a blanket consent for transactions is not sufficient.[237]

Fiduciary Obligations. Compliance with the disclosure and consent provisions of section 206(3) or rule 206(3)-3T alone does not satisfy an adviser's fiduciary obligations with respect to a principal trade. The SEC has expressed the view that section 206(3) must be read together with sections 206(1) and (2) of the Act to require that the adviser disclose additional facts necessary to alert the client to the adviser's potential conflict of interest in the principal trade.[238]

Affiliated Broker-Dealer. The SEC applies section 206(3) not only to principal transactions engaged in or effected by any adviser, but also when an adviser causes a client to enter into a principal transaction that is effected by a broker-dealer that controls, is controlled by, or is under common control with, the adviser.[239]

Pooled Investment Vehicles. The SEC staff has stated that section 206(3) may apply to client transactions with a pooled investment vehicle in which the adviser or its personnel may have interests depending on the facts and circumstances, including the extent of the interests held by the adviser and its affiliates.[240] The SEC staff, however, believes that section 206(3) does not apply to a transaction between a client account and a pooled investment vehicle of which the investment adviser and/or its controlling persons, in the aggregate, own 25% or less.[241]

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[237] *Opinion of Director of Trading and Exchange Division*, Advisers Act Rel. No. 40 (Jan. 5, 1945). The SEC has instituted enforcement actions against investment advisers for violating section 206(3) when they entered into principal transactions with their clients using only prior blanket disclosures and consents. *See Stephens, Inc.*, Advisers Act Rel. No. 1666 (Sept. 16, 1997); *Clariden Asset Mgmt. (New York) Inc.*, Advisers Act Rel. No. 1504 (July 10, 1995).

[238] Release 1732, *supra* note 236. *See also Rocky Mountain Financial Planning, Inc.*, SEC Staff No-Action Letter (Feb. 24, 1983) ("While section 206(3) of the Advisers Act of 1940 requires disclosure of such interest and the client's consent to enter into the transaction with knowledge of such interest, the adviser's fiduciary duties are not discharged merely by such disclosure and consent. The adviser must have a reasonable belief that the entry of the client into the transaction is in the client's interest."). *See also* Advisers Act Rel. No. 40, *supra*, *note* 237 ("disclosure of the capacity in which he is acting" requires investment adviser to disclose any adverse interests it has in the transaction any other material information that the client needs to make an investment decision).

[239] Release 1732, *supra* note 236. The SEC has instituted enforcement actions when advisers have effected principal transactions through affiliates without complying with section 206(3). S*ee, e.g.*, *Calamos Asset Mgmt.*, Advisers Act Rel. No. 1594 (Oct. 16, 1996). Principal transactions include "riskless principal" transactions. *Rothschild Investment Corporation*, Advisers Act Rel. No. 1714 (Apr. 13, 1998); *Concord Investment Co.*, Advisers Act Rel. No. 1585 (Sept. 27, 1996).

[240] *American Bar Association Subcommittee on Private* Entities, SEC Staff Letter (Dec. 8, 2005). The SEC has instituted enforcement actions based on claims of violations of section 206(3) against advisers and their principals when the advisers effected transactions between their advisory clients and accounts in which the principals of the advisers held significant ownership interests. *See SEC v. Beacon Hill Asset Mgmt., LLC, et al.*, Lit. Rel. No. 18950 (Oct. 28, 2004); *Gintel Asset Mgmt., et al.*, Advisers Act Rel. No. 2079 (Nov. 8, 2002).

[241] *Gardner Russo & Gardner*, SEC Staff No-Action Letter (June 7, 2006). *See* discussion regarding consents to assignments of advisory contract, *infra at* Section VI.D.2 of this outline.

Under the *Goldstein* decision,[242] the private fund (rather than the fund investors) may be deemed to be the client for purposes of section 206(3), in which case the fund's general partner (rather than fund investors) would have authority to consent to any principal transaction. However, a general partner that is a related person of the adviser may not be viewed as capable of consenting to the adviser's conflict.[243] In such circumstances, some advisers seek the consent of fund investors or a committee of independent investors established for such purposes.[244]

Exemptions:

Directed Trades. The restrictions on principal transactions do not apply to transactions by a client where the adviser (or an affiliate) is also a broker-dealer, but "is not acting as an investment adviser with respect to the trade," *i.e.*, it has not given the advice to buy or sell the security.[245]

A broker-dealer providing advisory services to a client may thus accept a directed trade from the client and execute the trade as principal without compliance with section 206(3) but would remain subject to general fiduciary obligations of the Act with respect to that trade.

Impersonal Advice. Advisers that are registered broker-dealers (or are affiliated with registered broker-dealers) are exempt from the principal trading restrictions of section 203 with respect to trades in which the investment adviser has provided only "impersonal advice."[246] These types of transaction would include, for example, those placed by a client in response to recommendations made by the adviser in a newsletter.

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[242] *Goldstein v. SEC*, *supra* note 144.

[243] The SEC suggested that it would regard such consents as ineffective in a 2014 enforcement actions against an adviser involving loans the adviser made to a private fund it advised. *Clean Energy Capital, LLC*, Advisers Act Rel. No. 3785 (Feb. 25, 2014) (the adviser "as an adverse party with a conflict of interest, could not consent to the loans on behalf of the [private] funds."). *See also* *Blackstone Management Partners*, Advisers Act Rel. No. 4219 (Oct. 7, 2015) (because of conflict of interest as a recipient of fees paid by private equity funds, the adviser "could not effectively consent to either of these practices on behalf of the fund it advised.").

[244] The SEC has, at least implicitly, approved of such an approach. *Paradigm Capital Mgmt. Inc.*, Advisers Act Rel. No. 3857 (June 16, 2014) (review committee established to approve principal trades was ineffective because membership was conflicted). This method, subject to similar constraints, should be available for advisers to obtain the consent of private funds to other conflicts of interest, including those specifically requiring client consent by the Act. *See e.g.*, section 205(a)(2) (assignments—discussed *infra*, section VI.D.2 of this outline).

[245] Section 206(3) provides that the section's "prohibitions…shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction."

[246] Rule 206(3)-1. Impersonal investment advice is described by the rule as advice, whether written or oral, that does not purport to meet the objectives or needs of specific individuals. The advice must include the statement that if a purchaser uses the services of the adviser, the adviser may act as principal for its own account or as agent for another person. The rule contains a note indicating that the rule does not relieve the adviser from its obligations to make further disclosures that may be imposed by other provisions of the Act.

Exemptive Orders. The SEC adopted Rule 206(3)-3(T) as a temporary rule in 2007 to permit advisers that are also registered with the SEC as broker-dealers to comply with section 206(3) by providing oral (instead of written) notice of principal transactions so long as certain conditions are met.[247] The rule was adopted subsequent to the *FPA* decision, which overturned an SEC rule (discussed above) that provided an exemption from the Act (including Section 206(3)) for broker-dealers offering fee-based brokerage.[248] The rule is limited to certain transactions with non-discretionary clients. The rule was used by few advisers and the SEC permitted it to expire by its own terms on December 16, 2016. The SEC has issued several exemptive orders in late 2016 that provide similar relief.[249]

b. *Agency Cross Transactions*. Section 206(3) also prohibits an adviser from knowingly acting as broker for both its advisory client and the party on the other side of the transaction without obtaining its client's consent before each transaction.[250]

Impersonal Trades. Advisers that are registered broker-dealers (or are affiliated with registered broker-dealers) are exempt from the restrictions on agency cross transactions with respect to trades in which the investment adviser has provided only "impersonal advice."[251]

Safe Harbor. The notice and consent requirements of section 206(3) made it impractical for advisers managing client assets to effect these transactions. The principal concern risk is that the adviser will use client assets to generate trades for itself or its broker-dealer affiliate. Thus, the SEC has adopted a rule permitting these "agency cross-transactions" without transaction-by-transaction disclosure if, among other things:

(1) the client has executed a written blanket consent after receiving full disclosure of the conflicts involved, which must be renewed each year;

(2) the adviser provides a written confirmation to the client before the completion of each transaction providing, among other things, the source and amount of any remuneration it received; and

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[247] *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Advisers Act Rel. No. 2653 (Sep. 24, 2007) (adopting rule 206(3)-3T); Advisers Act Rel. No. 3984 (Dec. 17, 2014) (extending expiration date to Dec. 31, 2016).

[248] *See supra, note 44.*

[249] *See, e.g., Merrill Lynch, Pierce, Fenner & Smith Incorporated*, Advisers Act Rel. No. 4578 (notice); Advisers Act Rel. No. 4595 (order) (Dec 28, 2016).

[250] Section 206(3). The SEC staff has expressed the view that the provisions of section 206(3) regarding cross-trading do not apply when the adviser/broker effects the trade without charging a commission or other fee. Advisers Act Rel. No. 1732 *supra* note 236.

[251] Rule 206(3)-1, *supra*, note 246.

(3) the disclosure document and each confirmation conspicuously disclose that consent may be revoked at any time.[252]

c. *Cross-Trades.* Effecting cross-trades between clients (with a third-party broker-dealer) is not specifically addressed by the Act or SEC rules, but implicates the anti-fraud provisions of the Act.[253] All cross-trades involve potential conflicts of interest because the adviser could favor one client over another.[254]

The SEC staff has observed that "[a]n adviser's trading of securities among client accounts can create risks that securities will be 'dumped' from one client account to another, that the securities may be mispriced because they are not traded in the open market, or that one client may otherwise be disadvantaged."[255] The risks are particularly great when the trade involves less liquid assets "because limited markets for such assets indicates that there are fewer alternative options for disposing of the assets."[256]

d. *Aggregation of Client Orders*. In directing orders for the purchase or sale of securities, an adviser may aggregate those orders on behalf of two or more of its accounts, so long as the aggregation is done for the purpose of achieving best execution, and no client is systematically advantaged or disadvantaged by the aggregation.[257]

Advisers that aggregate orders of securities face conflicts when they allocate the orders to client accounts since, for example, not all securities may have been acquired at the same price. Advisers should have procedures in place that are designed to ensure that the trades are allocated in such a manner that all clients

[252] Rule 206(3)-2. The rule does not apply to a transaction when the adviser has discretionary authority to act for the purchaser and seller. Paragraph (c) of the rule admonishes advisers that the rule does not relieve them of the duty to act in the best interests of their clients, including the duty to obtain best price and execution for any transaction. *See* *Agency Cross Transactions for Advisory Clients*, Advisers Act Rel. No. 589 (May 31, 1977) (adopting rule 206(3)-2).

[253] *See* *Renberg Capital Mgmt., Inc., supra* note 211. If one client is a registered investment company, the cross-trade must meet the requirements of rule 17a-7 under the Investment Company Act. *See* *Western Asset Management Co.* Advisers Act Rel. No. 3762 (Jan. 27, 2014). Merely following the procedures set forth in rule 17a-7 may not satisfy an adviser's fiduciary obligations to clients. The staff has explained that it must be in the interest of both clients to enter into a cross-trade and thus, for example, an adviser should not cause a client to enter into a cross-trade if it could obtain a better price in the markets. *Federated Municipal Funds*, SEC No-Action Letter (Nov. 20, 2006).

[254] "Although cross trades can be appropriate in many circumstances, they also can create the possibility of a conflict of interest for an adviser: the better the price the adviser obtains for the selling client, the worse it is for the buying client, and vice versa." *Highland Capital Mgmt., L.P.*, Advisers Act Rel. No. 3939 (Sept. 15, 2014). *See also* *Agamas Capital Mgmt., LLP*, Advisers Act Rel. No. 3719 (Nov. 19, 2013).

[255] SEC Staff Compliance Alert (July 2008). *See also*, *Morgan Stanley Investment Mgmt. Inc.* Advisers Act Rel. No. 4299 (Dec. 22, 2015).

[256] *Investment Company Liquidity Risk Management Programs*, Investment Company Act Rel. No. 32315 (Oct. 13, 2016) at Section III.F.

[257] *Pretzel & Stouffer*, SEC Staff No-Action Letter (Dec. 1, 1995).

are treated fairly and equitably, or at least fully disclosed.[258] For example, advisers can allocate orders based on a *pro rata*, rotational, or random basis.

Failure to Aggregate. Advisers are not *required* to aggregate trades. But if failure to aggregate would disadvantage clients, the adviser may be required to explain the consequences of not aggregating.[259]

e. *Allocation of Client Trades.* Allocation of trades for the benefit of favored clients, including proprietary accounts, is a breach of the Adviser's fiduciary obligations to its client.[260] Advisers must have procedures in place to assure that securities are being allocated in accordance with method the adviser has disclosed to clients. Absent specific disclosure to the contrary, advisers must treat clients fairly and equitably.[261]

(1) *Cherry Picking.* This practice occurs most often when an adviser trades through an omnibus brokerage account and delays allocation of the trades until it can determine the "winners" and "losers" and then allocates the winners to favored accounts or proprietary (house) accounts.[262]

(2) *Favorable Investment Opportunities.* Where the adviser can only obtain a limited supply of a desirable security, and unless it has disclosed to clients otherwise, it must allocate them fairly among clients that are legally and

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[258] *See, e.g.*, *John McStay Investment Counsel, L.P.*, Advisers Act Rel. No. 2153 (July 31, 2003) (adviser failed to disclose change in its method of allocating initial public offerings among accounts to a method that favored mutual fund account); *McKenzie Walker Investment Mgmt., Inc, et al.*, Advisers Act Rel. No. 1571 (1996) (adviser allocated profitable trades to accounts charged a performance-based fee); *Nicholas-Applegate Capital Mgmt.*, Advisers Act Rel. No. 1741 (Aug. 12, 1998) (adviser failed to supervise trader who allocated profitable trades to own personal account); *Ark Asset Mgmt. Co., Inc.*, Advisers Act Rel. No. 2962 (Dec. 14, 2009) (adviser allocated profitable trades to the proprietary hedge fund accounts at the expense of the client accounts without disclosing this practice).

[259] *Pretzel & Stouffer*, *supra* note 257.

[260] *Welhouse & Associates*, Advisers Act Rel. No. 4132 (June 29, 2015) (profitable options trades allocated to principal's personal account); *Nicholas-Applegate Capital Mgmt.*, Advisers Act Rel. No. 1741 (Aug. 12, 1998) (profitable trades allocated to personal account of head trader); *McKenzie Walker Investment Mgmt., Inc.*, Advisers Act Rel. No. 1571 (July 16, 1996) (profitable trades allocated to accounts paying a performance fee). The SEC is employing its economists to analyze and uncover trading patterns that favor some clients. *See* Complaint in *SEC v. Strategic Capital Mgmt., LLC.*

[261] Release 2204, *infra* note 379 at Section II.A.1. ("We expect that at an adviser's policies and procedures, at a minimum, should address the following issues to the extent that they are relevant to the adviser…allocation of investment opportunities among clients…"). The SEC has used expert witnesses to demonstrated misallocation of profitable trades by statistical analysis of allocations. *See* *J.S. Oliver Capital Mgmt., L.P*, Initial Dec. Rel. No. 649 (Aug. 5, 2014) (expert found favored accounts had a 90.4% share of favorable transactions).

[262] *See* *SEC v. Slocum, Gordon & Co.*, 334 F. Supp2d 144, (D. R.I. 2004) ("Cherry picking . . . is a practice by which an investment adviser purchases a security, waits to evaluate its performance, and then allocates it to himself or his firm rather than clients if it "pops," or goes up quickly within a short period of time."). The SEC enforcement actions involving cherry picking often also allege that the adviser made false and misleading statements to clients regarding it allocation practices. *See* *TPG Advisors*, Advisers Act Rel. No. 4588 (Dec. 15, 2016).

financially in a position to buy them or in accordance with disclosure made to clients.[263]

Method of Allocation. The most common method is allocating trades pro rata among clients. The SEC staff has, however, observed that there are other allocation methods that advisers can use without violating their fiduciary obligations.[264]

When Must a Trade be Allocated? The Advisers Act does not specify precisely when a trade must be allocated among clients. Where an adviser allocates the trade before the transaction there is, of course, no chance of abuse. Advisers may not, however, always be in a position to allocate before a trade is affected. The more time that passes before a trade is allocated, the greater the compliance risk that the trade will be misallocated. Moreover, the recordkeeping rules require that adviser's records be kept on a current basis. The failure to allocate transactions in a timely manner could cause the adviser's records to be inaccurate and not current.[265] An SEC complaint in federal court in 2013 described industry "best practice" as allocating trades immediately after the trade (before winners and losers can be ascertained) and the "industry standard" as allocating trades by the end of the trade day.[266]

f. *Trade Errors*. The SEC staff has interpreted an adviser's fiduciary duties to require it to bear losses that are incurred when the adviser makes an error while placing a trade for a client.[267] Similarly, an adviser will not be entitled to keep any gains arising from errors or use the gains to offset losses the adviser caused.

Advisers are not liable for every error in judgment they make when advising clients, but rather for client losses that result from a negligent breach of their fiduciary duties, here the duty of care. Misreading of trade directions by a trading desk will typically be viewed by the SEC as involving negligence, but the issues become murkier when the error involves misjudgments or simply poor advice.[268] Many advisers establish trade error policies that define a trade error and establish

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[263] *Monetta Financial Services, Inc.*, Advisers Act Rel. No. 2438 (Oct. 4, 2005), *vacated on other grounds, in Monetta and Robert S. Bacarella, Petitioners, v. SEC*, 390 F.3d 952 (7th Cir. 2004) (adviser that failed to disclose to clients that it would allocate "rare and valuable" shares in IPOs to certain clients and not others violated anti-fraud provisions of the Advisers Act); *Account Mgmt. Corp.*, Advisers Act Rel. No. 1529 (Sept. 29, 1995) (hot IPOs allocated predominantly to certain "gratis" clients).

[264] *SMC Capital, Inc.*, SEC Staff No-Action Letter (Sept. 5, 1995).

[265] *Michael L. Smirlock*, Advisers Act Release No. 1393 (Nov. 29, 1993) (adviser failed to write trade tickets and allocate transactions until two to nine business days after the trades were executed).

[266] *See* complaint in *SEC v. Charles J. Dushek, Case No. 13-cv-3669*.

[267] *Charles Lerner*, SEC Staff Letter (Oct. 25, 1988) (an investment adviser "is responsible for losses from an inaccurate or erroneous order place for an advised account").

[268] *See, e.g.*, *AXA Rosenberg Group LLC*, Advisers Act Rel. No. 3149 (Feb. 3, 2011) (settled enforcement action involving programming errors in model).

protocols for determining their appropriate resolution.[269] While there is a debate among lawyers about whether client disclosure of the adviser's policy of not reimbursing clients for their errors will satisfy an adviser's fiduciary duties, the industry "best practice" is for the adviser to bear those losses.

2. *Advertising*

The anti-fraud provisions of the Act apply with respect to both clients and *prospective* clients.[270] Rule 206(4)-1, the "advertising rule," prohibits any adviser registered with the SEC from using any advertisement that "contains any untrue statement of material fact or is otherwise misleading."[271] In addition, the rule contains several specific restrictions.

a. *Specific Restrictions*

(1) *Testimonials.* An advertisement may not use or refer to testimonials,[272] which the SEC staff views as including any "statement of a client's experience with, or endorsement of, an adviser."[273] When the SEC adopted the rule, it concluded that testimonials are misleading because "by their very nature they emphasize the comments and activities favorable to the investment adviser and ignore those which are unfavorable."[274] Over the years, the SEC staff has carved out some exceptions:

Reprints of Articles. Reprints are not covered by the prohibition if they are published by "unbiased third parties" and do not include a statement of a client's experience or endorsement.[275]

Rankings and Ratings. Third party ratings and rankings may be testimonials when they reflect an implicit statement of client experience with the

[269] *See Foxhall Capital Mgmt., Inc.*, Advisers Act Rel. No 3590 (Apr. 19, 2013) (settled enforcement action alleging failure of an adviser to follow its own error correction policy). Failure to follow those policy will be viewed by the SEC as a failure to implement compliance policies and procedures. *See Guggenheim Partners Inv. Mgmt., LLC*, Advisers Act Rel. No. 4163 (Aug. 10, 2015). The failure to have trade error policies and procedures may be viewed by the SEC as a failure to have adequate compliance policies and procedures and/or a failure to supervise employees who made the error. *See M&I Investment Mgmt. Corp.*, Advisers Act Rel. No. 1318 (June 30, 1992).

[270] *See*, e.g., *Ralph Harold Seipel*, 38 S.E.C. 256, 257-58 (1958) ("[T]he solicitation of clients is part of the activity of an investment adviser, and it is immaterial for purposes of an enforcement action under sections 206(1) and (2) that an adviser engaging in fraudulent solicitations was not successful in his efforts to obtain clients.").

[271] Rule 206(4)-1(a)(5), discussed below in section VI.B.2.c.

[272] Rule 206(4)-1(a)(1).

[273] *Cambiar Investors, Inc.*, SEC Staff No-Action Letter (Aug. 28, 1997).

[274] Advisers Act Rel. No. 121 (Nov. 2, 1961).

[275] *Stalker Advisory Services*, SEC Staff No-Action Letter (Jan. 18, 1994). *See also Patricia Owen-Michel*, Advisers Act Rel.. No. 1584 (Sept. 27, 1996) (settled administrative proceeding alleging that adviser distributed reprint of newspaper article quoting a client's testimonial). If the reprint contains false or misleading information, its distribution by the adviser would be prohibited by the general anti-fraud provision of the rule.

investment adviser, but the SEC staff has permitted their use if certain conditions are met that suggest their compilation and presentation are unbiased.[276]

Client Lists. The SEC staff does not view either a complete or partial list of clients as being a testimonial, as long as there is no accompanying client commentary.[277]

Social Media. The SEC staff has generally stated that public commentary (include those of clients) on an independent web site (*e.g.,* the adviser's Facebook page) would not raise issues when that adviser has no ability to affect the commentary and the web site publishes all comments unedited.[278]

(2) *Past Specific Recommendations.* An advertisement may not refer to past specific recommendations made by the adviser, unless the advertisement sets out a list of *all* recommendations made by the adviser during the preceding year.[279] The primary concern underlying the prohibition is that an adviser could "cherry pick" its profitable recommendations and omit the unprofitable ones.[280]

The SEC staff has permitted some exceptions:

Reports to Clients. The SEC staff does not view a report to existing clients as an "advertisement" merely because it refers to past specific recommendations, unless the context in which the past specific recommendations are presented suggests otherwise.[281]

Responses to Unsolicited Requests. A communication responding to an unsolicited request for information from a client, prospective client or

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[276] *DALBAR, Inc.*, SEC Staff No-Action Letter (Mar. 24, 1998) and *Investment Adviser Ass'n.*, SEC Staff No-Action Letter (Dec. 2, 2005).

[277] *Denver Investment Advisors, Inc.*, SEC Staff No-Action Letter (July 30, 1993) (full list); *Cambiar Investors, Inc.*, *supra* note 273 (partial list). A client list may, of course, not be presented in a way that is misleading. S*ee Reservoir Capital Mgmt. Inc.*, Advisers Act Rel. No. 1717 (Apr. 24, 1998)("representative list" of clients was not representative).

[278] IM Guidance Update No. 2014-4 (Mar. 2014). This guide addresses a number of other issues that may arise under the testimonial rule when the adviser uses social media.

[279] Rule 206(4)-1(a)(2). In addition, the rule requires the advertisement to include (i) the name of each recommendation, (ii) the date and nature of each recommendation, (iii) the market price at the time of the recommendation, (iv) the price of the security when the recommendation was acted upon, (v) the market price at the most recent practicable date, and (vi) a disclaimer regarding the profitability of recommendations in the future. For a recent SEC enforcement action alleging a violation of this provision, *see Navigator Money Mgmt., Inc.*, Advisers Act Rel. No. 3767 (Jan. 30, 2014).

[280] *Dow Theory Forecasts, Inc.*, SEC Staff No-Action Letter (Aug. 26, 1983). Merely offering to provide a list of securities does not satisfy the rule. *Starr and Kuehl, Inc.*, SEC Staff No-Action Letter (Apr. 17, 1976). The SEC staff does not apply the prohibition to statements about the composite performance of client accounts.

[281] *Investment Counsel Ass'n. of America*, SEC Staff No-Action Letter (Mar. 1, 2004).

consultant for specific information about the adviser's past specific recommendations would not be an advertisement, and thus not subject to the prohibition.[282]

Objective Non-Performance-Based Criteria. An adviser may, for example, use criteria, such as largest positions held, largest positions sold during the period without disclosing all of the securities recommended during the period.[283]

Unbiased Performance-Based Criteria. Subject to limitations set forth in a no-action letter, an adviser may be able to include in an advertisement a list showing the relative contribution to performance of certain securities, *e.g.*, "best and worst performers," where the methodology of selecting the securities is mechanical and presents, with equal weight, profitable and unprofitable recommendations."[284]

(3) *Graphs and Charts.* An advertisement cannot represent that any graph, chart, or formula can, in and of itself, be used to determine which securities to buy or sell;[285] and

(4) *Free Stuff.* An advertisement cannot refer to any report, analysis, or service as free, unless it really is.[286]

b. *False and Misleading Statements*

An advertisement may be considered false or misleading if it implies, or would lead a prospective client to infer, something about the investment adviser or its clients' experiences that is not true, and that the prospective client would not have inferred had all material facts been disclosed.[287] Common SEC enforcement actions against advisers for false and misleading advertisements include overstating performance of client accounts (discussed below), inflating the

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[282] *Id.*

[283] *Franklin Mgmt., Inc.*, SEC Staff No-Action Letter (Dec. 10, 1998).

[284] *The TCW Group, Inc.* SEC Staff No-Action Letter (Nov. 7, 2008).

[285] Rule 206(4)-1(a)(3). Advertisements involving such claims used to be more common, but the SEC continues to bring the occasional enforcement case. *See Hanes Morgan & Co., Inc. et al.*, Advisers Act Rel. No. 3326 (Nov. 29, 2011).

[286] Rule 206(4)-1(a)(4). *See Marketlines, Inc.*, Advisers Act Rel. No. 206 (Jan. 20, 1967) (SEC Opinion).

[287] *New York Investors Group, Inc.*, SEC Staff No-Action Letter (Sept. 7, 1982). In evaluating an advertisement under rule 206(4)-1, the SEC has stated that "we do not look only to the effect that they might have had on careful analytical persons. We look also to their possible impact on those unskilled and unsophisticated in investment matters." *Spear & Staff, Inc.*, Advisers Act Rel. No. 188 (Mar. 25, 1965).

number of clients or amount of assets under management,[288] and exaggerating the qualifications or achievements of principals.[289]

c. *Performance Advertising*

The SEC staff considers an advertisement containing performance information misleading if it implies, or if a reader would infer from it, something about an adviser's competence or possible future investment results that would be unwarranted if the reader knew all of the facts.[290] SEC rules do not require advisers to calculate or present the performance of client accounts in any particular way.[291] Performance data in advertisements is evaluated based on whether it is false or misleading. The adequacy of disclosure accompanying performance data thus, is critical. Some basic rules have been established:

Actual Performance of Accounts

(1) *Net of Expenses*. Performance must be net of expenses, including advisory fees, brokerage and any other fee the client would have paid or actually paid.[292] However, advisers may present performance results reflecting both gross and net of fees, if presented with equal prominence.[293]

(2) *Index Comparisons.* When account performance is compared to an index of securities, the index should reflect the reinvestment of dividends or

[288] *See*, SEC v. Locke Capital Mgmt., 794 F. Supp. 2d 355, 367 ("[I]t is undisputed that investors rely on assets under management in deciding which investment advisor to entrust their funds."); *Warwick Capital Mgmt., Inc.* Advisers Act Rel. No. 2694 (Jan. 16, 2008) (SEC Opinion that false statements regarding AUM are material because they give "an erroneous impression of [an adviser's] size and asset base, qualities that would be important to clients and prospective clients in selecting an investment adviser").

[289] *See, e.g.*, *FreedomTree Mutual Funds et al.*, Advisers Act Rel. No. 3095 (Sept. 30, 2010).

[290] *Edward F. O'Keefe*, SEC Staff No-Action Letter (Apr. 13, 1978); *Anametrics Investment Mgmt.*, SEC Staff No-Action Letter (May 5, 1977).

[291] If the adviser's performance claims relies on data or information provided by third parties, the SEC has asserted that the adviser must have a reasonable basis for knowing that such information is accurate. *See* *Cantella & Co.*, Advisers Act Rel. No. 4338 (Feb. 23, 2016) (adviser advertised performance of investment strategy relying on inflated performance of other adviser's investment signals).

[292] *Clover Capital Mgmt., Inc.*, SEC Staff No-Action Letter (Oct. 28, 1986). Disclosure of the failure of the performance to reflect expenses "would not be an adequate substitute for deducting advisory fees because of the compounding effect on performance figures that occurs if advisory fees are not deducted. . . .[I]t is inappropriate to require a reader to calculate the compounding effect of the undeducted expenses on the advertised performance figures." *Investment Company Institute*, SEC Staff No-Action Letter (July 24, 1987). The SEC has instituted enforcement actions asserting that an adviser failing to deduct expenses materially overstated its performance. See, *e.g.*, *Schield Mgmt. Co.*, Advisers Act Rel. No. 1872 (May 31, 2000).

[293] *Ass'n. for Investment Mgmt. Research*, SEC Staff No-Action Letter (Dec. 18, 1996). In addition, the SEC staff has accepted use of a "model fee" deduction equal to the highest fee charged to any account during the performance period. *J.P. Morgan Investment Mgmt., Inc.*, SEC Staff No-Action Letter (May 7, 1996). The basis for the letter is that advertisement of lower performance than actually attained is not misleading.

accompanying disclosure should explain the effect on the results of the failure to do.[294]

(3) *Market Conditions.* Advertisements should disclose the effect of any material market conditions on a prospective client's understanding of the performance portrayed, *e.g.*, an advertisement stating the client accounts appreciated by 25% during the time period would be misleading if it did not also disclose that markets generally appreciated by 40% during the same period.[295]

(4) *Material Strategies.* In some cases the strategies the adviser pursued that produced the performance are unlikely to be replicated in the future, in which case such facts must be disclosed (*e.g.*, the performance was attributable to "hot" IPOs acquired to boost performance).[296]

(5) *GIPS Standards*. The Global Investment Performance Standards are voluntary standards and principals published by the CFA Institute.[297] False claims of compliance with GIPs standards violate the advertising rule regardless of whether the performance data is otherwise accurate.[298]

Model Performance

Advisers may advertise performance results of a model portfolio, where advice was historically given but actual trading never occurred, subject to the requirement that fees and expenses are reflected, and that appropriate disclosure of all assumptions is made.[299]

Back-Tested Performance

There is no definition of back-testing, but it generally refers to the practice of applying an investment strategy retroactively to historical market data. Back-testing thus attempts to show the outcome of investment decisions that would have occurred had a later-developed strategy been followed.

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294 *See Trust & Investment Advisors, Inc., et al*, Advisers Act Rel. No. 4087 (May 18, 2015); *Seaboard Investment Advisers, Inc.*, Adv. Act Rel. No. 1918 (Jan. 10, 2001) (SEC Opinion) at n.9.

295 *Clover Capital Mgmt.*, *supra* note 292.

296 *Nevis Capital Mgmt., LLC*, Advisers Act Rel. No. 2214 (Feb. 9, 2004); *Van Kampen Investment Advisory Corp.* Advisers Act Rel. No. 1819 (Sept. 8, 1999); *The Dreyfus Corp.*, Advisers Act Rel. No. 1870 (May 10, 2000).

297 *See* Global Investment Performance Standards Handbook (3rd Ed. 2012).

298 *ZPR Investment Mgmt., Inc.*, Advisers Act Rel. No. 4249 (Oct. 30, 2015) (SEC Opinion); *Locke Capital Mgmt., Inc.*, Initial Decision Rel. No. 450 (Feb. 6, 2012); *Stan D. Kiefer & Associates*, Advisers Act Rel. No. 2023 (Mar. 22, 2002). *See also Riggs Investment Mgmt. Corp. v. Columbia Partners, LLC*, 966 F. Supp. 1250, 1268 (D.D.C 1997) ("Violation of [GIPS] does not, in and of itself, mean that the [law] is violated. But to advertise oneself as meeting such an important industry standard while knowingly being out of compliance is false advertising.").

299 *Clover Capital Mgmt., Inc.*, *supra* note 31. *See Modern Portfolio Mgmt., Inc.*, Advisers Act Rel. No. 3702 (Oct. 23, 2013) (adviser failed to reflect it advisory fee in model performance).

The use of back-testing in advertisements is viewed highly skeptically by the SEC staff because the investment strategy may be developed with the benefit of hindsight. The SEC staff has not expressed the view that back-tested performance is per-se misleading, but neither has it provided any guidance that could shape how advisers might develop and advertise back-tested performance. Instead, the SEC has brought a number of enforcement actions against advisers, ranging from failure to disclose performance was actually back-tested performance[300] to failure to disclose the limitations inherent in or aspects of back-tested performance.[301]

Raymond J. Lucia Company, Ltd. v. SEC. A recent federal appeals court upheld an SEC opinion that an adviser has violated Section 206 when, among other things, it failed to apply its own strategy and assumptions when back-testing performance, was unable to replicated the back-tested reports, and could not document support for its results.[302] The decision affirmed the SEC opinion that a generalized disclaimer that back-tested performance contained some hypothetical assumptions could not cure a misleading "overall impression" of an advertisement.

d. *Portability of Performance*

Advisers, often new advisers without a track record, sometimes wish to market as their own the performance of accounts managed by (i) a predecessor adviser, or (ii) individuals while employed by different firms. The SEC staff views the use of such predecessor performance as not, in and of itself, misleading provided that:

(1) The person or persons who manage accounts at the successor adviser were also those primarily responsible for the prior performance results;

(2) The accounts managed at the predecessor adviser are similar to the accounts currently under management;

(3) All accounts that were managed in a substantially similar manner are advertised unless the exclusion of such account would not result in a materially higher performance;

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300 *See, e.g.*, *F-Squared, Inc., et al.*, Advisers Act Rel. No. 3988 (Dec. 22, 2014); *Mackensen & Co., Inc. et al.*, Advisers Act Rel. No. 4188 (Sept. 3, 2015); *New England and Retirement Group, Inc.*, Advisers Act Rel. No. 3516 (Dec. 18, 2012); *F.X.C. Investors Corp.*, Initial Decision No. 218 (Dec. 9, 2002); *Meridian Inv. Mgmt. Corp.* Advisers Act Rel. No. 1779 (1998).

301 *William J. Ferry*, Advisers Act Rel. No 1747 (Aug. 19, 1998); *LBS Capital Mgmt., Inc.* Advisers Act Rel. No. 1644 (July 18, 1997); *Leeb Investment Advisers*, Advisers Act Rel. No. 1545 (Jan. 6, 1996).

302 *Raymond J. Lucia Companies, Ltd.*, No. 15-1345, slip op. (D.D.C. Aug. 9, 2016). The appellate court considered only whether oral statements made at a seminar were false and thus did not address whether the back-testing violated rule 206(4)-1. This was an issue, however, at the SEC whose the administrative law judge found that a live slideshow presentation was not an "advertisement," a conclusion with which the SEC disagreed. *Raymond J. Lucia Companies, Inc.*, Advisers Act Rel. No. 4190 (Sept. 3, 2015).

(4) The advertisement is consistent with staff interpretations with respect to the advertisement of performance results; and

(5) The advertisement includes all relevant disclosures, including that performance results were from accounts managed by another entity.[303]

An adviser that uses its predecessor's performance must have access to records substantiating the performance (discussed below).[304]

e. *Substantiation Rule*

Advisers registered with the SEC must maintain all working papers and other records "necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations."[305] The practical effect of the rule is to preclude an adviser from advertising performance data it cannot substantiate.[306]

(1) *Contemporaneous Records.* .The records must have been made contemporaneously with the recommendations made, although records published or generated subsequently may be used so long as they were accumulated contemporaneously.[307]

(2) *Safe Harbor*. The rule does not specify what records are required to be kept, but provides a safe harbor if the client maintains (i) client account statements, and (ii) worksheets showing how the individual account data was transformed into composite performance.

(3) *Third Party Records.* The rule anticipates that the adviser's own records would be used to substantiate performance, but the SEC has acknowledged that the retention of third party records could also satisfy the rule.[308]

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303 *Horizon Asset Mgmt. LLC*, SEC Staff No-Action Letter (Sept. 13, 1996).

304 *Great Lakes Advisors, Inc.*, SEC Staff No-Action Letter (Apr. 3, 1992) at n.3.

305 Rule 204-2(a)(16). The rule originally applied to communications distributed to 10 or more persons. The SEC amended the rule in 2016 to apply it to any "communication." Investment Advisers Act Rel. No. 4509, *supra* note 164. As a result, it arguably applies to communications that would not otherwise be advertisements under rule 206(4)-1, including a communication to a single client or prospective client.

306 *See* *Warwick Capital Mgmt., Inc.* Advisers Act Rel. No. 2694 (Jan. 16, 2008) (SEC Opinion). Rule 204-2(a)(16) operates to shift the burden of proof regarding a violation of the advertising rule, requiring an adviser that cannot produce records to refute SEC staff's (or its expert's) assertions of actual performance. *Id*. at n.22

307 Advisers Act Rel. No. 1135 (Aug. 17, 1988) (adopting paragraph (a)(16) of Rule 204-2).

308 *Jennison Associates LLC*, SEC Staff No-Action Letter (July 6, 2000) (contemporaneous auditor reports and accountant worksheets); *Salomon Brothers Asset Mgmt.*, SEC Staff No-Action Letter (July 23, 1999) (published records of net asset values of mutual funds managed and accountant worksheets).

f. *Definition of Advertisement*

While no communications to clients may be misleading, the specific restrictions discussed above apply only to "advertisements" by advisers. The SEC defines advertisements generally as communications (in writing or electronic form) to more than one person that offer advisory services.[309] It includes a communication made to prospective clients, or to existing clients, with the purpose to induce them to renew their advisory contracts or subscriptions.[310] Whether a communications constitutes an advertisement depends on all facts and circumstances,[311] and has been very broadly applied.

Responses to Unsolicited Requests. The SEC staff does not believe that a written communication by an adviser that does no more than respond to an unsolicited request by a client is an advertisement even if it received multiple requests for the same information, *e.g.*, in multiple RFPs.[312]

Reports to Clients. Generally, an advertisement includes both a communication offering advisory services to new clients and one designed to maintain existing clients.[313] However, the SEC staff does not view a client report that does no more than report on services provided to the client as an advertisement.[314]

Oral Communications. An oral communication (other than by radio or television) is specifically not covered by the rule.

Internet Postings. Use of internet postings, including communications through social media to communicate with clients and prospective clients implicates rule 206(4)-1.[315]

Pooled Investment Vehicles. The SEC staff has stated that it does not view prospectuses and sales material soliciting investors for a registered mutual fund to be advertisements for purposes of rule 206(4)-1 if the materials are designed to solicit new investors or maintain existing investors in the fund rather than new or

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309 Rule 206(4)-1(b) (defining "advertisement" to include "any notice, circular, letter or other written communication addressed to more than one person, or any notice or announcement in any publication or by radio or television. . . ."

310 *Spear & Staff*, 42 SEC. 549 (1965) (SEC Opinion).

311 *Investment Counsel Ass'n. of America*, SEC Staff Letter (Mar. 1, 2004).

312 *Investment Counsel Ass'n. of America*, SEC Staff Letter (Mar. 1, 2004).

313 *See* *SEC v. C.R. Richmond & Co.*, 565 F.2d 1101 (9th Cir. 1977); *Denver Investment Advisors, Inc.*, SEC Staff No-Action Letter (July 30, 1993).

314 *Munder Capital Mgmt.*, SEC Staff No-Action Letter (May 17, 1996).

315 The SEC staff has made observations regarding advisers' use of social media. *Investment Adviser Use of Social Media*, National Examination Risk Alert, Vol. II, Issue 1 (Jan. 4, 2012). The SEC has also instituted a settled enforcement action involving social media. *Navigator Money Mgmt., Inc.*, Advisers Act Rel. No. 3767 (Jan. 30, 2014) (investment adviser made false statements regarding performance of a model on Twitter account).

existing clients of the adviser.[316] The SEC staff has not yet addressed private funds, but it may be presumed that the Act's advertising rule applies to their solicitation material, an issue that has more significance with the SEC's implementation of the JOBS Act provisions permitting general solicitation.[317]

3. *Custody of Client Assets*

A registered adviser with custody of client funds or securities ("client assets") is required by rule 206(4)-2 to establish a set of controls to safeguard those client assets.[318] These requirements were most recently amended in December 2009.[319]

a. *Definition of Custody*. Custody means "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them." An adviser has custody if an affiliate has custody of its client funds or securities in connection with advisory services it provides to clients.

Custody includes:

(1) Physical possession of client funds or securities;

(2) Any arrangement under which an adviser is permitted or authorized to withdraw client funds or securities (such as check-writing authority or the ability to deduct fees from client assets); and

(3) Any capacity that gives an adviser or its supervised person legal ownership of or access to client funds or securities (such as acting as general partner or trustee of a pooled investment vehicle).[320]

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316 *Id.*

317 *See* Section III.B.6.a(2) of this outline. *See also*, Comment Letter of the Managed Funds Association (Mar. 22, 2013) ("[S]olicitation and advertising materials used by all private fund managers are subject to numerous anti-fraud provisions in the federal securities laws, including Section 206 of the Advisers Act, Rule 206(4)-1 and Rule 206(4)-8 under the Advisers Act. . .") (emphasis added). Private fund sales material is often used to solicit separate account clients of the sponsor of the private fund and thus in many cases the extension of the staff *Munder* letter to private funds may be of limited use.

318 Rule 206(4)-2. The SEC has instituted enforcement proceedings against advisers that have failed to comply with the custody rule. *See, e.g.*, *Comprehensive Capital Mgmt., Inc.*, Advisers Act Rel. No. 3636 (July 29, 2013) (adviser's failure to implement compliance policies related to protection of client assets, failure to supervise associated person, together with multiple violations of the rule 206(4)-2 led to theft of more than $16 million of client assets by associated person).

319 *See* *Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Rel. No. 2968 (Dec. 30, 2009) ("Release 2968"). The staff of the SEC's Division of Investment Management has published FAQs on the custody rule.

320 Rule 206(4)-2(d)(2). For a more detailed discussion of when an adviser may have custody of client assets, *see* Robert E. Plaze, *Understanding the Investment Adviser Custody Rule: Part I–Determining Custody*, 48 Rev. of Sec. & Com. Reg. 59 (Mar. 18, 2015). A second part of the article discusses the rule's safekeeping requirements. *See* *Understanding the Investment Adviser Custody Rule: Part II–Safekeeping Requirements*, 48 Rev. of Sec. & Com. Reg. 87 (Apr. 22, 2015).

Inadvertent Custody. An adviser may be granted authority by a custody agreement to which it is not a party and of which it is unaware (because it is simply authorized to withdraw funds or securities). The SEC staff has stated that an adviser can avoid having custody in such circumstances by entering into a writing to which both the client and custodian are parties limiting its authority.[321]

b. *Qualified Custodians.* An adviser with custody must maintain client funds and securities with "qualified custodians" either under the client's name or under the adviser's name as agent or trustee for its clients.[322] An adviser may not comingle its clients' funds or securities with its own.[323]

Qualified custodians are:

(1) Broker-dealers, banks, savings associations, futures commission merchants, and

(2) Non-U.S. financial institutions that customarily hold financial assets for their customers, if the institutions keep the advisory assets separate from their own.

Client assets that are not cash or securities need not be maintained with a qualified custodian.

Exceptions. Two types of securities are not required to be maintained with a qualified custodian:

(1) Shares of mutual funds held with the fund's transfer agent; and

(2) Privately offered securities, *i.e.*, un-certificated securities acquired in a private placement that are recorded in the name of the client only on the books of the issuer or its transfer agent and transferrable only with the consent of the issuer or holders of the securities.[324]

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[321] IM Guidance Update 2017-01 (Feb. 2017).

[322] Rule 206(4)-2(a)(1).

[323] *See* *SEC v. Sentinel Mgmt. Group, Inc., et al*, 2012 WL1079961, (N.D. Ill. 2012) (adviser comingled its clients' with proprietary assets held in a clearing account in violation of rule 206(4)-2, even though the client assets were held in the account for a short period of time).

[324] Rule 206(4)-2(b)(2). The staff has issued guidance indicating that it would not "object" if an adviser to a pooled investment vehicle that is subject to an audit in accordance with paragraph (b)(4) of the rule (discussed below) does not maintain private stock certificates with a qualified custodian under certain circumstances that suggest that loss of the certificate will not adversely affect the pooled investment vehicle. *See* IM Guidance Update 2013-04 (Aug. 2013).

c. *Quarterly Account Statements.* The adviser must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends quarterly account statements directly to the client.[325]

d. *Notification*. The adviser must notify the client as to where and how the funds or securities will be maintained, promptly after opening an account for the client and following any changes to this information.[326] If the adviser also sends its own account statements to clients, this notice and subsequent account statements from the adviser must contain a statement urging the client to compare account statements from the custodian with those from the adviser.[327]

e. *Surprise Examinations.* An adviser that has custody of client assets generally must undergo an annual surprise examination by an independent public accountant to verify the client's funds and securities.[328] If the accountant finds a "material discrepancy" during the examination, it must report the discrepancy to the SEC within one business day.[329]

Exception to Deduct Fees. An adviser that has custody *solely* because it has authority to deduct advisory fees directly from client accounts is not required to undergo a surprise examination.[330]

Report on Form ADV-E. The accountant conducting the examination must file a certificate on Form ADV-E within 120 days of the time chosen by the accountant for the examination.[331]

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325 A common method of forming a reasonable belief acceptable to the SEC is receipt of a copy of an account statement sent to the client. Release No. 2968, *supra* note 319.

326 Notice need not be given if the client opens the account himself.

327 Rule 206(4)-2(a)(2).

328 The timing of exams must be irregular from year to year. Rule 206(4)-2(a)(4). *See also* *Kaufman, Bernstein, et al.*, Advisers Act Rel. No. 2194 (Nov. 20, 2003) (independent auditor began examination the same date each year). The accountant conducting the examination must file a certificate on Form ADV-E within 120 days of the time chosen by the accountant for the examination. Rule 206(4)-2(a)(4)(i). The SEC has issued guidance for accountants performing an examination pursuant to this rule. *See* *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Advisers Act of 1940*, Advisers Act Rel. No. 2969 (Dec. 30, 2009).

329 Rule 206(4)-2(a)(4)(ii). Because the SEC does not have statutory authority over accountants under the Advisers Act, the obligations of an accountant under the rule are established pursuant to required contractual provisions. The SEC has instituted a settled an enforcement action under the Advisers Act against accountants who "caused" the adviser to violate the custody rule by failing to complete the surprise examination. *Rodney A. Smith, Michael Santicchia, CPA, and Stephen D. Cheaney, CPA*, Advisers Act Rel. No. 3738 (Dec. 12, 2013).

330 Rule 206(4)-2(b)(3). An adviser with custody solely because it deducts fees is also not required to report that it has custody of client assets on its Form ADV. *See* Instruction to Item 9.A. of Form ADV.

331 Rule 206(4)-2(a)(4)(i). Form ADV-E must be filed electronically by the accountant with the SEC through the IARD system. The following link explains how an accountant can upload its report to the IARD system http://www.iard.com/pdf/formADV-E.pdf.

f. *Pooled Investment Vehicles.* If the adviser is the general partner of a limited partnership (or holds a similar position with another form of pooled investment vehicle such as a hedge fund) the adviser has two alternatives to complying with the custody rule.

(1) *Audit Approach*. If the pool's financial statements are audited by an independent public accountant that is registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB"),[332] and the audited statements are distributed to the pool's investors:[333]

(A) The adviser is deemed to have complied with the annual surprise examination requirement;

(B) Custodial account statements need not be delivered to clients, and there is no obligation to send a notice when they make an investment; and

(C) The adviser may self-custody certain privately issued securities.[334]

(2) *Surprise Examination Approach.* If the investment adviser cannot comply with the audit approach, the adviser:

(A) Must obtain a surprise examination for the pooled investment vehicle; [335]

(B) Must provide notice to clients of custody, and form a reasonable belief that that each qualified custodian is sending account statements to investors, which account statements must report activities of the pooled investment vehicle, rather than the investors' capital account; and

(C) May not self-custody certain privately issued securities.

Non-U.S. Advisers to Pooled Investment Vehicles. An adviser whose principal office and place of business is located outside the United States is not subject to the custody rule with respect to the fund regardless of whether its investors are U.S. persons if (i) the fund is also organized in a place outside the United

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[332] The audited financial statements must be prepared according to, or reconciled to, U.S. GAAP.

[333] The audited financial statements must be distributed to investors within 120 days after the close of the pool's fiscal year. In 2006, the Division of Investment Management issued a letter indicating that it would not recommend enforcement action to the Commission under section 206(4) of the Act or rule 206(4)-2 against an adviser of a "fund of funds" relying on the annual audit provision of rule 206(4)-2 if the audited financial statements of the fund of funds are distributed to investors in the fund of funds within 180 days of the end of its fiscal year. *See* *ABA Committee on Private Investment Entities*, SEC Staff Letter (Aug. 10, 2006); Release 2968, *supra* note 319 at n. 45.

[334] Rule 206(4)-2(b)(4).

[335] Rule 206(4)-2(a)(5) and (a)(4).

States,[336] (ii) the adviser is an exempt reporting adviser, or (ii) the adviser is a foreign private adviser.[337]

g. *Adviser or "Related Person" as Custodian.*[338] If the adviser or its related person serves as the qualified custodian in connection with the adviser's advisory services, the adviser must:

(1) *Surprise Examination.* Have an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB perform the required annual surprise examination, unless the related person is "operationally independent" of the adviser;[339] and

(2) *Internal Controls Report*. Obtain, or receive from the affiliate, an annual report of the internal controls relating to the custody of client assets prepared by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB.[340]

Broker-Dealers. A compliance report required to be submitted by certain broker-dealers by rule 17a-5 under the Exchange Act, as amended, will satisfy the annual report on internal controls required by rule 206(4)-2.[341]

4. *Use of Solicitors*

An adviser registered under the Act is generally prohibited by rule 206(4)-3 from paying a cash fee, directly or indirectly, to a third party (a "solicitor") unless it meets the requirements of the rule.[342]

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[336] Advisers Act Rel. No. 3222, *supra,* note 117 at n. 515 ("[W]e do 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 Commission," adopting the staff no-action letter *Unibanco*, *supra* note 76; *Goldstein v. SEC, supra* note 144 (treating fund as client).

[337] An adviser, including a non-U.S. adviser, may advise a hedge fund or other private fund organized as a corporation or other entity with a board of directors, in which case the adviser would not have the legal capacity of a general partner or trustee, and thus may be able to avoid having custody of the fund's assets. *See* discussion in Section VI.B.3.a(3) of this outline.

[338] A "related person" includes any person, directly or indirectly, controlling or controlled by the adviser, and any person that is under common control. A person that owns more than 25% of the voting shares of a corporation are presumed to control the corporation. Rule 206(4)-2(d)(1).

[339] The surprise examination is not required of the adviser if it can demonstrate that the related person acting as qualified custodian is "operationally independent." This determination is made by examining the relationship between the adviser and the related person, including whether there are common employees, shared premises, and common supervision. *See* rule 206(4)-2(d)(5).

[340] Rule 206(4)-2(a)(6).

[341] Exchange Act Rel. No. 34-70072 (July 29, 2013) at 120.

[342] Undisclosed payments by an adviser to a third party for client referrals may also violate the general anti-fraud provisions of the Act. For a recent SEC enforcement action involving such payments, *see* *John W. Rafal*, Advisers Act Rel. No. 4601 (Jan. 9, 2017).

a. *Not Disqualified*. An adviser may not pay solicitation fees to a solicitor that would itself be subject to Statutory Disqualification as an investment adviser.[343]

This is one of several "bad boy" provisions in the federal securities laws, which are most frequently is implicated in connection with the settlement of a civil or criminal action against and adviser or a related person, often for conduct unrelated to the adviser's advisory activities.

b. *Written Agreement.* The solicitation fee must be paid pursuant to a written agreement that:

(1) describes the solicitation activities and the compensation to be paid;

(2) contains an undertaking by the solicitor to perform his duties according to the agreement and in compliance with the Act; and

(3) requires the solicitor to provide a prospective client a copy of:

(A) the adviser's disclosure statement (brochure), and

(B) a separate disclosure statement describing the terms of the solicitation arrangement, including that the solicitor is being compensated by the adviser.[344]

c. *Solicitors.* The rule defines a solicitor as anyone who, directly or indirectly, solicits any client for, or refers any client to, an investment adviser. The SEC believes that a solicitor would be a "person associated with an adviser" under the Act. The adviser has an obligation to supervise the activities of solicitors.[345]

d. *Client Referrals.* Rule 206(4)-3 does not apply to the direction of brokerage in return for client referrals. But an adviser directing brokerage to brokers referring clients to it has a significant conflict of interest. Accordingly, an adviser may be obligated to disclose to prospective clients material information regarding

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[343] *See supra* note 172 and accompanying text. Through a series of no-action letters, however, the SEC staff expressed the view that statutorily disqualified persons may act as solicitors if the disqualifying conduct is disclosed in a separate written document to be given to each solicited person (i) at least 48 hours before such solicited person enters into an advisory contract, or (ii) at the time the solicited person enters into the advisory contract, *if* the solicited person has the right to terminate the advisory contract within five days. Accordingly, the staff no longer issues no-action letters of this type, unless the facts raise novel or unusual circumstances. *See* *Dougherty & Company LLC*, SEC Staff No-Action Letter (July 3, 2003).

[344] If the solicitor is an employee of the adviser, however, the solicitor is not required to provide prospective clients a copy of the adviser's brochure or the separate disclosure statement.

[345] For discussion of an adviser's obligation to supervise cash solicitors acting on its behalf, *see* *Requirements Governing Payments of Cash Referral Fees by Investment Advisers*, Advisers Act Rel. No. 615 (Feb. 2, 1978) (proposing release); *Requirements Governing Payments of Cash Referral Fees by Investment Advisers*, Advisers Act Rel. No. 688 (July 12, 1979) (adopting release).

conflicts arising from the arrangement, including any effect on the adviser's ability to obtain best execution.[346]

e. *Hedge Funds.* The SEC staff has stated that the rule does not apply to payments by an adviser to solicit investments in a pooled investment vehicle sponsored by the adviser.[347]

5. *Pay to Play (Political Contributions)*

Rule 206(4)-5, among other things, prohibits an adviser from receiving compensation for providing advisory services for two years after the adviser or one of its executives makes a political contribution to certain candidates for public office.[348] The rule is designed to curtail adviser participation in so-called "pay to play activities" in which political contributions are made to influence the award of advisory contracts or investment in funds managed by the adviser.

The rule applies to SEC-registered investment advisers, certain exempt reporting advisers,[349] and foreign private advisers, who provide investment advisory services, or are seeking to provide investment advisory services, to state and municipal government entities.[350]

a. *Prohibitions.* The rule contains three main prohibitions:

(1) *Two-Year Time Out.* An investment adviser may not receive compensation for providing advice to a government entity, either directly or through a "covered investment pool," for two years after a contribution by the adviser or by any of its "covered associates" to an official of that government entity who can influence the award of advisory business.[351]

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[346] *Jamison, Eaton and Wood, Inc.*, *supra* note 212; *Portfolio Advisory Services LLC*, *supra* note 211; *Founders Asset Mgmt.*, Advisers Act Rel. No. 1953 (July 20, 2001); *Fleet Investment Advisers, Inc. (successor to Shawmut Investment Advisers, Inc.*), Advisers Act Rel. No. 1821 (Sept. 9, 1999).

[347] *Mayer Brown, LLP*, SEC Staff No-Action Letter (July 15, 2008). In its response, however, the staff noted that the solicitor may itself be an adviser subject to the antifraud provisions of the Act. The staff's response was amended on July 28, 2008 but indicates that the response letter should be deemed to have been issued on July 15. *See also* rule 206(4)-5 and Section VI.B.5of this outline regarding solicitation of government clients.

[348] The rule was adopted in 2010. *Political Contributions by Certain Investment Advisers*, Advisers Act Rel. No. 3043 (July 1, 2010) ("Pay to Play Release"). The SEC staff has issued responses to FAQs about the rule. A lawsuit brought against the SEC challenging, among other things, the constitutionality of Rule 206(4)-5 was dismissed by a in September 2014. *N.Y. Republican State Comm. et al. v. SEC, 70 F.Supp.3d 362* (D.D.C. Sept. 30, 2014). *aff'd*, 799 F.3d 1126 (D.C. Cir. Aug. 25, 2015).

[349] *See, e.g.*. Aisling Capital LLC, Advisers Act Rel. No. 4616 (Jan. 17, 2017) (venture capital adviser).

[350] Rule 206(4)-5(a). The rule is modelled on Rules G-37 and 38 of the Municipal Securities Rulemaking Board (MSRB).

[351] Rule 206(4)-5(a)(1). An adviser subject to the rule is not prohibited from providing advisory services to a government client, even after triggering the two-year time out. Instead, an adviser is prohibited from receiving *compensation* for providing advisory services to such client during the time out. This enables an adviser to act

Covered Associate. Covered associates are (i) the adviser's executive officers, (ii) any employees who solicit government clients (and their supervisors up the chain of command), and (iii) any political action committees they control.[352]

(a) *New Covered Associates.* The time out applies to political contributions made by a person within (i) two years of becoming a covered associate if the covered associate solicits clients upon becoming a covered person, or (ii) six months if he or she doesn't.[353] The adviser hiring the covered person (or promoting an employee to be a covered person) will be subject to the time out until the two-year (or six month) period has run with respect to that person's contribution.

The look-back provision provides regardless of whether the adviser is aware of the covered person's contributions so it is incumbent that an adviser requires full disclosure of candidates' relevant political contributions as an adviser would regarding other business activities that might present conflicts.[354]

(b) *Departing Covered Associates*. The time-out continues to run even if the covered associates making the political contribution leaves the firm.[355]

Government Officials. A government official is a person who, at the time of the contribution, is either an incumbent, candidate, or successful candidate for elective state or municipal office if the office is directly or indirectly responsible for or can influence the outcome of, the hiring of an investment adviser by the government entity.[356]

The SEC has brought actions involving:

- A State Treasurer of Massachusetts who sat on the board of a state pension fund and could appoint one other member of a state pension fund's board;[357]

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consistently with its fiduciary obligations and provide uncompensated advisory services for a reasonable period of time to allow the government client to replace the adviser. *See also supra* Section VI.B.4 of this outline regarding the cash solicitation rule that applies to all SEC-registered advisers.

[352] Rule206(4)-5(f)(2).

[353] Rule 206(4)-5(b)(2).

[354] Pay to Play Release *supra* note 348 at n.217.

[355] Pay to Play Release *supra* note 348 at n. 206.

[356] Rule 206(4)-5(f)(6). The time-out is triggered by contribution to a candidate for federal office only if the candidate is, at the time of the contribution, serving as an "government official" of a state or municipality.

[357] *Alta Communications, Inc.*, Advisers Act Rel. No. 4614 (Jan. 17, 2017).

- A New York City borough president who was on a pension board that selected investment advisers and pooled investment vehicles for the pension plan.[358]

- The governor of Illinois who had the ability to appoint six members of a public pension board that had influence in selecting advisers and pooled investment vehicles for the pension fund.[359]

- A candidate for governor of Pennsylvania (who appoints six members of the state pension fund board) who at the time was the state's Treasurer (who is on the board of a state pension fund) and which in *both* capacities had an ability to influence the selection of the fund's adviser and pooled investment vehicles.[360]

Strict Liability. The SEC does not have to prove that the covered associate intended to influence the selection of the adviser--only that the contribution was made and compensation continued to be received.[361]

De minimis Contributions. Individuals may make contributions without triggering the two-year time out of up to $350 per election to an elected official of candidate for whom he or she is entitled to vote, and up to $150 per election for an elected official or candidate for whom he or she cannot.

Exemptive Authority. The SEC can exempt advisers from the two-year time out if, among other things, the adviser had adopted and implemented policies and procedures reasonably designed to prevent violations of the rule, the adviser did not have actual knowledge of the contribution, and the adviser made reasonable efforts to obtain return of the contribution.[362]

(2) *Third Party Solicitor Ban.* Neither an investment adviser nor any of its covered associates may provide or agree to provide, directly or indirectly,

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358 Rel. No. 4616, *supra* note 349.

359 The Banc Funds Company, L.L.C., Advisers Act Rel. No. 4609 (Jan. 17, 2017).

360 *Adams Capital Mgmt. Inc.* Advisers Act Rel. No. 4617 (Jan. 17, 2017).

361 *Lime Rock Management LP*, Advisers Act Rel. No. 4611 (Jan. 17, 2017) (settled enforcement action in which the SEC stated that "Rule 206(4)-5 does not require a showing of *quid pro quo* or actual intent to influence an elected official or candidate.").

362 Rule 206(4)-5(e). The SEC has issued several exemptive orders pursuant to this provision. As suggested by the SEC release adopting rule 206(4)-5, the advisers who obtained these exemptive orders, upon learning of the violation, placed compensation earned from the government client subsequent to the date of the contribution in an escrow account for release upon issuance of the order. *See, e.g.*, Davidson Kempner Capital Mgmt. LLC, Advisers Act Rel. No. 3693 (Oct. 17, 2013) (notice) and 3715 (Nov. 13, 2013) (order) and; Ares Real Estate Mgmt. Holding, LLC, Advisers Act Rel. No. 3957 (Oct. 22, 2014) (notice), and 3969 (Nov. 18, 2014)(order).

payment to any third party to solicit government clients for the adviser unless such person is a "regulated person."[363]

Regulated Person. "Regulated persons" are:

(a) SEC-registered investment advisers that have not, and whose covered associates have not, within two years of soliciting a government entity, made a contribution to an official of that government entity; or bundled any contribution to an official or payment to a political party of a state or locality where the adviser is providing or seeking to provide investment advisory services to a government entity;

(b) Registered broker-dealers; and

(c) Municipal advisers.[364]

This provision covers payments to traditional solicitors for advisers as well as "placement agents" hired by private funds to find investors, typically broker-dealers.[365] The rule operates to permit use of placement agents that are themselves subject to a pay to play rule. Pay to play rules adopted by the SEC and the MSRB and proposed by FINRA are similar, and are based on the template of MSRB rule G-37, first adopted by the MSRB in 1994.

(3) *Soliciting Ban.* Rule 206(4)-5 prohibits an adviser and its covered associates from soliciting or "bundling" others' contributions—*i.e.*, coordinating or soliciting any person or political action committee to make (i) any contribution to an official of a government entity to which the adviser is providing or seeking to provide investment advisory services, or (ii) any payment to a political party of a state or locality where the investment adviser

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363 Rule 206(4)-5(a)(2)(i). The prohibition is limited to payments to third-party solicitors, and thus does not apply to any of the adviser's employees, general partners, managing members, or executives.

364 Rule 206(4)-5 limits broker-dealers and municipal advisers to those subject to a pay to play rule adopted by FINRA or the Municipal Securities Rulemaking Board ("MSRB") that the SEC has found by order to provide "substantially equivalent or more stringent than" the SEC rule. The SEC delayed the compliance date of this portion of rule 206(4)-5 pending the completion of FINRA and MSRB rulemaking. On June 25, 2015, the SEC issued a release announcing a compliance date of July 31, 2015. Advisers Act Release No. 4129. At the same time the SEC staff issued a FAQ, stating that it would not recommend enforcement action if an adviser subject to the rule made payments to broker-dealers or municipal adviser solicitors pending the adoption of rules by FINRA and the MSRB. *See* Question I.4. The FAQ has the effect of delaying the compliance date of the rule until FINRA and the MSRB Act. On August 25, 2016 the SEC published notices of its intent to issue orders finding that FINRA proposed rule 2030 and MSRB proposed amendments to rule G-37 were "substantially equivalent or more stringent than" rule 206(4)-5. *See* Advisers Act Rel. Nos. 4511 and 4512.

365 Placement agents for private funds who made political contributions to facilitate investment of public funds in certain private funds played a role in the enforcement actions by the SEC that precipitated the proposal of rule 206(4)-5. *See, e.g.*, *SEC v. Henry Morris, et al.*, Lit. Rel. No. 20963 (Mar. 19, 2009).

is providing or seeking to provide investment advisory services to a government entity.[366]

b. *Catch-All Provision.* Rule 206(4)-5(d) prohibits acts done indirectly, which, if done directly, would violate the rule.

This provision operates to trigger the two-year time out if, for example, a covered person makes a contribution through a spouse. In such a case the SEC would bear the burden of proving that the spouse's contribution was indirectly a contribution of the covered person.

c. *Covered Investment Pools.* Rule 206(4)-5 includes a provision that applies each of the prohibitions of the rule to an adviser that manages assets of a government entity through a "covered investment pool," which is defined generally to include a (i) registered investment company (including a closed-end fund), (ii) private fund (*e.g.*, hedge funds and private equity funds[367]), or (iii) bank sponsored collective investment trust.[368] The rule applies even if the government entity was already invested in the covered investment pool at the time of the contribution.

d. *Recordkeeping.* Rule 204-2 requires registered advisers that provide investment advisory services to a government entity, or to a covered investment pool in which a government entity is an investor, to make and keep certain records related to the pay to play rule.[369]

6. *Proxy Voting*

A registered adviser that exercises voting authority over client securities must vote them in the best interest of the client and not in its own interest. Rule 206(4)-6 requires that advisers with voting authority over client securities:

a. *Policies and Procedures.* Adopt and implement written policies and procedures that are reasonably designed to ensure that the adviser votes in the clients' best interests, and which must specifically address conflicts of interest that may arise between the adviser and its clients are resolved.

(1) *Voting Client Securities*. The scope of an adviser's authority to vote securities is typically provided in the advisory contract. Where an adviser does assume

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[366] Rule 206(4)-5(a)(2)(ii). *See* *Commonwealth Venture Mgmt. Corp.*, Advisers Act Rel. No. 4615 (Jan. 17, 2017) (settled enforcement action alleging, among other things, a covered associated solicited contributions for a covered by co-hosted a fundraising event for a covered).

[367] *TL Ventures Inc.*, Advisers Act Rel. No. 3859, (settled enforcement action alleging covered associate made contributions to candidates for both state and local offices that possessed the authority to manage public employee pension funds and which were invested in private equity funds).

[368] Rule 206(4)-5(f)(3).

[369] Rule 204-2(a)(18).

responsibility to vote proxies, the SEC has stated that an adviser's fiduciary obligation requires it to monitor corporate action and vote client securities.[370]

The SEC's position is not that an adviser need vote every security, but cannot be negligent in performing the obligation it has assumed. Thus, it may take into consideration the costs and benefits of voting a proxy. For example, the costs of voting a security issued by a company in a foreign country may be very high, and there may be no benefit to client in voting a security no longer held by clients.

(2) *Resolving Conflicts of Interest*. In the absence of client disclosure and consent (which is often impracticable to obtain), the SEC stated that an adviser with a material conflict of interest "must take other steps designed to ensure, and must be able to demonstrate that those steps resulted in, a decision to vote the proxies that was based on the clients' best interest and was not the product of the conflict."[371] It suggested two additional ways:

- Vote based on pre-determined voting policy; and
- Vote based on a recommendation of an *independent* third party, such as a proxy voting adviser.

The SEC staff issued a staff legal bulletin in 2014 that addresses the obligations of an adviser relying on a proxy advisory firm.[372] These include ascertaining whether the advisory firm has capacity and competency to analyze the proxy issues, and whether the proxy adviser has sufficiently robust policies and adequate policies and procedures in place that address any conflicts it may have.[373]

b. *Disclosure.* Describe their voting policies and procedures to clients, deliver a copy of the policies and procedures to clients upon request, and inform clients how they can obtain information on how the adviser voted their securities; and

c. *Recordkeeping.* Keep certain records relating to voting of client securities.[374]

7. *Duty to Supervise*

An adviser has a continuing responsibility to supervise all persons acting on its behalf.[375] The SEC may sanction the adviser or any of its management personnel

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[370] *Proxy Voting by Investment Advisers*, Advisers Act Rel. No. 2059 (Sept. 20, 2002).

[371] *Id.*

[372] Staff Legal Bulletin 20 (June 30, 2014).

[373] *See* *Intech Investment Mgmt.*, Advisers Act Rel. No. 2872 (May 7, 2009) (settled enforcement action against adviser that selected a third-party proxy voting service whose guidelines would be helpful to the adviser's effort's, to attract union-affiliated clients).

[374] *See also* Section VI.A.5 of this outline.

who "has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision."[376]

a. *Who is a Supervisor?* The SEC has stated that the president or chief executive officer of an [adviser] is responsible for the firm's compliance unless he or she has reasonably delegated responsibilities to another person in the firm, and neither knows nor has reason to know that such person is not properly performing their duties.[377] Other managers down the chain of command have supervisory responsibilities when the adviser or its organizational documents have identified the person as another's supervisor.

   Legal and Compliance Personnel. Difficult questions arise when determining whether persons outside of the employee's chain of command, *e.g.*, legal or compliance personnel, have supervisory responsibility for the employee. The SEC has stated that having the position of general counsel or chief compliance officer does not, in and of itself, carry supervisory responsibilities so that an adviser's chief compliance officer would not necessarily be subject to a sanction for failure to supervise other advisory personnel.[378] Whether a person has responsibility as a "supervisor" depends on whether, under the facts and circumstances of a particular case, the person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.[379]

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[375] The SEC has stated that the "delicate fiduciary relationship" between an investment adviser and a client imposes an obligation on an adviser to review and to monitor the activities of its employees. *Shearson Lehman Brothers, Inc. and Stein Roe & Farnham*, Exchange Act Rel. No. 23640 (Sept. 24, 1986). The SEC has repeatedly emphasized that the duty to supervise is a critical component of the federal regulatory scheme. *See Nicholas-Applegate Capital Mgmt.*, Advisers Act Rel. No. 1741 (Aug. 12, 1998), *supra* note 258 (adviser failed reasonably to supervise employee and did not have policies and procedures designed to detect and prevent employees from engaging in improper personal trading); *In re Van Kampen American Capital Asset Mgmt., Inc.*, Advisers Act Rel. No. 1525 (Sep. 29, 1995) (adviser failed reasonably to supervise employee and did not have policies and procedures designed to detect and prevent employees from mispricing fund securities). Both registered and unregistered advisers have an obligation to supervise persons acting on their behalf. *Wilfred Meckel and Robert A. Littell*, Advisers Act Rel. No. 2203 (Dec. 15, 2003). *See also Western Asset Mgmt. Co. and Legg Mason Fund Adviser, Inc*., Advisers Act Rel. No. 1980 (Sept. 28, 2001) (duty to supervise a sub-adviser); *TBA Financial Corporation*, SEC Staff No-Action Letter (Nov. 7, 1983) (duty to supervise employees who are also "registered representatives").

[376] Section 203(e)(6).

[377] *Richard F. Kresge*, Exchange Act Rel. No. 55988 (June 29, 2007).

[378] Advisers Act Rel. No. 2204 (Dec. 17, 2003) ("Release 2204") at n. 73.

[379] *See John H. Gutfreund*, Exchange Act Rel. No. 31554, 51 SEC 93, 113 (Dec. 3,1992). The SEC staff has published FAQs describing, among other things, the questions that should be considered when evaluating whether a person has supervisory responsibilities over another person in the firm. *See Frequently Asked Questions about Liability of Compliance and Legal Personnel at Broker-Dealers under Sections 15(b)(4) and 15(b)(6) of the Exchange Act* (Sept. 30, 2013). Although the staff FAQs speak only to obligations under the Exchange Act, the relevant provisions of the Advisers Act are substantially identical.

b. *What are the Obligations of a Supervisor*? Management personnel have an obligation to oversee employees (which are not limited to so-called "statutory employees") of the adviser in a manner reasonably designed to ensure compliance with the securities laws. This requires supervisors to take reasonable steps to determine whether an employee is engaging in unlawful conduct[380] and, if they are, to prevent further violations.[381] Many of the cases brought by the SEC involve the failure of a firm or supervisor to react promptly and effectively after receiving some indication (*i.e.*, a red flag) that a violation has or may occur.[382] For example, supervisors have been held liable for not acting effectively when they have merely relied on "unverified representations of employees."[383]

Safe Harbor. A person (*e.g.*, an adviser or an officer of the adviser) will not be deemed to have failed to supervise a person if (i) the adviser had established procedures and a system for applying such procedures that are reasonably expected to prevent and detect the conduct, and (ii) the person reasonably discharged his supervisory duties and had no reasonable cause to believe that the procedures were not being complied with.[384]

8. *Compliance Programs*

Under rule 206(4)-7 each registered adviser must establish an internal compliance program administered by a chief compliance officer ("CCO") that addresses the adviser's performance of its fiduciary and other obligations under the Act.[385]

a. *Chief Compliance Officer*. Each adviser must designate a chief compliance officer.[386] The CCO must be knowledgeable about the Act and have the authority

[380] Liability for failure to supervise may be imposed when a supervisor fails "to learn of improprieties when diligent application of supervisory procedures would have uncovered them" *Stephen Jay Mermelstein*, Advisers Act Rel. No. 2961 (Dec. 14 2009).

[381] The SEC believes that "supervisory obligations imposed by the federal securities laws require a vigorous response even to indications of wrongdoing." *John H. Gutfeund*, *supra* note 379.

[382] *See, e.g.*, *Cambridge Investment Research Advisors*, Advisers Act Rel. No. 4361 (Apr. 5, 2016) (heightened supervision of employee was not implemented by supervisors); *Steven A Cohen*, Advisers Act Rel. No. 4307 (Jan. 8, 2016); *Rhumbline Advisers*, Advisers Act Rel. No. 1765 (Sept. 29, 1998); *Scudder Kemper Investments, Inc.*, Advisers Act Rel. No. 1848 (Dec. 22, 1999) (adviser failed reasonably to supervise employee and did not have policies and procedures designed to detect and prevent employees' unauthorized trading in client accounts).

[383] *Robert T. Littell*, Advisers Act Rel. No. 2203 (Dec. 15, 2003) (executive of unregistered adviser failed to have a reasonable basis to believe the accuracy of performance information and other information supplied by portfolio manager to investors); *Scudder Kemper Investments, Inc.*, Advisers Act Rel. No. 1848 (Dec. 22, 1999) (adviser's controls over trader's activities relied too much on traders self-reporting).

[384] Section 203(e)(6). *See* *Dawson-Samberg Capital Mgmt., Inc.*, *supra* note 226 (discussion of failure of adviser to qualify for the safe harbor). The safe harbor and the requirements to meet it have significant overlap with the obligations of the rule 206(4)-7, the compliance rule. *See* *Cambridge Investment Research Advisors, Inc.*, *supra* note 382.

[385] Failure of an adviser or fund to have implemented adequate compliance policies and procedures constitutes a violation of SEC rules independent of any other securities law violation. Release 2204, *supra* note 378.

[386] Rule 206(4)-7(c). The name of the CCO must be reported on Form ADV (Item 1.J.).

to develop and enforce appropriate compliance policies and procedures for the adviser.[387]

Identity of the CCO. Larger advisers will typically designate an individual to act as its full time CCO, but the rule does not require it. The CCO may be an employee who has other duties, such as the general counsel,[388] or may be a third party (i.e., one not employed by the adviser) specifically engaged to be the adviser's CCO.[389] Regardless, the SEC will hold the adviser the same standards in assessing compliance with the rule.

Liability of CCOs. The SEC has brought a number of enforcement actions against CCOs of advisers. In many of these actions the CCO was actually engaged in the misconduct that was the subject of the action although in a different capacity, e.g. CEO.[390] In a growing number of cases, however, the SEC has asserted that a CCO has "caused" the adviser's violation of rule 206(4)-7 when the CCO covered up a violation, knew about the violations and did not act;[391] failed to cooperate with the SEC[392] or failed to perform one or more of her compliance functions she was specifically designated to perform by the firm's compliance policies and procedures, such as the annual review of compliance procedures.[393]

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[387] *See* *IMC Asset Mgmt., Inc.*, Advisers Act Rel. No. 3537 (Jan. 29, 2013). The obligation of having a knowledgeable CCO with sufficient authority is not specified in rule 206(4)-7, but rather discussed in the SEC's adopting release. The lack of experience and competence of its CCO were identified as aggravating factors in the SEC's finding that IMC failed to meet its compliance obligations under the rule. *See also* *Parallax Investments, LLC*, Advisers Act Rel. No. 4159 (Aug. 6, 2015), and several other enforcement releases in which the SEC makes observations about the competence of the CCO and the amount of time the CCO devoted to compliance matters.

[388] Release 2204, *supra* note 378 at Section II.C. However, on at least one occasion the SEC conditioned settlement of an enforcement action on the engagement by the adviser of a CCO who had no other responsibility. *Goelzer Investment Mgmt. Inc.*, Advisers Act Rel. No. 3638 (July 31, 2013).

[389] The rule provides only that the CCO must be a "supervised person." The SEC examination staff has issued a "risk alert" identifying certain risks attendant to engaging a CCO who is not an on-site employee of the adviser. National Exam Program Risk Alert, Vol. V Issue 1 (Nov. 9, 2015).

[390] *See, e.g.*, *Eric David Wanger and Wanger Investment Mgmt.*, Inc., Advisers Act Rel. No. 3427 (July 2, 2012); *Anthony Walker Young and Acorn Capital Mgmt.*, Advisers Act Rel. No. 3379 (Feb 28, 2012); Alphabridge Capital Mgmt., LLC, Thomas T. Kutzen, and Michael J. Carino, Advisers Act Rel. No. 4135 (July 1, 2015). In one enforcement action, the CCO had signed the Form ADV on behalf of the adviser and was held responsible for the mis-statements therein. *Susan M. Diamond*, Advisers Act Rel. No. 4619 (Jan. 19, 2017).

[391] *Gintell Asset Mgmt.*, Advisers Act Rel. No. 2079 (Nov. 8, 2002).

[392] *Strong Capital Mgmt. Inc. et al.*, Advisers Act Rel. No. 2239 (May 20, 2004) (CCO failed, among other things, to provide SEC with requested documents despite knowledge of such documents); *Rick Cho*, Advisers Act Rel. No. 3488 (Oct. 15, 2012) (CCO, among other things, unlawfully refused to allow SEC staff to review adviser's books and records); *Charles L. Rizzo and Gina M. Hornbogen*, Advisers Act Rel. No. 3321 (Nov.28, 2011)(CCO, among other things, took steps to conceal fraudulent transactions); *Consulting Services Group, LLC, and Joe D. Meals*, Advisers Act Rel. No. 2669 (Oct. 4, 2007) (CCO, among other things, directed supervised persons to backdate acknowledgements of receipt of adviser's code of ethics).

[393] *See, e.g.*, *Equitas Capital Advisors, LLC et al*, Advisers Act Rel. No. 3704 (Oct. 23, 2013) (CCO, among other things, failed to conduct compliance reviews, establish adequate compliance procedures, and failed to correct

The specific reasons the SEC has named an adviser's CCO in a given enforcement action is not always clear. The actions brought to date do not suggest that the SEC considers the CCO a guarantor of the adviser's compliance or even that it will hold the CCO responsible for negligently failing to prevent a violation of the Advisers Act. Most appear to involve a significant breakdown of the adviser's compliance program or recidivism that suggested to the SEC culpability of the CCO.[394] *Several involved the failure of a CCO to implement compliance controls,*[395] *sometimes in face of deficiencies previously identified by SEC examiners.*

b. *Policies and Procedures.* Each adviser must also adopt *and* implement written policies and procedures reasonably designed to prevent the adviser or its personnel from violating the Act.[396] The rule does not specify any manner of approval; it simply requires approval by the adviser.

Design of Policies and Procedures. The SEC has stated that the policies and procedures should be designed to:

(1) Prevent violations from occurring by, for example, separating operational functions such as trading and reporting.

(2) Detect violations that have occurred by, for example, requiring review of securities transactions and reports. The SEC staff has strongly suggested that adviser CCOs should in some cases undertake forensic testing designed to detect violations.[397] The SEC staff performs these types of tests as part of a compliance examination.[398]

(3) Correct promptly any violations that have occurred.

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weaknesses in examination program identified by SEC examiners notwithstanding representations to SEC staff); *Buckingham Research Group, Inc., et al*, Advisers Act Rel. No 3109 (Nov. 17, 2010) (CCO failed to discharge his responsibilities adequately by failing to establish policies reasonably designed to prevent misuse of material non-public information, implement compliance policies, conduct an annual review, and cure deficiencies in an examination); *OMNI Investment Advisers Inc. and Gary R. Beynon*, Advisers Act Rel. No. 3323 (Nov. 28, 2011) (CCO was living in Brazil); *Ronald S. Rollins*, Advisers Act Rel. No. 3635 (July 29, 2013) (CCO, among other things, failed to implement policy against holding custody of client assets).

[394] The SEC has brought some enforcement actions involving a significant compliance breakdown in which it did not include the CCO who seemed to be doing his best notwithstanding inadequate funding and management support. *See* Pekin Singer Strauss Asset Mgmt. Inc., *supra* note 214.

[395] *See, e.g.*, *Envision Capital Mgmt., Ltd*, Advisers Act Rel. No. 3160 (Feb. 16, 2011).

[396] Rule 206(4)-7(a).

[397] *See* "Forensic Measures for Funds and Advisers," Office of Compliance Inspections and Examinations, CCO Outreach National Seminar (Nov. 14, 2007).

[398] *See* *Welhouse & Associate, Inc.*, *supra* note 260 (settled administrative action against an adviser for allocating profitable options trades to principal's personal account in which the SEC staff rebutted the principal's defense by statistical analysis, concluding that there was "an infinitesimal likelihood" of achieving the profit like those of the principal's from a chance combination of trades).

The policies and procedures need not be maintained in a single document or binder, and should incorporate policies and procedures adopted pursuant to other provisions of the federal securities laws.[399]

Scope of Policies and Procedures. The policies must be tailored to the operations of the operations of the adviser. The SEC explained that each adviser, in designing its policies and procedures, should identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks.[400]

These policies and procedures should cover, at a minimum, the following areas to the extent applicable to the adviser:

(1) Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions;

(2) Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregated trades among clients;

(3) Proprietary trading of the adviser and personal trading activities of supervised persons;

(4) The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements;

(5) Safeguarding of client assets from conversion or inappropriate use by advisory personnel;

(6) The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;

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[399] *Compliance Programs of Investment Companies and Investment Advisers*, Advisers Act Rel. No. 2107 (Feb. 5, 2003) at n. 26. (proposing rule 206(4)-7). *See* Robert E. Plaze, "Commissioner Gallagher's Dissent in SEC Enforcement Act Misses the Mark," Hedge Fund Law Report, Vol.8, No.30 (July 30, 2015) (discussing enforcement cases involving compliance rule).

[400] The SEC has brought enforcement actions against advisers that adopted a "pre-packaged" policies and procedures manual that failed to reflect the risk factors or conflicts of interest of the adviser; the SEC found that the adviser violated rule 206(4)-7 by failing to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act by that adviser's supervised persons. *See, e.g.*, *Consulting Services Group, LLC, and Joe D. Meals*, *supra* note 392; *Feltl & Company, Inc.*, Advisers Act Rel. No. 3325 (Nov. 28, 2011).

(7) Marketing advisory services, including the use of solicitors;

(8) Processes to value client holdings and assess fees based on those valuations;

(9) Safeguards for the privacy protection of client records and information; and

(10) Business continuity plans.[401]

Implement Policies and Procedures. It is not enough to merely have policies and procedures—they must be implemented. The SEC treats the failure of an adviser to follow its own policies and procedures as a failure to implement them and thus as a violation of rule 206(4)-7 even if the adviser would not have been required to adopt the specific policy or procedure.[402]

c. *Annual Review.* The adviser must review the adequacy and effectiveness of its policies no less frequently than annually.[403] The review need not, however, be conducted entirely at the same time—an adviser may conduct portions of the review at different times each year.

Interim Reviews. The annual review requirement must be considered in the context of the rule's requirement that the adviser establish and implement an effective compliance program, which requires that the program be effective at all times. The SEC has suggested that an adviser review its policies and procedures in response to (i) significant compliance events affecting the adviser or other advisers; (ii) any changes in the business activities of the adviser, *e.g.*, the adviser offers a new type of advisory program, manages assets for a new type of client, or acquires a new affiliation (a broker-dealer),[404] or (iii) changes in applicable laws or regulations.[405] Any of these events may suggest the need for changes.

Conducting Reviews. Rule 206(4)-7 does not require that the CCO conduct the annual review, although in many cases the CCO will be tasked with the responsibility.[406] An adviser may have, for example, a director of internal audit or other executive who may conduct the review or a portion of the review.

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[401] Release 2204, *supra* note 378.

[402] *See, e.g.*, *Envision Capital Mgmt. Ltd. supra note* 395*; Comprehensive Capital Mgmt., Inc.*, *supra* note 318 (failed to reasonably implement adviser's policy of not acquiring custody of client assets); *SFX Financial Advisory Mgmt. Enterprises, Inc.*, Advisers Act Rel. No. 4116 (June 15, 2015) (failed, among other things, to review client account cash flows, as stated in compliance policies). *See also*, *Modern Portfolio Mgmt.*, *supra* note 299.

[403] Rule 206(4)-7(b).

[404] *Feltl & Co., Inc.*, *supra* note 400 (adviser's "compliance breakdown was caused by its failure to invest necessary resources in the firm's advisory business as it changed and grew in relation to its brokerage business").

[405] Release 2204, *supra* note 378 at Section II.B.1.

[406] The SEC has held CCOs responsible for conducting the annual review personally responsible for failing to do so in accordance with the advisers policies and procedures. *See e.g.*, *Equitas Capital Advisors, LLC*, *supra* note 393.

Results of Reviews. The SEC examination staff expects advisers to address compliance issues uncovered in the annual review.

Annual Report. There is no requirement, but some advisers (or their CCO) create an annual report similar to one required to be provided by the CCO of a registered investment company to its board of directors setting forth any (i) material changes to the compliance report during the year, and (ii) any "material compliance matters" that occurred.[407]

Recordkeeping. While the recordkeeping rule requires only that the adviser maintain any records it creates in the course of conducting an annual review, the SEC examination staff typically looks for such records as evidence that an annual review has been conducted.[408]

9. *Codes of Ethics/Gifts and Entertainment Policies*

Rule 204A-1 requires that all advisers registered with the SEC adopt and enforce a written code of ethics reflecting the adviser's fiduciary duties to its clients.[409] The adviser's code of ethics must (or should, as discussed) cover several following matters set out below.

a. *Standard of Conduct.* The code must set forth a minimum standard of conduct for all supervised persons.

   Minimum Standards. The SEC has not stated what this minimum standard should be, but in adopting the rule stated that a "good code of ethics should effectively convey to employees the value the advisory firm places on ethical conduct and should challenge employees to live up not only to the letter of the law, but also to the ideals of the organization."[410]

b. *Compliance with Federal Securities Laws.* The code must require supervised persons to comply with federal securities laws.

c. *Personal Securities Transactions.* The code must require each of an adviser's "access persons" to:

   (1) *Initial and Annual Holdings Reports*. Report his securities holdings (and those of his immediate family members) at the time that he becomes an access person and at least once annually thereafter, and

[407] Rule 38a-1(a)(4)(iii).

[408] Rule 204-2(a)(17)(ii).

[409] *See* Consulting Services Group, LLC, and Joe D. Meals, *supra* note 392 (adviser failed to timely adopt and accurately document ethics code).

[410] *Investment Adviser Codes of Ethics*, Advisers Act Rel. No. 2256 (July 2, 2004).

(2) *Quarterly Transaction Reports.* Report at least once quarterly all his personal securities transactions (and those of his immediate family members) in "reportable securities" to the adviser's CCO or other designated person.[411]

Exceptions. Access persons are not required to submit transaction reports (i) for trades effected pursuant to an automatic investment plan; (ii) for securities held in accounts over which the access person has no direct or indirect influence or control;[412] and (iii) that would duplicate information in account statements or confirmations.[413]

Brokerage Statements. Access persons can satisfy the transaction report by directing their broker-dealers to deliver account statements to the investment adviser.[414]

Commercially-developed software programs permit advisers to download trading data directly from the relevant broker and compare employee and client trading activity to permit compliance staff evaluate trading for conflicts and compliance with the adviser's personal trading policies. Some advisers require access persons to conduct all personal securities transactions in accounts with broker-dealers that will link to these types of programs.

Access Persons. Access persons are personnel of the adviser (including clerical employees, officers, directors and partners) (i) who are involved in making recommendations to clients or (ii) who have access to the recommendations before they are made public.[415] These personnel include back office, accounting, and information technology personnel who have access to client recommendations. They ordinarily do *not* include employees of service providers (such as broker-dealers executing client trades) or related persons, even though such persons may have access to such information.[416]

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[411] Rule 204A-1(b) (1) (holdings reports), and (2) (transaction reports).

[412] Securities placed in a blind trust pursuant to which the access person would have no knowledge of the specific investment action taken by the trustee and no right to intervene it its management would meet these requirements. The SEC staff has stated that an adviser could not rely on this exception solely because the access person has provided a third party asset manager with discretionary investment authority over his account. IM Guidance Update (June 2015).

[413] Rule 204A-1(b)(2)(ii). The exceptions are not available for holdings reports.

[414] Such account statements would not satisfy the holdings report requirements. *See* *Thomas E. Meade*, Advisers Act Rel. No. 3855 (June 11, 2014) (settled enforcement action involving an adviser that failed to collect holdings or transaction reports from access persons).

[415] Rule 204A-1(e)(1) (defining "access person" as certain supervised persons). In addition to employees, access persons include other persons that provide advice on behalf of the investment adviser. Section 202(a)(25) (defining "supervised persons"). A supervised person who has access to nonpublic information regarding the portfolio holdings of affiliated mutual funds is also an access person. *Id*.

[416] An adviser cannot, however, create a related person to avoid obligations under the Advisers Act, including the code of ethics rule. *See* Section 208(d) of the Act. Accordingly, the personnel of a related person that shares personnel, facilities or is otherwise operationally integrated with the adviser may be considered to be access

(1) *Directors, Officers and Partners.* If the primary business of the adviser is providing investment advice, all of its directors, officers and partners are presumed to be access persons.[417] An adviser that chooses not to treat any director, officer or partner as an access person has the burden of demonstrating that the person is not involved in making recommendations to clients and does not have access to the recommendations before the client does.

Although SEC rules do not require the adviser to document determinations that directors, officer or partners are not access persons, appropriate documentation of the basis of the determination would seem to be necessary to sustain the adviser's burdens under the rule.

(2) *Immediate Family Members.* An access person is presumed to have beneficial ownership of securities holdings of members of his immediate family residing in his household, which therefore must be reported.[418]

The term "access person" is designed to include advisory personnel who are in a position to exploit non-public information about client trades and holdings.[419] The rule operates to require those persons to submit securities reports and to obtain pre-approval for certain proposed trades. Some advisers may elect to require reporting from or pre-approval of trades of all personnel. "This approach, while not required, offers certainty as to whether reports are required from a given individual."[420]

Reportable Securities. Access persons must report holdings of all reportable securities, *i.e.*, securities, other than: (i) direct obligations in of the U.S. government; (ii) certain bank instruments, commercial paper and agreements; (iii) shares of money market funds; (iv) shares in open-end investment companies (mutual funds and ETFs) that are not advised by either the adviser or an entity in a

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persons of the adviser. Where an adviser's code contains a broader definition of access person than provided for in Rule 204A, the SEC will likely assert that the failure to enforce the broader definition will violate the adviser's code.

[417] Rule 204A-1(e)(1)(ii). This provision prevents, for example, all of the officers of an insurance company from being treated as access persons simply because the company is registered as an investment adviser. *See* *Prudential Insurance Company of America*, SEC Staff No-Action Letter (Mar. 1, 2005).

[418] Rule 204A-1(b)(1)(i)(A) and (2)(i) require information about shares directly or indirectly beneficially owned by the access person. Beneficial ownership is defined by reference to rule 16a-1(a)(2) under the Exchange Act, which presumes an access person to have beneficial ownership of securities held by his or her immediate family members sharing the same household. Rule 204A-1(a)(3). Immediate family includes any child, stepchild, grandchild, parent, stepparent, grandparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, brother-in-law, or sister-in-law, and adoptive relationships. Rule 16a-1(e).

[419] *Investment Adviser Codes of Ethics*, Advisers Act Rel. No. 2256 (July 2, 2004) (adopting rule 204A-1) at Section II.B.2.

[420] *Id*. at n.27.

control relationship with the adviser); or (v) shares of a (U.S.) unit investment trust that invests exclusively in an unaffiliated mutual fund.[421]

Other Financial Investments. Although the reporting requirements of rule 204A-1 do not extend to commodities contracts and other forms of financial investments that are not securities, an adviser's obligation to supervise its employees is not so limited. Accordingly, some advisers require access person to report such transactions and positions.

Implementation. Securities transactions and holdings reports must be reviewed (typically by the CCO or his designate) with an eye towards identifying conflicts of interests and preventing misconduct by access persons by, for example, front-running client trades.[422] The SEC has stated that an adviser, in addition to "compar[ing] the personal trading to any restricted lists," should, among other things, "assess whether the access person is trading for his own account in the same securities he is trading for clients, and if so whether the clients are receiving terms as favorable as the access person takes for himself."[423]

d. *Pre-approval of Certain Securities Transactions.* The code must require the CCO or other designated persons to pre-approve investments by the access persons in (i) IPOs and (ii) limited (private) offerings, which would include most investments in hedge funds or other private funds.

e. *Gifts and Entertainment.* An adviser's code of ethics is *not* required by rule 204A-1 to include a policy on receipt of gifts and entertainment by its personnel. All advisers, however, have an obligation to supervise their employees "with a view to preventing violations" of law."[424] A properly implemented gifts and entertainment policy helps prevent employees from being improperly influenced in their decision making by receipt of gifts and entertainment, and thus protects the interests of the adviser and its clients.[425] A gifts and entertainment policy,

[421] Rule 206(4)-1(e)(10) (defining "reportable security"). *See also* *M&G Investment Mgmt. Ltd.*, SEC Staff No-Action Letter (Mar. 1, 2007) (permitting access persons of U.K.-based registered adviser to exclude from reports certain analogous instruments).

[422] Front-running occurs when a person trades in advance of his or her client in order to take advantage of changes in the market price of a security that will be caused by that client's trade. *See, e.g.*, *In re Roger W. Honour*, Advisers Act Rel. No. 1527 (Sept. 29, 1995).

[423] *Investment Adviser Code of Ethics*, Advisers Act Rel. No. 2256 (July 9, 2004). The SEC has brought enforcement actions against advisers who failed to sufficiently implement this part of their code of ethics. *Alliance Capital Mgmt. L.P.*, Advisers Act Rel. No. 1630 (Apr. 28, 1997).

[424] Section 203(e)(6) discussed, *supra* Section VI.B.7 of this outline.

[425] The acceptance by advisory personnel of excessive gifts and policies has been cited by the SEC as causing a violation of the adviser's duty to seek best execution (*Fidelity Mgmt. & Research Co.*, Advisers Act Rel. No. 2713 (Mar. 5, 2008) (adviser "allowed certain employees' receipt of travel, entertainment and gifts and certain employee's romantic relationships to enter into the selection of brokers. . .")), and failing to adequately implement policies and procedures to prevent the misuse of non-public information. *Institutional Shareholder Services*, Advisers Act Rel. No. 3611 (May 23, 2013) (proxy adviser failed to take sufficient steps to implement gifts and entertainment policy that resulted in employees trading information about proxy votes for gratuities).

either as a stand-alone policy or as a component of the adviser's code of ethics is considered a "best practice."

When crafting gifts and entertainment policies many advisers draw on FINRA rules that prohibit broker-dealers or their associated persons from giving anything of value in excess of $100 per year to any person where the payment is related to the business of the recipient's employer.[426] FINRA has interpreted the rule as not prohibiting "ordinary and usual business entertainment" (such as occasional meals, sporting event, theater production or comparable entertainment) if the entertainment "is neither so frequent nor so extensive as to raise any questions of propriety."[427] The failure of an adviser to follow its own gifts and entertainment policies will be viewed by the SEC as a failure to implement its code of ethics or compliance policies and procedures.[428]

Investment Company Clients. Section 17(e)(1) of the Investment Company Act precludes an employee of an adviser from accepting *any* gifts or entertainment where the employee is acting as agent in the purchase or sale of property for the investment company.[429] These include employees who are in a position to influence the selection of broker-dealers to effect transactions for the fund, including portfolio managers.[430] The adviser's policies and procedures (or its code of ethics) should identify these persons and disallow their receipt of *any* gifts and entertainment from broker-dealers.[431]

ERISA Clients. Section 406(b)(3) of ERISA makes it unlawful for a plan fiduciary to "receive any consideration for his own personal account from any party dealing with such a plan in connection with a transaction involving the assets of the plan." While there is no *de minimis*, the DOL, as an enforcement

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[426] FINRA Rule 3220 (Influencing or Rewarding Employees of Others). FINRA has proposed to increase the de minimis amount to $175.

[427] *See FINRA Interpretive Letter (June 10, 1999)*. Gratuities must be valued at cost, and "may not be discounted on the theory that they would not otherwise be used."

[428] *See Jeffrey Slocum & Associates*, Advisers Act Rel. No. 4647 (Feb. 8, 2017); *Guggenheim Partners Inv. Mgmt.*, *supra* note 269.

[429] Section 17(e)(1) makes it unlawful for any "affiliated person" of a registered investment company to accept from any source any compensation (other than a regular salary or wage) for the purchase or sale of property to or for the registered investment company. Generally, an associated person of an adviser to the investment company would be an "affiliated person" under the Investment Company Act. Section 2(a)(3) of the Investment Company Act. Compensation includes anything the associated person believes of value at the time he receives it. "The precise value of the gratuity in the marketplace is of little importance." *U.S. v. Milken*, 759 F. Supp. 109, 120 (S.D.N.Y 1990).

[430] *Acceptance of Gifts or Entertainment by Fund Advisory Personnel—Section 17(e)(1) of the Investment Company Act*, IM Guidance Update (Feb. 2015); *Decker v. SEC*, 631 F.2d 1380 (10th Cir. 1980).

[431] *Id.*

matter, treats gifts and entertainment as "not substantial" if the annual aggregate value to any single person is less than $250.[432]

f. *Outside Business Activities.* Similarly, while not required by the rule, many advisers include in their code of ethics provisions regarding other business activities and interests of their supervised persons. Supervised persons' conflicts may affect their ability to make proper decisions on behalf of clients and are attributed to the adviser. SEC enforcement actions suggest that such provisions should address (i) permitted activities, (ii) approval of outside activities, (iii) when disclosure to clients may be required,[433] and (iv) the ongoing supervision of such activities.[434]

g. *Reporting Violations.* The code must require all supervised persons to promptly report any violations of the code to the adviser's CCO or other designated person.

The obligation applies to matters required to be a part of the code of ethics as well as those that are not, e.g., gifts and entertainment policies.

h. *Distribution and Acknowledgment.* The code must require the adviser to provide each supervised person with a copy of the code, and any amendments, and to obtain written acknowledgment from each supervised person of his receipt of a copy of the code.

i. *Recordkeeping.* Finally, the code of ethics must require the adviser to keep copies of the code, records of violations of the code and of any actions taken against violators of the code, and copies of each supervised person's acknowledgement of receipt of a copy of the code.

10. *Fraud Against Investors in Pooled Investment Vehicles*

Rule 206(4)-8 prohibits advisers from defrauding investors and prospective investors in pooled investment vehicles they advise.[435] The anti-fraud provisions of the Act (section 206(1) and (2)) prohibit advisers from defrauding "clients." A 2006 court decision created doubt about whether an investor in a pooled investment vehicle (*e.g.*, a hedge fund) is a "client" of the fund's adviser, and thus whether the SEC could

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[432] Department of Labor, Field Assistance Bulletin No. 2008-01 (Feb. 1, 2008).

[433] Disclosure of a supervised persons outside business activities may be required in the adviser's brochure supplement by Item 4 (Other Business Activities) of Part 2 of Form ADV.

[434] *See e.g., BlackRock Advisors, LLC*, Advisers Act Rel. No. 4065 (Apr. 20, 2015) (portfolio manager involved in family energy business that formed a joint venture with publicly traded company held by mutual fund and other clients of adviser); *Guggenheim Partners Investment Mgmt.*, *supra* note 269 (adviser failed to disclose executive's loan from a client that could have caused the executive to place the interests of the client over those of other clients).

[435] Rule 206(4)-8. *See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles*, Advisers Act Rel. No. 2628 (Aug. 3, 2007).

enforce these provisions against an adviser that defrauds the investors, but not the fund.[436]

a. *Prohibition on False or Misleading Statements*. Rule 206(4)-8 prohibits advisers to pooled investment vehicles from making any materially false or misleading statements to investors or prospective investors in those pools. Most of the fraud cases the SEC brings today against advisers to private funds include violations of this provision of the rule.[437]

b. *Prohibition of Other Frauds.* In addition, the rule prohibits advisers to pooled investment vehicles from otherwise defrauding the investors or prospective investors in those pools.[438] This provision is designed to apply more broadly to fraudulent conduct that may not involve statements.

c. *No Fiduciary Duty.* Rule 206(4)-8 does not create a fiduciary duty to investors or potential investors in a pooled investment vehicle not otherwise imposed by law, nor does it alter any duty or obligation an adviser has under the Advisers Act, or any state law or requirement to investors in a pooled vehicle.[439] In adopting the rule, the SEC explained that rule 206(4)-8 would, however, permit the SEC to enforce an adviser's fiduciary duty created by other law if the adviser fails to fulfill that duty by negligently or deliberately failing to make the required disclosure.

d. *Pooled Investment Vehicles.* Pooled investment vehicles include hedge funds, private equity funds, venture capital funds, and other types of privately offered pools that invest in securities, as well as investment companies that are registered with the SEC under the Investment Company Act.[440]

11. *Misuse of Non-Public Information*

Section 204A of the Act requires advisers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, non-

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[436] *Goldstein v. SEC*, *supra* note 144.

[437] *See, e.g.*, *F-Squared Investments, Inc.*, Advisers Act Rel. No. 3988 (Dec. 22, 2014) (misleading performance information).

[438] *See* *Western Asset Mgmt.*, Advisers Act Rel. No. 3762 (Jan. 27, 2014).

[439] An adviser to a hedge fund may have a separate advisory relationship with an investor in a hedge fund that it advises that gives rise to fiduciary obligations. *U.S. v. Lay*, 566 F. Supp. 2d 791 (N.D. Ohio 2008) *affd.* 612 F. 3d 440 (6th Cir. 2010); *SEC v. Lauer*, 2012 US App Lexis 7889 (11th Cir. 2012); *Goldenson v. Steffens*, 802 F. Supp. 2d 240 (D. ME) (2011).

[440] Rule 206(4)-8(b) provides that a "pooled investment vehicle" means any investment company as defined in section 3(a) of the Investment Company Act of 1940 or any company that would be an investment company under section 3(a) of that Act but for the exclusion provided from that definition by either section 3(c)(1) or section 3(c)(7) of that Act.

public information by the adviser or any of its associated persons,[441] including the misuse of material, non-public information about the adviser's securities recommendations and client securities holdings and transactions.[442] The provision applies to *all* advisers, including state-registered and unregistered advisers.[443]

Insider Trading. Illegal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information (MNPI) about the security. Insider trading violations may also include "tipping" such information, securities trading by the person "tipped," and securities trading by those who misappropriate such information. An adviser's insider trading may violate the Advisers Act if its trading breaches a duty to a client or disadvantages a client, but even when an adviser's clients benefit from the trading, insider trading will violate rule 10b-5 under the Exchange Act. Insider trading by advisers to hedge funds have been a significant focus of the SEC, as well as criminal authorities.

Information Barriers. When personnel of an advisory firm come into possession of MNPI (even unintentionally) about an issuer or security, such information will be imputed to the advisory firm, making it unlawful for the adviser to trade the securities or to *advise* clients to buy or sell the securities. The presumption is subject to an affirmative defense that (i) the individual making the investment decision (or providing the advice) is not aware of the MNPI, and (ii) the adviser had established and enforced a set of controls designed to ensure that individuals in the firm making investment decisions (or providing investment advice) are not doing so on the basis of MNPI.[444] These often include:

a. Information barriers designed to "wall off" groups of employees (or individual employees) with MNPI, allowing those employees on the "other side of the wall" to advise clients or trade securities freely;[445]

[441] The SEC has brought enforcement proceedings against advisers for violating section 204A. *See* *Wells Fargo Advisors, LLC*, Advisers Act Rel. No. 3928 (Sept. 22, 2014); *Institutional Shareholder Services, Inc.*, Advisers Act Rel. No. 3611 (May 23, 2013); *Gabelli & Co. Inc.*, Advisers Act Rel. No. 1457 (Dec. 8, 1994).

[442] *See also* *Investment Adviser Code of Ethics*, Advisers Act Rel. No. 2256 (July 2, 2004) ("We … remind advisers that they must maintain and enforce policies and procedures to prevent the misuse of material, non-public information, which we believe includes misuse of material, non-public information about the adviser's securities recommendations, and client securities holdings and transaction").

[443] *Marwood Group Research, LLC*, Advisers Act Rel. No. 4279 (Nov. 24, 2015) (state-registered adviser).

[444] Rule 10b-5-1(c)(2) under the Exchange Act.

[445] The information barrier procedures often require legal or compliance personnel to "chaperone" meetings of groups of employees who are otherwise on separate sides of the firm's firewall to assure information is not improperly conveyed. Failure to properly maintain an information barrier may result in a violation of Section 204A even in the absence of insider trading. *Janney Montgomery Scott*, LLC, Exchange Act Rel. No. 64855 (July 11, 2011).

b. Maintenance of restricted lists or blackout periods during which all employees (or only those employees with access to MNPI) are prohibited from trading a security once the adviser has obtained MNPI;

c. Enforcing trading restrictions and barriers by, among other things, monitoring trading of employees, requiring pre-clearance of trades, and surveillance of electronic communications among employees; and

d. Educating employees about insider trading and their obligations under the firm's policies and procedures governing MNPI.[446]

The design of the controls will turn on the size and structure of the adviser as well as the nature of the MNPI its employees is likely to receive.[447] Information barriers are likely to work better for larger firms while firm-wide trading restrictions might be necessary for smaller firms. Insider trading policies will often be a part of an adviser's code of ethics.

12. *Brochure Rule*

a. *Firm Brochure*. Rule 204-3, as amended in 2010, requires a registered adviser to prepare and deliver to clients a plain English, narrative brochure that contains all information required by Part 2A of Form ADV, including, among other things, the adviser's business practices, investment strategies, fees, conflicts of interest, and disciplinary information.[448] The adviser must deliver the brochure to a client before or at the time of entering into an advisory contract with the client, and must annually deliver to the client either (i) an updated brochure which contains or is accompanied by a summary of material changes, or (ii) a summary of material changes with an offer to deliver the updated brochure upon request.[449]

(1) *Non-Required Information.* Delivery of a brochure meeting the requirements of Part 2A does not necessarily satisfy an adviser's full disclosure obligation under the anti-fraud rules.[450] Accordingly, many advisers include additional information in their brochures.

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[446] *See* Staff Summary Report on Examinations Of Information Barriers (Sept. 27, 2012).

[447] *See, e.g.*, *SEC v. Charles Schwab Investment Mgmt.*, Lit. Rel. No. 21806 (Jan. 11, 2011) (settled civil action alleging an adviser to mutual fund failed to adopt insider trading policies designed to prevent employees with MNPI from redeeming shares of funds); *Wells Fargo Advisors, LLC, supra* note 441 (adviser's policies and procedures failed to require compliance personnel to share information about trading with other compliance group or management; adviser failed to implement policies and procedures by not following them); *Wolverine Trading, LLC*, Adv. Act Release No 4221 (Oct. 8, 2015) (information barrier policies were vague—executives were permitted access "above the wall" for unclear reasons contributing to failure to prevent misuse of MNPI).

[448] As discussed in Section V.B.2 of this outline, the adviser must also file with the SEC the brochure that it delivered to its client to satisfy its registration requirements under rules 203-1 and 204-1. The SEC staff has issued responses to FAQs on Part 2 of Form ADV.

[449] Rule 204-3(b)(1)&(2).

[450] Instruction 3 to Part 2 of Form ADV.

(2) *Exceptions to Delivery Obligation.* Advisers are not required to deliver a brochure (i) to investment company clients, or (ii) to clients for whom they provide only impersonal services for less than $500.[451]

(3) *Sub-advisers.* As a general matter, the SEC treats a sub-adviser as having the same obligations to a client under the Act as an adviser. The SEC staff has expressed the view that, under certain circumstances, the brochure delivery obligations of a sub-adviser that provides investment advice through an unaffiliated adviser that has discretionary authority to select and allocate client assets to the sub-adviser can be satisfied by delivery of the sub-adviser's brochure to the adviser.[452]

(4) *Private Funds*. The brochure must be delivered to private funds, even if it may mean delivering the brochure to the general partner of the fund (typically an affiliate of the adviser), since the fund could be deemed to be the "client" under the *Goldstein* decision.[453] The practical effect of this provision is to require that hedge fund brochures be available on the SEC's web site.[454]

While the brochure is not required to be delivered to investors in private funds, it may be advisable to provide them with a copy should a dispute later arise regarding whether an investor was provided all material information about the fund.

(5) *Electronic Delivery.* Advisers may deliver brochures electronically with client consent.[455]

(6) *Interim Updates.* Brochures must be updated (and filed with the SEC) between annual amendments *promptly* whenever any information in the brochure becomes materially inaccurate.[456] An adviser's obligations under

[451] Rule 204-3(c).

[452] Goldman Sachs & Co., SEC Staff No-Action Letter (June 20, 2013).

[453] *Goldstein v. SEC*, *supra* note 144.

[454] The SEC has stated that publication of an adviser's brochure discussing advisory services provided to a private fund would not jeopardize the ability of a fund to rely on the private offering exemption or the safe harbor provided in section 506 (now 506(b)) unless the information included in the brochure went beyond that which is required by Part 2 of Form ADV to include matters such as subscription instructions, performance information, and financial statements. Advisers Act Rel. No. 3060, *supra* note 176.

[455] *Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information*, *supra*, note 15 (publishing Commission interpretive guidance with respect to use of electronic media to fulfill investment advisers' disclosure delivery obligations).

[456] Instruction 4 to Part 2 of Form ADV. An exception is provided regarding the amount of the adviser's assets under management, which may change between annual updates.

the anti-fraud provisions of the act would require it to provide the updated information to clients.[457]

b. *Brochure Supplement.* Rule 204-3 also requires the adviser to deliver a brochure supplement that contains information about an advisory employee, including the employee's educational background, business experience, other business activities, and disciplinary history, to a client before or at the time the employee begins to provide advisory services to that client.[458]

(1) *Covered Employees*. An adviser (or its employee) must deliver a brochure supplement to clients for each employee who formulates investment advice for the client and has direct client contact; or makes discretionary investment decisions for the client even if the employee has no direct client contact.[459]

Options. Adviser required to deliver a brochure supplements for one or more advisory employees has the choice to (i) include the information required in the supplement in the adviser's own brochure, in which case no separate brochure supplement is required (an option suited to small firms); (ii) prepare and deliver a separate brochure supplement for each supervised person; or (iii) prepare and deliver a brochure for groups of employees (*e.g.*, one for each business unit).[460]

(2) *Exceptions to Delivery*. Advisers are not required to deliver a brochure supplement to a client: (i) to whom the adviser is not required to deliver a brochure; (ii) who receives only impersonal service; or (iii) who is an officer, employee or other persons related to the adviser that would be a "qualified client" under rule 205-3(d)(1) for purposes of charging a performance fee.[461]

(3) *Electronic Delivery.* Advisers may deliver brochure supplements electronically with client consent.

13. *Systemic Risk Reporting on Form PF*

Each registered investment advisers with at least $150 million in "private fund assets under management" must submit periodic reports on Form PF.[462] Advisers must file

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[457] Such updated information could be provided to clients in a "sticker" or "supplement" to the brochure (or even an email if the client has authorized electronic delivery of documents) so that brochure need not be reprinted.

[458] Rule 204-3(b)(3). The brochure supplements do not have to be filed with the SEC, but they are records required to be maintained by rule 204-2(a)(14). S*ee* Instruction 5 to Part 2 of Form ADV.

[459] *Id*. Note that if the investment advice is provided by a team comprised of more than 5 employees, only the 5 employees that have the most significant responsibility for the day-to-day advice to a client need to provide brochure supplements to that client. For more information, *see* Part 2 FAQs, *supra* note 176.

[460] Instruction 6 to Part 2 of Form ADV.

[461] Rule 204-3(c)(2).

[462] Rule 204(b)-1

Form PF electronically on a confidential basis. Form PF is designed, among other things, to assist the Financial Stability Oversight Council (FSOC) in its assessment of systemic risk in the U.S. financial system.[463]

a. *Determining Private Fund Assets under Management*

Private Fund Assets. For purposes of Form PF, private fund assets (or, "regulatory assets under management") must include assets attributable to investors, whether U.S. or non-U.S. investors, and any uncalled capital commitments. Private fund assets must be calculated on a gross basis. Advisers cannot subtract any outstanding indebtedness or other accrued but unpaid liabilities (including accrued fees or redemptions not yet paid out). Accordingly, borrowings to provide leverage will not reduce the amount of private fund assets.[464]

Similarly Managed Accounts. An adviser must aggregate "parallel funds," "dependent parallel managed accounts," and "master-feeder funds" (as those terms are defined in Form PF) it advises to determine whether the adviser meets the various reporting thresholds of Form PF. The form also requires that the adviser treat any private fund or parallel managed account advised by related persons as though it were advised by the adviser unless the related person is separately operated.[465]

b. *Reporting Obligations*

Smaller Private Fund Advisers. Advisers that manage at least $150 million of private fund assets, but less than the amounts that make them "large private fund advisers," complete only section 1 of Form PF.[466] They file annually within 120 days of the end of their fiscal year.

Section 1 requires, for each private fund, limited information about the size, leverage, investor types, investor concentration, liquidity and fund performance. This section also requires information regarding strategy, counterparty exposures, and use of trading and clearing mechanisms for each private fund that is a hedge fund.

[463] *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF*. Advisers Act Rel. No. 3308 (Oct. 2011) ("Form PF Adopting Release"). The SEC staff has responded to *FAQs about Form PF*. Form PF is filed through the IARD system, which charges a $150 filing fee.

[464] Instruction 5.b(4) and (5) to Form ADV.

[465] Instruction 5 of Form PF.

[466] The amount of private fund assets must be determined as of the last day of the most recently completed fiscal year. *See* Instruction 1.C. to Form PF. As a result, an adviser may report different amounts on its Form PF than on its Form ADV, which permits use of a more recently-determined RAUM.

Larger Private Funds Advisers. Three types of "large private fund advisers" that meet certain thresholds for assets under management based on investment strategy type are required to complete additional sections of Form PF.

(1) *Large Hedge Fund Advisers.* Advisers managing at least $1.5 billion in hedge fund assets must file quarterly within 60 days of their quarter end and, in addition to Section 1, must complete Section 2 of Form PF. For purpose of Form PF, a hedge fund is generally any private fund that has the ability to pay a performance fee to its adviser, borrow in excess of a certain amount, or sell assets short. A commodity pool must be treated as a hedge fund

Section 2a requires information about aggregate hedge fund assets the adviser manages, such as the value of investments in different types of assets, the duration of fixed income holdings, the value of turnover for certain asset classes and the geographical breakdown of investments. Section 2b requires, for each hedge fund that has net assets of at least $500 million, more granular information about the fund's exposures, leverage, risk profile, and liquidity.

(2) *Large Private Equity Fund Advisers.* Advisers managing at least $2 billion in private equity fund assets must file annually within 120 days of the end of their fiscal year (same as smaller advisers) and, in addition to Section 1, must complete section 4 of Form PF. A private equity fund is a private fund that is not a hedge fund, liquidity fund or a real estate fund or a venture capital fund (as those terms are defined in Form PF) and which does not provide redemption rights to its investors.

Section 4 of Form PF requires information about the extent of leverage incurred by funds' portfolio companies, use of bridge financing, funds' investments in financial institutions and geographical and industry breakdowns of funds' investments in portfolio companies.

(3) *Large Liquidity Fund Advisers.* Advisers managing at least $1 billion in combined unregistered and registered money market fund assets must file quarterly within 15 days of their quarter end and, in addition to Section 1, must complete Section 3 of Form PF.

Section 3 of Form PG requires information about each liquidity fund's portfolio, certain information relevant to the risk profile of the fund and the extent to which the fund has a policy of complying with all or some aspects of rule 2a-7 under the Investment Company Act.

c. *Non-U.S. Advisers*. A registered adviser with a principal office and place of business outside the U.S. may omit reporting of any private fund that, during the preceding fiscal year: (i) was not organized in the U.S.; (ii) was not beneficially owned by one or more U.S. persons; and (iii) was not offered in the U.S.[467]

[467] General Instruction 1 (last paragraph) to Form PF.

C. Substantive Requirements (Other Security Laws)

1. *Privacy of Client Information*

The privacy rules, codified in Regulations S-P, S-AM and S-ID require certain financial institutions, including advisers registered under the Advisers Act, to protect client information and to refrain from disseminating it without their consent.[468] Although the regulations, which the SEC administers jointly with the other financial regulators, generally refer to protection of "consumers," the term is defined to include clients of advisers.[469]

a. *Safeguarding Client Information (Regulation S-P)*

Rule 30 of Regulation S-P requires registered advisers to adopt written policies and procedures that address administrative, technical and physical safeguards for the protection of client records.[470] These policies and procedures must be reasonably designed to:

(1) Insure the security and confidentiality of client records and information;

(2) Protect against any anticipated threats or hazards to the security or integrity of client records or information; and

(3) Protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.[471]

The SEC has brought enforcement actions under Rule 30 against advisers (as well as broker-dealers) as a result of the theft of laptop computers containing customer

[468] Regulation S-P applies to all investment advisers that are registered with the SEC, regardless of whether their clients are U.S. persons or not U.S. persons, and regardless of whether they conduct their activities through U.S. or non-U.S. offices. Rule 248.1(b). While provisions of Regulation S-AM and S-ID (discussed below) do not address applicability to non-U.S. advisers, it can be presumed that the SEC will apply them to the same extent.

[469] Rule 248.3(g)(1)-(2). The term consumer information does not include aggregate information that does not identify a client. The privacy rules implement provisions of the Gramm-Leach-Bliley Act (15 USC 6801) and Fair Credit Reporting Act (15 USC 1681)("FCRA").

[470] Rule 30(a) implements Title V of the Gramm-Leach-Bliley Act and is applicable to registered investment advisers, as well as broker-dealers, and investment companies. Title V is codified at 15 U.S.C. 6801-6827. The SEC's rules implementing Rule 30(a) and the other privacy rules can be found at 17 CFR Part 248.

[471] 15 U.S.C. 6801(b). Violation of rule 30(a) may implicate Section 206 (breach of duty of care), Section 204A (required policies and procedures to prevent disclosure of material, nonpublic information), and rule 206(4)-7 (required compliance policies and procedures) under the Advisers Act. *See* Advisers Act Rel. No. 2204, *supra* note 378 ("We expect that an adviser's policies and procedures, at a minimum, should address safeguards for the privacy protection of client records and information."). There is no private right of action under Regulation S-P. *Dunmire v. Morgan Stanley DW, Inc.*, 475 F.3d 956, 960 (8th. Cir. 2007).

information,[472] and the downloading of customers data by a departing employee to use to solicit clients to move to a new firm,[473] and sharing customer information with a third party in connection with opening unauthorized brokerage accounts.[474] Most recently the SEC brought an action alleging that the adviser's controls on employee access to personal financial information were flawed and failed to prevent unauthorized access that ultimately led to public disclosure. Although the adviser discovered the data breach, the SEC, the SEC asserted that the adviser failed to audit its user controls or monitor for suspicious activities.[475]

Third Party Vendors. An adviser's obligations under Rule 30 include maintaining oversight procedures of third party vendors that have access to client personal financial information.

Reasonably Designed. The written policies and procedures must be reasonably designed to protect client records. The SEC recently settled a case with a broker-dealer whose policies and procedures failed to address methods by which the broker received sensitive client information, in this case via eFaxes and personal email accounts of employees.[476]

Cybersecurity. The SEC has brought enforcement actions against advisers for failing to take adequate precautions to prevent unauthorized access to electronic client records.[477] Examination of advisers' cybersecurity compliance and controls is currently a priority for the SEC staff,[478] which issued a report in February 2015 on a 2014 examination sweep it conducted of broker-dealers and investment advisers. The report, among other things, discusses the types of cybersecurity controls firms deploy to prevent, detect and respond to data breaches.[479] Subsequently, the Division of Investment Management issued guidance that

[472] Marc A. Ellis, Exchange Act Rel. No. 64220 (Apr. 7, 2001). *See also* Commonwealth Equity Services, Advisers Act Rel. No. 2929 (Sept. 29, 2009) (adviser recommended—but did not require—that its registered representatives maintain antivirus software on their computers).

[473] Stephen Derby Gisclair, Advisers Act Rel. No. 3703 (Oct. 23, 2013); David C. Levine, Exchange Act Rel. No. 64222 (Apr. 7, 2011). *See discussion infra.*

[474] Gilford Securities, Inc., Exchange Act Rel. No. 65450 (Sept. 30, 2011).

[475] *Morgan Stanley Smith Barney*, Advisers Act. Rel. No. 4415 (June 8, 2016). The employee involved was convicted of a violation of exceeding his authorized access to a computer and thereby obtaining information contained in a financial record of an institution, in violation of 18. U.S.C. 1030(a)(2)(A).

[476] Craig Scott Capital LLC, Exchange Act Rel. No. 77595 (April 12, 2016). The SEC also alleged that the employees failed to implement the broker-dealer's policies by neglecting to encrypt customer records transmitted to laptops.

[477] *R.T. Jones Capital Equities Mgmt., Inc.*, Advisers Act Rel. No. 4204 (Sept. 22, 2015) (hackers gained access to personal client data stored on third-party hosted web server); LPL Financial Corp., Advisers Act Rel. No. 2775 (Sept. 11, 2008) (hackers gained access to client accounts and placed or attempted to place trades); Commonwealth Equity Services, *supra* note 472.

[478] "Examination Priorities for 2015," Office of Compliance Inspections and Examinations.

[479] "Cybersecurity Examination Sweep Summary," Office of Compliance Inspections and Examinations (Feb. 13, 2015).

suggested that investment advisers address cybersecurity risk, to the extent relevant by:

(1) Conducting periodic assessments of cybersecurity vulnerabilities, security controls and processes in place, the impact of breaches and the effectiveness of the adviser's management of cybersecurity risk;

(2) Creating a strategy to prevent, detect and respond to cybersecurity threats by, for example, limiting access to data management systems encrypting data, restricting use of removable storage media and monitoring for the unauthorized intrusion or downloading of sensitive information, data backup and retrieval protocols and developing an incident response plan;

(3) Writing policies and training employees about measures to prevent, detect and respond to threats.[480]

Rule 30 reiterates the statutory obligations of advisers under the Gramm-Leach-Bliley Act. The SEC has yet to adopt more specific safeguarding standards it proposed in 2008, including standards for responding to data security breaches.[481]

b. *Restrictions on Sharing Client Information (Opt Out Rights)*

Rule 10 of Regulation S-P prohibits a registered adviser from disclosing nonpublic personal information it collects from clients to non-affiliated third parties unless they notify their customers of their right to opt out of such disclosure and provide them with a reasonable opportunity to opt out.[482] Rule 10 protects only individuals' personal privacy interests, and not those of businesses or individuals who seek to obtain the services of an adviser for business purposes.[483]

[480] "Cybersecurity Guidance," IM Guidance Update (Apr. 2015). The SEC has since cited failure to take these types of precautions as the basis for an enforcement action under Rule 30. *R.T. Jones Capital Equities Mgmt., Inc.*, *supra* note 477.

[481] Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Personal Information, Advisers Act Rel. No. 2712 (Mar. 4, 2008). Such rules have been adopted by the other financial regulators. Many of the elements of the proposed standards have, however, found their way into "suggestions" made by OCIE and other SEC staff.

[482] Rule 248.10. *See* *Maximillian Santos*, Advisers Act Rel. No. 4346 (Feb 29, 2016) (associated person of adviser aided and abetted violation of Rule 10 by sharing non-public personal information of clients with an unaffiliated broker-dealer while failing to disclose and provide opportunity to opt out). The SEC staff has posted responses to FAQs about Regulation S-P.

[483] *See* rule 248.3(g)(1). The rules apply to SEC-registered advisers. Rule 248.1(b). Advisers that are unregistered (including exempt reporting advisers) or are registered only with the states are subject to privacy regulations administered by the Consumer Financial Protection Bureau ("CFPB"). The CFPB's rules are slightly different from the SEC's, but the CFPB views compliance with SEC rules by advisers that are not registered with the SEC as compliance with its rules. 65 FR 33649 (2000).

(1) *Notices*

Initial Notice. An adviser must provide individual clients an *initial* notice of the adviser's privacy policies, including a right to opt out.[484] The initial notice must be provided no later than when the client enters into an advisory contract.[485] Notices must be clear and conspicuous, *i.e.*, reasonably understandable and designed to call attention to the nature and significance of the notice.[486]

Annual Notice. As long as the advisory relationship continues, the adviser must provide individual clients an annual notice of its privacy policies and opportunity to opt out *unless* (i) its policies regarding disclosure of non-public personal information has not changed since the last notice sent clients, and (ii) the adviser does not disclose nonpublic personal information of clients other than as permitted without the notice or consent of clients (*see* below).[487]

Model Form. The SEC has adopted a two-page model form that advisers may choose to use to satisfy the initial and annual notice disclosure requirements. Use of the form provides advisers with a "safe harbor" for the content of the required notice under the privacy rules.[488]

(2) *Opt-Out.* An adviser must provide clients with an opportunity to "opt out" or block the adviser from sharing "non-public" personal financial information with nonaffiliated third parties.[489] A client's decision to block information sharing is effective until it is revoked in writing.[490] A client's decision to consent to disclosure may be revoked at any time.[491]

"*Non-public personal information*" includes "personally identifiable financial information" and any list, description, or other grouping of clients derived

[484] Rules 248.4(a).

[485] Rule 248.4(a), (c)(3)(iii).

[486] Rule 248.6. Notices must include, among other things: (i) categories of non-public personal information the adviser collects; (ii) categories of information the adviser shares; (iii) categories of affiliates and non-affiliates with which the adviser shares the information; and (iv) the adviser's policies and practices for protecting the confidentiality and security of information.

[487] Rule 248.5(a). The annual notice requirement in Rule 428 was amended on December 4, 2015 by Section 75001 of the FAST Act, *supra* note 129, to circumscribe the circumstances under which advisers must provide each client an annual privacy notice.

[488] Rule 248.2, *adopted in*, Final Model Privacy Form under the Gramm-Leach-Bliley Act, Advisers Act Rel. No. 2950 (Nov. 16, 2009) ("2009 Adopting Release").

[489] Rule 248.10.

[490] Rule 248.7(g).

[491] Rule 248.7(f).

such information, *e.g.*, a client list.[492] It does not include information the adviser reasonably believes is lawfully made available to the general public from government records, widely distributed media or public disclosures required by law.[493]

"*Personally identifiable financial information*" includes information (i) a client provides to an adviser that results from services the adviser provides to the client and (ii) an adviser otherwise obtains about the client in connection with providing advisory services.[494]

Exceptions. An adviser can share personally identifiable financial information without obtaining an opt out from a client in three circumstances:

(A) the information is provided to an affiliate, but the affiliate may disclose the information only to the extent the adviser could under its own policies;[495]

(B) the adviser shares the information to service providers (*e.g.*, to a broker, transfer agent, or lawyer) in the course of providing advisory services to the client with the client's consent, or as required by law;[496] or

This provision permits an adviser to share client information, for example to open a custodial account for a customer and direct the execution of trades to a broker-dealer without obtaining client consent.

(C) the adviser shares the information with a non-affiliate that performs services, including marketing, for the adviser, but the adviser must have entered into a contract with the service provider that prohibits it from using the information except for the purpose for which it is received.[497]

Departing Adviser Representatives. A number of cases under Regulation S-P have involved employees or executives of advisers (and broker-dealers) who have taken "their" client files with them to new jobs. In each case, the SEC or court concluded that such transfer was prohibited by the privacy rules unless client

[492] Rule 248.3(t). If an adviser has determined that information is relevant for providing investment advice, then the information is deemed to be "financial" even if, as in the case of medical or health information, it is not intrinsically "financial." 2009 Adopting Release, *supra* note 488.

[493] *See* Rule 248.3(v).

[494] Rule 248.3(u)(1). Personally identifiable information includes client lists derived from information provided by a client, as well as the fact that a person is a client.

[495] Rule 248.11(b)(1).

[496] Rule 248.14. *See* also rule 248.15 for other examples of when the adviser can share information without obtaining an opt out from a client. Third parties receiving client information under these exceptions are generally prohibited from disclosing the information they have received except to the adviser's affiliates, the third party's affiliates, and to other parties in the regular course of business. Rule 248.11.

[497] Rule 248.13.

consent was first obtained.[498] The SEC proposed, but has never adopted, an exemption under which a departing employee could take limited client records to the employee's new firm.[499]

c. *Proper Disposal of Client Information*

A registered adviser must adopt written procedures reasonably designed to protect client records and information, and to dispose of such records properly.[500] The records covered by this provision include only records that identify individuals.

d. *Affiliated Marketing Rules (Regulation S-AM)*

Regulation S-AM (the "Affiliated Marketing Rule") allows a client, in certain limited situations, to block affiliates of an adviser from soliciting the client, if the solicitation is derived from certain private information that the adviser has shared with the affiliate.[501] Unlike Regulation S-P, Regulation S-AM does not restrict the ability of the adviser to share information; instead, it limits the ability of adviser's affiliate to use "eligibility information" received from the adviser to make a "marketing solicitation" to the client.[502]

(3) *Scope*. The affiliated marketing rule applies to all registered investment advisers and their "affiliates," which are persons that are related by common ownership or common control.[503] These are the same affiliates that

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[498] *See*, e.g., *Stephen Derby Gisclair*, Advisers Act Release No. 3703, *supra*, note 473; *David C. Levine*, Exchange Act Release No. 64222, *supra*, note 473; *Stevens v. Interactive Financial Advisors*, 2015 WL 791384 (N.D. Ill. Feb. 24, 2015); *In re S.W. Bach & Co*., 435 B.R. 866, 891-892 (Bankr. S.D.N.Y 2010). The exception in Rule 284.14 for transfer of accounts is unavailable unless the adviser has obtained the clients' affirmative consent to the transfer. Frederick O. Kraus, Exchange Act Rel. No. 64221 (Apr. 7, 2011). The SEC has asserted that a broker-dealer recruiting representatives from other brokerage firms and encouraging them to transfer records without client consent "aided and abetted" and "caused" the other broker-dealer's failure to safeguard customer information. NEXT Financial Group, Inc. Initial Decision Rel. No. 349 (June 18, 2008).

[499] Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Personal Information, Advisers Act Rel. No. 2712 (Mar. 4, 2008).

[500] Rule 30(b). The release adopting this provision contains examples of reasonable disposal methods. Disposal of Consumer Report Information, Advisers Act Rel. No. 2332 (Dec. 2, 2004). The SEC has brought enforcement actions against investment advisers that failed to adopt procedures reasonably designed to protect client records and information. *See* LPL Financial Corporation, Advisers Act Rel. No. 2775 (Sept. 11, 2008), *supra* note 477; J.P. Turner & Company, LLC, Initial Decision Rel. No. 395 (May 19, 2010) (customer records left on curbside).

[501] The Affiliated Marketing Rule implements Section 624 of the FCRA. The rules were adopted in *Regulation S-AM: Limitations on Affiliate Marketing*, Advisers Act Rel. No. 2911 (Aug. 4, 2009). Unregistered and state-registered advisers are subject to similar rules adopted by the CFPB.

[502] Unlike Regulation S-P, there is a private right of action under the Fair Credit Reporting Act, for violation of Regulation S-AM. *See* Sections 616 and 617 of the FCRA. Accordingly, an adviser could be liable to a client if its affiliate uses eligibility information to make a solicitation if the adviser failed to comply with the regulations.

[503] Rule 248.120(a) and (h) (defining the term "control"). The definition is slightly different from the definition in Regulation S-P, but the SEC does not believe that there is a substantive difference.

Regulation S-P permits advisers to share non-public personal financial information with without client consent.

(4) *Marketing Solicitation.* A marketing solicitation is marketing initiated by the affiliate based on "Eligibility Information" that is designed to encourage the client to purchase the affiliate's products or services.[504] It excludes general advertisements.

(5) *Eligibility Information.* Eligibility Information includes information about a client's credit standing, character, reputation, personal characteristics and mode of living, as well as transaction or experience information, such as information about his or her account history and information from his or her account application.[505]

While the definition is designed primarily for banking institutions, it covers the account information an adviser will typically have, including information from its client it acquired for determining "suitability" of investment advice.

(6) *Disclosure and Opt Out.* An affiliate that receives information may not use that information to make a marketing solicitation to the adviser's clients unless (i) the potential marketing use of the information has been disclosed to the client in writing, (ii) the client has been provided reasonable opportunity to opt out of receiving the solicitation, and (iii) the client has not opted out.[506]

Scope and Duration of Opt Out. The client must be given the option of opting out of receiving marketing information from all affiliates. A client's decision to opt out is effective for a period of at least 5 years, and can be extended by the client. A client that opts out can revoke his decision at any time.[507]

Exceptions. The restrictions do not apply if the affiliate uses the eligibility information (i) to solicit a client with which the affiliate has a pre-existing business relationship; (ii) to communicate to a person for whose benefit the affiliate provides employee benefits; (iii) to perform services for another affiliate; (iv) in response to a communication initiated by the client; (v) in response to an affirmative authorization or request by the client orally; or (vi) if the adviser's or affiliate's compliance with the notice and opt-out requirements would prevent it from complying with certain state insurance laws.[508]

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[504] Rule 248.120(o).

[505] Rule 248.120(j); Section 603(d) of the FCRA.

[506] Rule 248.121(a). The disclosure and opt out notices may accompany disclosure and opt out notices provided in privacy notice under Regulation S-P. The SEC has adopted a model form.

[507] Rules 248.121(a), 122(b) and 122(c).

[508] Rule 248.121(c).

2. *Identity Theft Red Flags (Regulation S-ID)*

Regulation S-ID requires certain *registered* investment advisers to prepare a program designed to prevent identity theft ("Red Flags Rules").[509]

a. *Scope of Rule*. The Red Flags Rules apply only to registered advisers that are either "financial institutions" or "creditors,"[510] and only as to "covered accounts."[511]

(1) An adviser is a "financial institution" if it holds "transaction accounts," of "consumers" which are accounts that permit clients to make direct or indirect payments to third parties.[512] "Consumers" are defined as individuals, and thus an adviser without individual clients is not a "financial institution."[513] An adviser that provides bill paying services, for example, to individual clients would be a financial institution and subject to the rule (and it may have custody over those assets).

(2) An adviser is a "creditor" if it regularly extends or carries credit for any of its clients, including institutional clients.[514]

(3) If an adviser is a financial institution or creditor, its program need apply only to "covered accounts," which are accounts that are either (i) primarily for personal, family, or household purposes and involve multiple payments, or (2) if not used for such purposes, nonetheless involve a reasonably foreseeable risk of identity theft.[515]

b. *Elements of an Identity Theft Program.* The Red Flags Rules require each adviser with covered accounts to instate a written identity theft program with four elements:[516]

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[509] Regulation S-ID is codified in 17 CFR 248. 201-202. The rules were adopted pursuant to Section 1088(a)(10)) of the Dodd-Frank Act, which, among other things, amended Section 615(e) of the FCRA, to require the SEC to adopt rules protecting against identity theft of consumer information. Before Dodd-Frank, investment advisers were subject to similar rules administered by the Federal Trade Commission. Regulation S-ID was adopted in Identity Theft Red Flags Rules, Advisers Act Rel. No. 3582 (Apr. 10, 2013). The rule also applies to broker-dealers, and thus an investment adviser also acting as a broker-dealer may be covered as a result of its brokerage activities. Rule 248.201(a)(1).

[510] Rule 248.201(a)(3). Even if an adviser does not maintain any covered accounts, the rule requires an adviser to periodically review its accounts to determine whether it does. Rule 248.201(c).

[511] Rule 248.201(b)(3).

[512] Rule 248.201(b)(7) (defining "financial institution" by reference to Section 603(t) of the FCRA).

[513] *See* definition of "Consumer" in Section 603(b) of the FCRA.

[514] Rule 248.201(b)(5) (defining "creditor" by reference to Section 615(e)(4) of the FCRA).

[515] Rule 248.201(b)(3).

[516] Rule 248.201(d)(2). The SEC has published guidelines that must be considered by an adviser in implementing its program. Appendix A to 17 CFR Part 248.

(1) Procedures and policies designed to identify possible red flags relevant to the business of the adviser. A "red flag" is "a pattern, practice, or specific activity that indicates the possible existence of identity theft."[517]

(2) Detect red flags.

(3) Respond appropriately to any red flags detected to prevent and mitigate identity theft.

(4) Update program periodically to reflect changed risks of identity theft.

3. *Beneficial Ownership Reporting on Schedules 13D and 13G*

Schedule 13D. Persons, including advisers, that acquire "beneficial ownership" of 5% or more of shares of a voting class of security registered under Section 12 of the Exchange Act (generally securities publicly traded on a U.S. securities exchanges) must file Schedule 13D with the SEC (unless they are eligible to file Schedule 13G) within 10 days of the transaction that caused the person to hold more than 5%.[518] The requirement is designed to notify the company and markets that an investor has accumulated a substantial amount of voting securities and the intentions of the investor. Schedules 13D and G must be filed electronically, via the SEC's Electronic Data Gathering, Analysis and Retrieval system ("EDGAR") (rather than the IARD system).[519]

Beneficial Ownership. A person has beneficial ownership of a security if he, directly or indirectly (by contract, agreement, understanding, relationship or otherwise), has or shares (i) authority to vote a security, or (ii) investment power over the securities, including the right to acquire a security within 60 days.[520] More than one person may be a beneficial owner of the same securities.

a. *Discretionary Authority*. An adviser will ordinarily have beneficial ownership of securities held in proprietary accounts as well as client accounts over which it has discretionary authority, including registered investment companies and private *funds.[521] An adviser must aggregate these holdings to determine whether it has a*

[517] Rule 248.201(b)(10).

[518] Rule 13d-1(a) under the Exchange Act. The day after the trade date is treated as day number one. Section 929R of the Dodd-Frank Act eliminated the requirement that the investor deliver a copy of the Schedule to the issuer of the security and the securities exchanges on which the security is traded, and permitted the SEC to shorten the 10 day filing window. The SEC has announced that it will no longer enforce the delivery requirements, but has not yet proposed to amend the rule to shorten the window.

[519] The SEC recently brought several settled against investment advisers (and others) for failure to timely file Schedule 13D or 13G. *See, e.g.*, *P.A.W. Capital Partners, L.P.*, Exchange Act Rel. No. 73038 (Sept. 10, 2014); *Ridgeback Capital Mgmt. LP*, Securities Exchange Act Rel. No. 73032 (Sept. 10, 2014).

[520] Rule 13d-3.

[521] S*ee* *William R. Grant*, Exchange Act Rel. No. 26339 (Dec. 5, 1988) (adviser failed to disclose securities over which it had discretionary authority); *Gabelli Group, Inc.*, *et al.*, Exchange Act Rel. No. 26005 (Aug. 17, 1988) (adviser failed to disclose securities held by two closed-end funds it advised).

filing obligation, and thus may have a filing obligation even if each of its clients would not.[522]

b. *Control Persons and Parent Companies*. Persons who control the adviser, including parent companies, have indirect beneficial ownership of securities held in the adviser's proprietary and client accounts and must generally aggregate positions they hold with those indirectly held through the adviser.[523]

c. *Groups*. Persons acting in concert for purpose of acquiring, holding, disposing, or voting securities are treated as a single beneficial owner, and the resulting group is required to file a Schedule 13D even if each member of the group owns less than 5%.[524] No formal agreement to act is necessary; a group may be inferred by conduct.[525]

As a consequence of the beneficial ownership rules, multiple persons may be required to file Schedule 13Gs reporting ownership of the same securities. For example, a hedge fund, its general partner, its adviser and a control person of the adviser may all be required to report the same position. As discussed below, in many cases a single Schedule 13G may be filed for all.

Schedule 13G. SEC-registered advisers are "Qualified Institutional Investors" under SEC rules and may, in lieu of Schedule 13D, submit reports on Schedule 13G.[526] Schedule 13G requires substantially less information, and is generally not required to be filed until 45 days after the end of the calendar year in which the adviser becomes

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[522] Rule 13d-3(c). A client granting beneficial ownership of securities to an adviser will continue to have beneficial ownership of the securities if it may regain voting and investment authority over the shares by terminating the adviser's authority. *See* Rule 13d-3(d)(1) and Staff Compliance and Disclosure Interpretations, Question 105.04. Each client alone, however, may not have sufficient ownership to trigger the filing of a Schedule 13D.

[523] The SEC has suggested, however, that beneficial ownership held by a subsidiary, a related person, or a unit within the firm may not have to be attributed to the parent, adviser, or other units (either for reporting or determining whether the 5% threshold has been reached) if effective information barriers have been created such that voting and investment decisions are exercised independently. *Amendments to Beneficial Ownership Reporting Requirements*, Exchange Act Rel. No. 39538 (Jan. 12, 1998). The SEC explained that when an adviser relies on information barriers to avoid attributing ownership, the various business units should maintain and enforce policies and procedures reasonably designed to prevent the flow of information to the other business units, and should obtain an annual independent assessment of their operation. *See* section VI.B.11.a. of this outline.

[524] Rule 13d-5(b)(1). S*ee* *Roth v. Jennings*, 489 F.3d 499 (2d Cir. 2007) (discussing requirements for formation of a group under section 13(d)). *See also* Staff Compliance and Disclosure Interpretations, Question 105.6. Each member of the group would not, however, have a separate filing obligation.

[525] *Wellman v. Dickinson*, 862 F.2d 355 (2nd Cir. 1982).

[526] Rule 13d-1(b)(1). Advisers filing Form 13G must file an annual amendment within 45 days after the end of each calendar year if there are any changes in the information reported in the previous filing (subject to certain exceptions). Rule 13(d)-2(b). In addition, advisers must amend Schedule 13D promptly upon acquiring beneficial ownership of 10% of a class of equity securities, and must thereafter promptly amend the Schedule 13G upon increasing or decreasing its beneficial ownership by more than 5%. Rule 13(d)-2(d)

a 5% beneficial owner.[527] Only holdings that exceed the 5% threshold as of the end of the calendar year must be reported. A separate filing is made with respect to each reportable position in a class of equity securities.

a. *Eligibility*. An adviser must have (i) acquired the securities in the ordinary course of its business, and (ii) not with the purpose or effect of changing or affecting control of the company.[528] Once eligibility is lost, the adviser must begin filing on Schedule 13D.[529]

b. *Joint Filings.* A single Schedule 13G can be used to report on behalf of multiple persons as long as each reporting person is a Qualified Institutional Investor. Schedule 13G will often be filed by a parent holding company on behalf of its control persons, investment adviser subsidiaries, and clients of the adviser (*e.g.*, investment companies) that have reporting obligations because they hold 5% positions.[530]

c. *Private Funds*. Private funds are not Qualified Institutional Investors. Accordingly many advisers to private funds file Schedule 13G as "passive investors," an approach available for investors that meet the eligibility criteria discussed above in paragraph (a), but are not among the institutions listed in the rule. This approach is available only to investors that have beneficial ownership of less than 20%, and requires investors to file within 10 days of acquiring 5% beneficial ownership.[531] An adviser filing as a passive owner may file jointly with the private funds they advise.

d. *Non-U.S. Advisers.* Advisers that are not U.S. persons are subject to the filing requirements.[532]

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[527] Rule 13d-2(b). If, however, the ownership interest exceeds 10% on the last day of any month (other than December), it must make its initial filing within 10 days after the end of the month.

[528] Rule 13d-1(b). *See* *Perry Corp.*, Exchange Act Rel. No. 60351 (July 21, 2009) (shares are not held in the "ordinary course" when an adviser is acquiring ownership of securities for the purpose of influencing the direction or management of the issuer or influencing the outcome of a transaction; thus the adviser is not eligible to file Form 13G).

[529] *See* *Lazarus Management Company LLC.* Exchange Act Rel. No. 73039 (Sept. 10, 2014) (settled administrative action alleging adviser failed to resume filing Schedule 13D following loss of eligibility for Schedule 13G).

[530] A parent company or control person that is not otherwise a Qualified Institutional Investor can use Schedule 13G only if the aggregate amount of securities held directly or indirectly by the parent or control person is no more than 1% of the class of securities of the issuer. Rule 13d-1(b)(1)(ii)(G).

[531] Rule 13d-1(c).

[532] *Montagu Investment Mgmt. Limited*, Exchange Act Rel. No. 19591 (Mar. 10, 1983) (settled enforcement proceeding against a U.K. investment adviser that failed to file Schedule 13D required as a result of beneficial ownership of securities held by a U.K. investment trust).

4. *Institutional Investor Reporting on Form 13F*

An SEC-registered investment adviser that has investment discretion over at least $100 million in "section 13(f) securities" must file Form 13F listing those positions.[533] The filing must be made quarterly with the SEC through the SEC's EDGAR system. This requirement was designed "to create a central repository of historical and current data about the investment activities of institutional investment managers" to assist investors and regulators.[534]

Control Persons. A persons controlling an adviser having discretionary authority over section 13(f) securities is deemed to have discretionary authority over such securities.[535] As a result, a person controlling multiple advisers may have an obligation to file Form 13F because it and the advisers it controls collectively have discretionary authority over $100 million of section 13(f) securities even if some or all of the advisers it controls do not. Only one of the advisers must file Form 13F, and can report aggregate holdings for all the advisers having a filing obligation under section 13(f).

Section 13(f) Securities. These primarily include equity securities traded on U.S. exchanges (*e.g.*, NYSE, NASDAQ), shares of closed-end investment companies and ETFs.[536] Form 13F must be filed electronically via the SEC's EDGAR system within 45 days after the end of each calendar quarter. Form 13F reports must identify, among other things: (i) the name of the issuer; (ii) the number of shares owned; and (iii) the fair market value, as of the end of the quarterly filing period, of the reported securities.[537]

Confidential Treatment. Section 13(f) of the Exchange Act authorizes the SEC to grant confidential treatment or delay of disclosure where the disclosure would (i) identify securities holdings of a natural person, or (ii) reveal the adviser's program of acquisition or disposition of a security the disclosure of which would cause substantial harm to the strategy.[538] The SEC also grants confidential treatment where the information might otherwise qualify for one or more exemptions under the

[533] Section 13(f) of the Exchange Act; rule 13f-1(a) under the Exchange Act. Form 13 F can be found here. *See Quattro Global Capital, LLC*, Advisers Act Rel. No. 2634 (Aug. 15, 2007) (adviser failed to file Form 13F); *Cabot Money Mgmt. Inc.*, Advisers Act Rel. No. 1577 (Aug. 15, 1996).

[534] S. Rep. No. 94-75, 94th Cong., 2d Sess. 82-85 (1975).

[535] Rule 13f-1(b).

[536] "Section 13(f) securities" also include certain equity options and warrants, and some convertible securities. Shares of open-end investment companies are not "section 13(f) securities." Rule 13f-1(c). Each quarter, the SEC publishes a list of section 13(f) securities to assist institutional investment managers in the preparation of their Form 13F filings.

[537] The Division of Investment Management has published a FAQ regarding Form 13F ("13F FAQs").

[538] Section 13(f)(4) of the Exchange Act.

Freedom of Information Act (FOIA), typically for trade secrets or other types of confidential commercial information.[539]

Non-U.S. Advisers. Non-U.S. investment advisers must file Form 13F if they (i) use any means or instrumentality of United States interstate commerce in the course of their business; and (ii) exercise investment discretion over $100 million or more in section 13(f) securities.[540]

5. *Large Trader Reporting on Form 13H*

An investment adviser that qualifies as a "large trader" must obtain a large trader identification number from the SEC, file and periodically update Form 13H, and disclose to each SEC-registered broker-dealer through which it trades its large trader identification number and all accounts to which that number applies.[541] These requirements are designed to assist the SEC in both identifying, and obtaining trading information on, market participants that conduct a substantial amount of trading activity.[542]

Large Trader. An adviser is a "large trader" if it exercises investment discretion over one or more accounts through which transactions in "national market system securities" are effected through one or more registered broker-dealers in amounts that, in the aggregate, amount to either: (i) 2 million shares or shares with a fair market value of $20 million during a calendar day; or (ii) 20 million shares or shares with a fair market value of $200 million during a calendar month.[543]

National Market System Securities. These securities include options and equity securities listed on the NYSE and Nasdaq, as well as equity securities listed on other U.S. national exchanges.[544] The scope of securities that fall under this definition is narrower than the scope of securities that trigger Form 13F filing.[545]

To comply, a large trader must file a Form 13H initial filing (via EDGAR) generally within 10 days after effecting aggregate transactions equal to or greater than the

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[539] *See* Letter from the Division of Investment Management to Section 13(f) Confidential Treatment Filers (June 17, 1988) (explaining circumstances under which confidential treatment will be granted).

[540] *See also* 13F FAQs at FAQ #4.

[541] *See* *Large Trader Reporting*, Exchange Act Rel. No. 34-64976 (July 27, 2011) ("LTR Release"). The Commission adopted rule 13h-1 and related Form 13H, as directed by section 13(h) of the Exchange Act, on July 27, 2011. Form 13H can be found here.

[542] *Id*.

[543] *See id*.

[544] *See* Regulation NMS, rule 600(b)(46), (47) and (82).

[545] *See supra* note 536 and accompanying text.

identifying activity level.[546] A large trader must then submit an annual filing within 45 days after the end of each calendar year, and must file an amendment no later than the end of the calendar quarter in which information became stale.[547]

Non-U.S. Advisers. Non-U.S. investment advisers that are "large traders under the rule" (*i.e.*, trades through SEC-registered broker-dealers) must comply with the rule's filing and disclosure requirements.[548]

Large traders were required to begin complying with the rule's requirements on December 1, 2011.[549]

6. *Broker-Dealer Registration*

A broker is generally defined in the Exchange Act to include "any person engaged in the business of effecting transactions in securities for the account of others."[550] A dealer is any person who is in the business of buying and selling securities for his own account, including through a broker.[551] There is no exemption for investment advisers and, absent another exemption, an adviser whose activities cause it to meet either definition must register as, or be associated with, a broker-dealer registered under the Exchange Act.

a. *Advisory Activities.* Some traditional advisory activities undertaken on behalf of clients such as transmitting orders to broker-dealers may be encompassed by the Exchange Act definitions. The SEC staff has not, however, required investment advisers to register as a broker-dealer if the adviser: (i) does not receive transaction-related compensation;[552] (ii) does not have possession of its client's

546 The form requires disclosure of, among other things, the large trader's contact information, its and its affiliates companies, businesses, the forms it and its securities affiliates file with the SEC, its organizational structure and legal form, and a list of broker-dealers with which it maintains accounts. *Id*.

547 *See* LTR Release, *supra*, note 541. A large trader may avoid updating filings if it obtains "inactive status" through a Form 13H filing by not having effected aggregated transactions in excess of the thresholds at any time during the previous full calendar year. *Id*.

548 In some cases, the laws of a non-U.S. jurisdiction may prevent a non-U.S. large trader (whether itself a broker-dealer or adviser) from disclosing certain personal identifying information of an underlying principal. In such cases, a foreign large trader or it representatives may request an exemption from the SEC pursuant to section 36 of the Exchange Act and subsection (g) of rule 13h-1. *Id*.

549 The rule also requires registered broker-dealers to monitor accounts for the purpose of identifying "unidentified large traders," capture certain information relating to all transactions on behalf of large traders and unidentified large traders that are effected directly or indirectly by or through it, and make such information available to the SEC through the already-established trade-reporting infrastructure, commonly referred to as the "electronic blue sheets." *Id*.

550 Section 3(a)(4)(A) of the Exchange Act.

551 Section 3(a)(5) of the Exchange Act. The definition includes securities-based swaps, but excludes other swaps.

552 Transaction-related compensation includes compensation that depends upon, or is related to, the outcome of size of a securities transaction, and include commissions, mark-ups, and finders fees. It may also include receipt from mutual funds of trail commissions or other ongoing payments, however characterized, if they compensate the adviser for sales activities. Although, the SEC appears to permit advisers to receive a .25% fee for from mutual

securities; and (iii) does no more than route the orders to an SEC-registered broker or a bank or trust company for execution.[553]

b. *Private Fund Distribution Activities.* Interests in private funds are considered to be securities, and promotional and sales activities on behalf of private funds by advisory personnel may require registration. Rule 3a4-1 under the Exchange Act provides a "safe harbor" from broker-dealer registration for an adviser that markets interests in a fund it manages.[554] However, the conditions of the rule are narrow, prohibit the payment of transaction-based compensation to employees, and limit the frequency of an offering.[555] There is significant uncertainty about the circumstances under which an adviser not using the services of a broker-dealer to distribute shares of a private fund making a continuous offering must register as a broker-dealer.[556]

c. *Private Equity Fund Deal Activities*. Advisers to private equity funds may be required to register as broker-dealers when they participate in and receive transaction fees in connection with the acquisition or disposition of portfolio companies. The SEC has recently brought an enforcement action against an adviser for failure to register as a broker-dealer involved in such a transaction without the participation of a broker-dealer.[557]

7. *Whistleblowers*

Section 21F of the Exchange Act directs the SEC to pay awards to eligible whistleblowers who provide the SEC with information that leads to a successful enforcement action, and prohibits investment advisers from retaliating against their employees for whistleblowing. Whistleblower protections were originally enacted by Congress in 2002 as part of the Sarbanes-Oxley legislation in response to the collapse

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funds for providing services to fund shareholders (*i.e*., answering questions and forwarding reports), receipt of payments in excess of this amount—even if offset by reduction of the adviser's own advisory fee—may require the adviser to register as a broker-dealer. The adviser's receipt of fees from a fund it recommends to clients also present the adviser with a conflict that must be disclosed to clients.

[553] *InTouch Global, LLC*, SEC Staff No-Action Letter (Nov. 14, 1995); *First Atlantic Advisory Corp*., SEC Staff No-Action Letter (Feb. 20, 1974).

[554] Rule 3a4-1 provides an exemption for an associated person of an issuer of securities, which in the case of a private fund may include a natural person who is a partner, officer, director or employee of the fund or the corporate general partner of the issue.

[555] *Ranieri Partners*, LLC, Exchange Act Rel. No. 69091 (Mar. 8, 2013) (settled enforcement action involving a consultant to an adviser to two real estate funds who solicited investors for a private fund and received transaction-based compensation).

[556] *See* "A Few Observations in the Private Fund Space," Speech by David W. Blass, Chief Counsel, SEC Division of Trading and Markets," ("Blass Speech") Apr. 6, 2013.

[557] *Blackstreet Capital Mgmt. LLC*, Advisers Act Rel. No 4411 (June 1, 2016) (settled order stating that sponsor adviser provided brokerage services to and received transaction-based compensation from portfolio companies, and thus was acting as an unregistered broker-dealer). It has been suggested by the SEC staff that an adviser that offsets its advisory fees by the amount of advisory transaction compensation may be able to avoid registration as a broker dealer. *See* Blass Speech, *supra* note 556.

of Enron,[558] and were expanded by the Dodd-Frank Act to, among other things, cover investment advisers (whether or not registered).[559]

a. *Bounty Program.* The SEC, at its discretion, may pay an award to any individual or group of individuals who voluntarily provide original information to the SEC that leads to its successful prosecution of an enforcement action under the federal securities laws, including the Advisers Act, resulting in monetary sanctions exceeding $1 million.[560] The awards may range from between 10% to 20% of the monetary sanctions the SEC obtains.

(1) *SEC Examinations.* An award may be paid for tips the SEC receives that cause it to open an examination or investigation, or tips it receives during an examination or investigation.[561] However, information provided to the SEC at the direction of the adviser or after a request was made to the employee by an SEC examiner or investigator is not considered "voluntary" and thus does not make the employee eligible for an award.[562]

(2) *Internal Reporting.* Whistleblowers are eligible for awards regardless of whether they report violations through internal reporting channels. SEC rules, however, provide certain incentives to encourage reporting internally, including a 120-day "look-back" provision under which a whistleblower will receive "credit" for reporting the information as of the date of the internal report.[563] An internal whistleblower will remain eligible for an award even if the adviser self-reports to the SEC.[564]

Limitations

(1) *Lawyers.* Information obtained through a communication subject to attorney-client privilege or obtained as a result of legal representation is not considered "original information."[565] This exception applies to both lawyers and non-lawyers who learn of the information through a confidential attorney client communication.

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[558] Advisers that are public companies may also be subject to the whistleblowing provisions of the Sarbanes-Oxley Act. This outline does not address those provisions, some of which are administered by the Department of Labor. Advisers to publicly offered investment companies may be subject to the Sarbanes-Oxley provisions. *See* *Lawson v. FMR, LLC*, 134 S. Ct. 1158 (2014).

[559] Section 922 of the Dodd-Frank Act.

[560] Section 21F(a)-(c).

[561] Rule 21F-4(c). While most of the awards have been given to firm employees, former employees, victims of fraud, professionals working in the same or related industries, and industry experts have also been given awards. *See* *SEC*, 2016 Annual Report to Congress on the Dodd-Frank Whistleblower Program, (Nov. 15, 2016).

[562] Rule 21F-4(a)(3). An employee interviewed in an internal investigation, however, would be eligible for an award.

[563] Rule 21F-4(b)(7).

[564] Rule 21F-4(c)(3).

[565] Rule 21F-4(b)(4)(i). There are narrow exceptions, such as when privilege is waived.

(2) *Officers and Internal Compliance and Audit Staff.* Officers, directors trustees, and partners as well as other personnel of the adviser having internal audit or compliance responsibilities must (with some exceptions) first internally disclose misconduct and then wait 120 days before reporting the misconduct to the SEC.[566] The 120 day period is designed to give the adviser an opportunity to investigate the matter and, if appropriate, self-report any misconduct.[567]

(3) *Persons Involved in the Misconduct.* Whistleblowers are often employees involved in the misconduct. They are nonetheless eligible for awards unless criminally convicted for the misconduct.[568] Becoming a whistleblower does not provide amnesty from an SEC enforcement action, but the SEC may take it into consideration in determining whether to bring an action and the penalties it seeks against the whistleblower.[569]

b. *Anti-Retaliation Provisions.* Advisers and other employers are prohibited from discharging or otherwise retaliating against an employee who provides information to the SEC.[570] The SEC takes the position that internal whistleblowers are protected as well even if they never report to the SEC.[571] The protections apply regardless of whether the employee qualifies as a whistleblower for the purpose of obtaining an award, and as long as he or she has a reasonable belief that the information provided relates to a *possible* securities law violation that has occurred, is occurring or is about to occur.[572]

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[566] Rule 21F-4(b)(4)(iii)-(v). The SEC issued an award in 2015 to a compliance officer who reported the misconduct to the SEC after the company failed to take action on an internal report. Exchange Act Rel. No. 72947 (Aug. 29, 2014).

[567] Such whistleblowers need not wait 120 days who have a reasonable basis to believe either that (i) reporting misconduct was necessary to prevent the adviser from engaging in conduct that was likely to cause substantial injury to the financial interests or property of [clients], or (ii) the adviser is impeding an investigation of the misconduct. *See* Exchange Act Release No 74781 (Apr. 22, 2015) at n.1 (compliance officer received award without reporting misconduct).

[568] Rule 21F-8(c)(3). *See, e.g., Paradigm Asset Mgmt. supra* n.244 (whistleblower alleging unlawful trading was head trader of adviser).

[569] Rule 21F-15. Participation in misconduct may also cause the SEC to reduce the amount of an award. *See* Exchange Act Rel. No. 80115 (Feb. 28, 2017) (award reduced to 20% of monetary sanctions because of whistleblower's culpability and delay in reporting).

[570] Section 21F(h)(1)of the Exchange Act.

[571] *Interpretation of the SEC's Whistleblower Rules under Section 21F of the Securities Exchange Act of 1934*, Exchange Act Rel. No. 75592 (Aug. 4, 2015). The federal courts are split over whether protections extend to internal whistleblowers. *Compare Asadi v. G.E. Energy (USA), LLC*, 720 F.3d 620 (5th Cir. 2013) with Berman v. Neo@ogilvy LLC, 801 F.3d 145 (2nd Cir. 2015) and *Sommers v. Digital Reality Trust Inc.*, No 15-17352 (9th Cir. Mar. 8, 2017) (deferring to SEC's interpretation). *See also Sandridge Energy, Inc.* Exchange Act Rel. No. 79607 (Dec. 20, 2016) (settled enforcement action alleging retaliation against an internal whistleblower).

[572] Rule 21F-2(b). A whistleblower may be mistaken in believing that a securities violation had occurred, yet still be protected from retaliation if the belief was objectively reasonable. *Beacom v. Oracle Am., Inc.*, 825 F.3d 376 (8th Cir. 2016).

Retaliation. Retaliation includes firing, demoting, suspending, threatening, harassing, "directly or indirectly, or in any other manner discriminating against a whistleblower in the terms or conditions of employment because of any lawful act done by the whistleblower. . . "[573] The first SEC enforcement action alleging retaliation involved an adviser that removed the whistleblower from his position as head trader, and according to the SEC, "task[ed] him with investigating the very conduct he had reported to the Commission, chang[ed] his job function from head trader to a full-time compliance assistant, stripp[ed] him of his supervisory responsibilities, and otherwise marginaliz[ed] him."[574] Other employees were involved in the unlawful activity; the SEC concluded that the head trader was singled out because he reported the misconduct.

As a result of this provision, advisers must consider the impact of the prohibition on retaliation on personnel actions involving an employee who has alleged improper conduct and thus could be deemed to be a whistleblower. Advisers should consider adopting firm-wide anti-retaliation policies.

Private Right of Action. An employee of an adviser may bring an action against the adviser alleging retaliation for whistleblowing. A court may award the employee (i) reinstatement at the same position, (ii) twice the back pay owed to the employee, and (iii) legal costs.[575]

c. *Prohibitions Against Impeding a Whistleblower.* Advisers are prohibited from impeding an employee or other individual from communicating to the SEC a possible securities law violation.[576] The enforcement or attempted enforcement of a nondisclosure or confidentiality agreement against an employee seeking to communicate with the SEC staff is treated as an effort to impede a whistleblower.[577] The SEC asserts that unduly restrictive agreements alone may improperly impede whistleblowers,[578] including provisions in agreements that

[573] Section 21F(h)(1).

[574] *Paradigm Capital Management, Inc.*, *supra* n 244.

[575] Section 21(F)(h)(1)(B)-(C).

[576] Rule 21F-17(a).

[577] *Id. See NeuStar, Inc.*, Exchange Act Rel. No. 79593 (Dec. 19, 2016) (settled enforcement action involving an employer that entered into severance agreements with departing employees that prohibited employee from making a communication to, among others, the SEC, disparaging, denigrating, maligning or impugning the employer); *KBR, Inc.*, Exchange Act Rel. No 74619 (Apr. 1, 2015) (settled enforcement action involving a company that required employees to sign a confidentiality statement before being interviewed in connection with an internal investigation).

[578] OCIE has issued a Risk Alert (Oct. 24, 2016) announcing that it will be examining advisers internal documents, including employment agreements and severance agreements to determine whether they contain language that "by itself or under the circumstances in which the agreements were used, impede employees and former employees from communicating with the Commission concerning possible securities laws violation."

require employees to waive "recovery incentives" for reporting misconduct.[579] Agreements to protect privileged communications are permitted.

As a result, standard nondisclosure agreements designed to protect intellectual property may require a "savings clause" excluding whistleblowing.[580]

d. *Applicability to Non-U.S. Persons.* Non-U.S. persons who provide tips to the SEC that otherwise meet the requirements are eligible to obtain bounties.[581] The anti-retaliation provisions, however, may not always be available to foreign nationals who experienced retaliation outside the U.S.[582]

D. Contractual Requirements

While the Advisers Act deems an adviser to be a fiduciary with respect to its client, the scope of its obligation to a client is determined in the first place by the terms of the advisory contract it enters into with its client. The Act does not require an advisory contract to be written, and the existence of a contract and the interpretation of its terms are generally matters of state law.[583] Section 205 of the Act, however, requires all advisory contracts to include certain provisions and prohibits contracts entered into by advisers registered with the SEC from including other provisions.

1. *Advisory Fees*

Advisers and clients are free to mutually agree to the amount of the adviser's compensation for its services and the method by which it will be paid. The SEC staff has taken the position, however, that an investment adviser that charges fees which substantially exceed those charged by other investment advisers may violate section 206 of the Act unless it discloses to existing and prospective clients that such a fee is higher than that charged by other advisers that provide the same or similar services.[584]

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579 *Blackrock, Inc.*, Exchange Act Rel. No. 79804 (Jan. 17, 2017).

580 See *KBR, Inc.*, *supra* n. 577 (savings clause added to new confidentiality agreement).

581 The SEC has made awards to several individuals not residing in the U.S. *See, e.g.*, Exchange Act Rel. No. 73174 (Sept 22, 2014).

582 Liu Meng-Lin v. Siemens AG, 763 F.3d 175 (2d Cir. Aug. 14, 2014) (Taiwanese employee of a Chinese company alleged retaliation abroad after reporting a suspected Foreign Corrupt Practices Act violation to the SEC of a subsidiary of a NYSE listed company). It is unclear what connection to the U.S. retaliation activities will be necessary not to be "extraterritorial."

583 Advisory contracts commonly specify the laws of the jurisdiction in accordance with it will be construed and enforced. Section 15(a) of the Investment Company Act requires advisory contracts with investment companies to be in writing.

584 The staff indicated that it considers an advisory fee greater than 2% of the total assets under management as excessive and would violate section 206 unless the adviser discloses that the fee is higher than that normally charged by advisers. *See* *Equitable Communications Co.*, SEC Staff No-Action Letter (Feb. 26, 1975); *Consultant Publications, Inc.*, SEC Staff No-Action Letter (Jan. 29, 1975); *Financial Counseling Corporation*, SEC Staff No-Action Letter (Dec. 7, 1974); *John G. Kinnard & Co., Inc.*, SEC Staff No-Action Letter (Nov. 30, 1973).

Performance Fees. With significant exceptions discussed below, section 205(a)(1) of the Act prohibits advisers from entering into a contract with a client that varies with the adviser's success in managing the client's money, *i.e.*, a fee based on a share of the capital gains or appreciation of a client's funds.[585] Congress included this provision in the Act because of its concern that a performance fee would encourage undue speculation with clients' investments.[586]

a. *Assets Under Management.* The commonly charged fee based on an amount of assets under management is specifically excepted.[587]

b. *Fulcrum Fee.* The Act excepts from the performance fee prohibition a type of fee known as a "fulcrum fee." This is a fee for "big players" where the investment advisory contract involves registered investment companies or clients with over $1 million of assets.[588] The fee must be based on the asset value of the funds under management over a "specified period" and must increase or decrease proportionately with the "investment performance" of funds under management in relation to an "appropriate index of securities prices."[589]

c. *Non-U.S. Clients.* The Act also excepts contracts with persons who are not residents of the United States.[590] Congress added this exception in 1996 in recognition that the common use of performance fee arrangements in other countries placed U.S. advisers at a competitive disadvantage.

d. *Qualified Clients*. Rule 205-3 permits an adviser to enter into a performance fee contract with certain "qualified clients." A qualified client is a:

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[585] Section 205(a)(1). The SEC staff has taken the position that section 205(a)(1)'s prohibition of investment advisory contracts that contain performance fees extends to investment advisory contracts that provide for "contingent fees." Contingent Advisory Compensation Arrangements, Advisers Act Rel. No. 721 (May 16, 1980). A contingent fee is "an advisory fee [that] will be waived or refunded, in whole or in part, if a client's account does not meet a specified level of performance" or that is contingent on the investment performance of the funds of advisory clients.

[586] *See* H.R. Rep. No 2639, 76th Cong., 2d Sess. 29 (1940).

[587] Section 205(b)(1).

[588] Section 205(b)(2). Rules 205-1 and 205-2 define the terms in the text. The SEC has published a release discussing factors that investment companies considering entering into a fulcrum fee should consider. Advisers Act Rel. No. 315 (Apr. 6, 1972).

[589] *But see* *Royce Value Trust*, SEC Staff No-Action Letter (Dec. 22, 1986) (the SEC staff stated it would not object if an advisory agreement with a performance fee that decreased at a greater rate than it increased and provided for no compensation if the net asset value per share declined). In 2006, the SEC has instituted several settled enforcement actions against advisers that entered into advisory contracts with investment companies that charge performance fees that did not comply with section 205(b). In each case, the adviser charged the fund more than it could charge under section 205(b). *See, e.g.*, *Gartmore Mutual Fund Capital Trust*, Advisers Act Rel. No. 2548 (Sept. 7, 2006).

[590] Section 205(b)(5).

(1) natural person or company that has at least $1 million under management with the adviser immediately after entering into the contract;[591]

(2) natural person or company that the adviser reasonably believes has a net worth of more than $2.1 million at the time the contract is entered into,[592] or is a "qualified purchaser";[593] or

(3) natural person who is an officer, director, trustee, or general partner (or a person serving in a similar capacity) of the adviser, or an employee who participates in investment decisions of the adviser and has done so for at least 12 months.[594]

e. *Qualified Purchaser Funds*. The Act also excepts contracts with certain funds not registered under the Investment Company Act of 1940 because they are offered only to certain wealthy or sophisticated investors.[595] The funds, which include many hedge funds, rely on the exception from the definition of "investment company" provided by section 3(c)(7) of the Investment Company Act.

f. *Other Funds.* Rule 205-3 excepts contracts with other types of funds, but only if *each* equity owner of the company is a qualified client with whom the adviser could otherwise enter into a performance fee contract under the rule.[596] This exception is available to (i) public investment companies registered under the Investment Company Act, (ii) business development companies, and (iii) private funds that rely on the exception provided by section 3(c)(1) of the Investment Company Act of 1940.[597]

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591 Rule 205-3(d)(1)(i).

592 Rule 205-3(d)(1)(ii)(A). The SEC recently increased the amount from $2 million to $2.1 million of assets under management. Advisers Act Rel. No. 4421 (June 14, 2016) (Order Approving Adjustment for Inflation). Section 205(e) of the Act requires the SEC, every five years, to adjust for inflation the amount of both the net worth and assets tests under management test. In 2016, only the net worth test was adjusted.

593 Rule 205-3(d)(1)(ii)(B). A "qualified purchaser" is defined in the rule by reference to section 2(a)(51) of the Investment Company Act, which generally defines a "qualified purchaser" to include: (i) a natural person who owns not less than $5 million in investments; (ii) a trust that meets certain requirements; and (iii) any person (including an investment adviser) who in the aggregate owns and invests on a discretionary basis not less than $25 million in investments.

594 Rule 205-3(d)(1)(iii).

595 Section 205(b)(4).

596 For a discussion of the contours of this exception, *see* *Seligman New Technologies Fund II, Inc.*, SEC Staff No-Action Letter (Feb. 7, 2002). The adviser itself and any equity owner not charged a performance fee need not be qualified clients. Rule 205-3(b). In an arrangement involving multiple tiers of funds, the analysis of whether a performance fee may be charged must be repeated at each tier. *Exception to Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account*, Advisers Act Rel. No. 1731 (July 15, 1998).

597 Rule 205-3(b) and (d)(3). Related advisers registered under the Act jointly on a single Form ADV may aggregate an equity owners interests in each of the related advisers when determining whether the investor has more than

Non-U.S. Funds. The SEC staff has stated that if the fund is organized under the laws other than the U.S., only the equity owners who are U.S. residents must be qualified clients.[598]

Overbilling of Advisory Fees

By entering into an advisory contract, a client consents to the deduction of fees specified therein from their accounts. Withdrawal of amounts greater than that which the client has authorized will be viewed by the SEC as conversion of client assets or disclosure of false information and a violation of the anti-fraud provisions of the Act, *i.e.*, not merely a breach of contract.

Some of the overbilling cases the SEC has brought against advisers involve schemes to misappropriate client assets,[599] while others simply involved back-office errors.[600] In some cases, the SEC has alleged that advisers to pooled investment vehicles overstated the value of assets to collect fees to which they were not entitled.[601] Recent cases against advisers to private equity funds allege that the adviser misallocated expenses to the fund properly paid by the adviser under terms of the limited partnership agreement, or imposed fees on controlled portfolio companies (and indirectly on the private equity fund) to which they were not entitled.[602]

2. *Assignments of Advisory Contracts*

Section 205(a)(2) of the act requires that advisory contracts of registered advisers contain a provision prohibiting their assignment without consent of the client.[603] An

$1 million of assets under management with each. *See* IM Guidance Update No. 2013-10 (Nov. 2013) and section 0 of this outline (discussing joint registration).

598 *See* *Lazard Frères Asset Mgmt.*, SEC Staff No-Action Letter (Feb. 12, 1996).

599 *Westend Capital Mgmt., LLC*, Advisers Act Rel. No. 3919 (Sept. 17, 2014)(settled administrative action alleging portfolio manager withdrew money from private fund in amounts that "bore no relation to the fees" the adviser had earned); *William Fretz, Jr. et al.*, Advisers Act Rel. No. 4206 (Sept 23, 2015)(settled administrative action alleging principals awarded themselves performance fees despite failing to meet performance benchmarks).

600 *Marco Investment Mgmt. LLC*, Advisers Act Rel. No. 4348 (Mar. 2, 2016); *Equitas Capital Advisers*, *supra* note 392; *Guggenheim Partners Inv. Mgmt.*, *supra* note 269; *Envision Capital Mgmt.*, *supra* note 395.

601 *See, e.g.*, *Cornerstone Capital Mgmt*., Advisers Act Rel. No. 2855 (Mar. 20, 2009).

602 *Clean Energy Capital LLC*, Advisers Act Rel. No. 3955 (Oct., 17, 2014); *Kohlberg Kravis Robert & Co., L.P*, Advisers Act Rel. No. 4131 (June 29, 2015); *Blackstone Mgmt. Partners L.L.C.*, Advisers Act Rel. No. 4219 (Oct. 7, 2015). The SEC staff has suggested that the opaqueness of limited partnership and other agreements has "allowed advisers to charge fees and pass along expenses that are not reasonably contemplated by investors." "Spreading Sunshine in Private Equity," Speech by Andrew J. Bowden, Director, SEC Office of Compliance Inspections and Examinations, May 16, 2014.

603 Section 205(a)(2). The staff has expressed the view that the assignment of an advisory contract without the consent of the client could constitute a breach of the advisory contract but not a violation of Section 205(a)(2). *American Century Companies, Inc*., SEC Staff No-Action Letter (Dec. 23, 1997). Assignment without consent, however, could be construed as a violation of an adviser's fiduciary responsibilities in violation of section 206 of the Act and today, the staff is likely to view the failure of an adviser to follow the terms of the advisory contract

assignment includes any direct or indirect transfer or hypothecation of an advisory contract.[604] The restrictions on assignment are designed to restrict an adviser's sale of its fiduciary office.[605]

Section 205(a)(2) applies regardless of the form of organization of the adviser, but when the adviser is organized as a corporation or partnership, the Act and SEC rules have special provisions that deem when an "indirect" assignment may have occurred as a result of changes to the ownership of the corporation or membership of the partnership.

a. *Advisers Organized as Corporations.* In the case of a corporation, an assignment includes any direct or indirect transfer of a controlling block of the adviser's outstanding voting securities.[606] The Act does not include a definition of "controlling block of an adviser's voting securities," but "control" is defined as "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company."[607] The SEC looks to this definition to interpret the term "controlling block."

   No Presumption. There is no presumption of control in the Advisers Act similar to that in Section 2(a)(9) of the Investment Company Act under which a person beneficially owning more than 25% of the voting securities of a company is deemed to control the company.[608] Nonetheless, many lawyers look to the rebuttable presumption set forth Section 2(a)(9) in evaluating whether a transaction involving control of a corporate adviser is an assignment under the Advisers Act.

b. *Advisers Organized as Partnerships*. An assignment will not be deemed to have occurred if a withdrawing partner has only a minority interest in the partnership or a newly admitted partner will have only a minority interest.[609] As a consequence,

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as a failure to implement compliance controls. Thus, it is not advisable, in practice, to draw the distinction the staff has drawn.

[604] Section 202(a)(1).

[605] Investment Trusts and Investment Companies: Hearings on S. 3580, 76th Cong., 3d Sess. 253 (1939) (statement of David Schenker, Chief Counsel, Securities and Exchange Commission Investment Trust Study) .

[606] Section 202(a)(1).

[607] Section 202(a)(12). The SEC views a "controlling influence" to mean the "act or process, or power of producing an effect which may be without apparent force or direct authority and is effective in checking or directing action, or exercising restraint or preventing free action." Investors Mutual, Inc., Inv. Co. Act Rel. No. 4595 (May 11, 1966), *affd.*, *Phillips v. SEC*, 388 F.2d 964 (2d. Cir. 1968). Thus, a person may have a controlling influence without actually exercising it; the latent power to exercise it is sufficient. Whether a person has controlling influence is a question of fact.

[608] Conversely, a person who does not own more than 25% of the voting securities of a company is presumed not to control the company. The SEC has incorporated, however, the Section 2(a)(9) presumption into the definition of "control" in Form ADV (Glossary).

[609] Section 202(a)(1).

in some cases a change of effective control of a partnership may occur without requiring the adviser to obtain client consent. The advisory contract must, however, provide that the adviser will notify the client of any change in its membership.[610]

c. *Safe Harbor*. The SEC has adopted a rule providing a safe harbor for a transaction that does not result in a change of *actual* control or management of the adviser would not be deemed to be an assignment for these purposes.[611]

Thus the merger of two widely-held public corporations may not be an assignment under the Act even though there would be a transfer of a controlling block of stock of the acquired corporation to the surviving corporation.[612] *A transfer of advisory contract upon incorporation of a sole proprietor should also be within the safe harbor*.

d. *Consent*

Who Must Consent? Section 205(a)(2) requires that the "other party to the contract" must consent to the assignment. In most cases this will be the affected client, but what if the client is a pooled investment vehicle whose general partner is a related person of the adviser—and thus a party with an interest in the assignment? The SEC has stated in recently settled enforcement actions that an interested party does not have the capacity to consent, but that a fully informed investor committee may.[613]

How Must Consent be Obtained? The statute and rules do not address how an adviser must obtain consent for an assignment. Some staff letters and a form instruction suggest that consent may be obtained through actual consent, or may be inferred through the use of a negative consent, if clients are given appropriate notice, *e.g.*, 60 days.[614]

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[610] Section 205(a)(3). The SEC staff treats limited partnership interests as the equivalent of corporate shares for purposes of this section so that notification need not be provided. *Ayco Company, L.P.* (Dec. 14, 1995).

[611] Rule 202(a)(1)-1. While rule 202(a)(1)-1 was adopted primarily to deal with intra-corporate reorganizations and reorganizations resulting from changes in domicile, the Division of Investment Management explained in a staff no-action letter that the rule is not so limited. *Zurich Insurance Company, Scudder Kemper Investments*, SEC Staff No-Action Letter (Aug. 31, 1998). Zurich involved a complex corporate transaction, the substance of which the Division did not address. Instead, the Division stated that the adviser must itself evaluate whether a particular transaction involves a change of actual control or management.

[612] *Dean Witter, Discover & Co.; Morgan Stanley Group Inc*., SEC No-Action Letter (Apr. 18, 1997). The staff response does not indicate that it was premised on the safe harbor. It suggests that for a transfer of control to occur a controlling shareholder must lose control or there must be a new controlling shareholder as a result of the merger.

[613] *See* discussion *supra* Section VI.B.1.a. of this outline regarding consent for principal transactions.

[614] Instruction to Item 5 of Form ADV-W; *Jennison Associates Capital Corp*. SEC Staff No-Action Letter (Dec. 2, 1985) (60 days).

3. *Hedge Clauses*

The Act voids any provision of a contract that purports to waive compliance with a provision of the Act.[615] The SEC staff takes the position that an adviser that includes any such provision in a contract misleads its clients in violation of the Act's anti-fraud provisions by creating in the mind of the client the belief that a legal right or remedy under the Act is not available.[616]

Culpability Provisions. Historically, the SEC staff took the position that the prohibition would, for example, preclude an adviser from purporting to limit its culpability to acts involving gross negligence or willful malfeasances,[617] even if the hedge clause explicitly provides that rights under federal or state law cannot be relinquished.[618] More recently, the SEC staff has stated that whether such a provision would be effective, turns on "the form and content of the particular hedge clause (*e.g.*, its accuracy), any oral or written communications between the investment adviser and the client about the hedge clause, and the particular circumstances of the client."[619] The current approach of the staff thus permits culpability clauses based upon regular standards for modifying fiduciary duties when the obligation of full disclosure and consent is satisfied.

Culpability provisions do not, however operate to restrict the SEC's ability to enforce violations of Section 206(2) of the Act, which has been interpreted to include negligent conduct.[620] Commonly included in advisory contracts, they operate primarily to limit an adviser's civil liability for breaches of duties to clients under state law.

Arbitration Clauses. Provisions in advisory contracts that require clients to submit disputes with the adviser to arbitration (rather than seeking a court remedy) are not specifically prohibited in advisory contracts and have been enforced by at least one court.[621]

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[615] Section 215(a).

[616] *Opinion of the General Counsel*, Advisers Act Rel. No. 58 (Apr. 10, 1951). The SEC has instituted enforcement actions against advisers that have utilized hedge clauses in their advisory contracts. *William Lee Parks*, Advisers Act Rel. No. 736 (Oct. 27, 1980); *Olympian Financial Services, Inc*., Advisers Act Rel. No. 659 (Jan 16. 1979).

[617] *Auchincloss & Lawrence Inc*., SEC Staff No-Action Letter (Feb. 8, 1974).

[618] *Omni Mgmt. Corp*., SEC Staff No-Action Letter (Dec. 13, 1975); *First National Bank of Akron*, SEC Staff No-Action Letter (Feb. 27. 1976).

[619] *Heitman Capital Mgmt., LLC, et al*., SEC Staff No-Action Letter (Feb. 12. 2007).

[620] *SEC. v. Steadman*, *supra* note 196.

[621] *Bakas v. Ameriprise Financial Services, Inc*., 651 F. Supp. 997 (D. MN 2009). In 1986, the SEC staff expressed the view that arbitration provisions in advisory contracts were incompatible with the Advisers Act, which affords certain non-waivable rights of action, including "the right to choose the forum, whether arbitration or adjudication, in which to seek resolution of disputes." *McEldowney Financial Services*, SEC Staff No-Action Letter (Oct. 17, 1986). As the court pointed out in *Bakas*, that staff letter was based on a Supreme Court decision

Dodd Frank Act. Section 921(b) of the Dodd-Frank Act added a new section 205(f) of the Advisers Act, authorizing the SEC to prohibit, or impose conditions or limitations on the use of advisory contracts that contain arbitration provisions if it finds that the prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors.[622] The SEC has not yet exercised this authority.

4. *Termination Restrictions*

The SEC staff takes the position that certain fees that restrict the ability of a client to terminate an advisory contract, penalize a client for ending the advisory relationship, or that may make the client reluctant to terminate an adviser, are inconsistent with the adviser's fiduciary duties and may violate section 206.[623] Thus, the SEC staff interprets the anti-fraud provisions of the Act to require an adviser receiving its fee in advance to give a client terminating a contract a *pro rata* refund of pre-paid fees (less reasonable expenses),[624] unless the adviser is to receive a pre-determined amount upon termination for services already performed, and the client is provided adequate disclosure.[625]

5. *Rescission Rights*

Advisory contracts entered into in violation of the Advisers Act are void.[626] A client may sue for rescission of such contract,[627] and obtain restitution of any fees, commissions or other compensation paid to the adviser pursuant to the contract.[628]

(*Wilko v. Swan*, 346 U.S. 427 (1953)), which had been overturned in a decision more sympathetic to arbitration clauses. *See* *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220 (1987).

[622] The Senate report explains that the provision results from "concerns over the past several years that mandatory pre-dispute arbitration is unfair to the investors." Report of the Senate Com. on Banking, Housing, and Urban Affairs on S. 3217, S. Rep. No. 111-176, at 110.

[623] *See, e.g.*, *National Deferred Compensation*, SEC Staff No-Action Letter (Aug. 31, 1987) ("an adviser may not fulfill its fiduciary obligations if it imposes a fee structure penalizing a client for deciding to terminate the adviser's service or if it imposes an additional fee on a client for choosing to change his investment"); *Robert D. Brown Investment Counsel, Inc.*, SEC Staff No-Action Letter (July 19, 1984) (contract for investment supervisory services containing a provision restricting a client's ability to terminate the contract or forcing the client to forfeit a portion of prepaid fees in the event of termination may violate Section 206). An advisory contracts with a registered investment company must be terminable at any time. Section 15(a)(3) of the Investment Company Act. *See* *Orinda Asset Mgmnt. LLC.*, Advisers Act Rel. No. 4513 (Aug. 25, 2016).

[624] *National Regulatory Services*, SEC Staff No-Action Letter (Dec. 2, 1992). The staff does not see this view altered by the decision *Transamerica v. Lewis*, *supra* note 80, that clients do not have a private right of action under section 206 of the Act, because they continue to have rights to sue for equitable damages under section 215 of the Act.

[625] *BISYS Fund Services, Inc.*, SEC Staff No-Action Letter (Sept. 2, 1999).

[626] Section 215(b).

[627] *Transamerica Mortgage*, *supra note 80*. This is the only private right of action under the Act recognized by the courts. In order to sue under Section 2015(b), a claimant must be a party to the contract. *Zurich Capital Markets Inc. v. Coglianese*, 332 F. Supp. 2d 1087, 1114 (N.D. Ill. 2004).

[628] *Washington v. Baenziger*, 656 F. Supp. 1176, 1178 (N.D. Cal. 1987) (citing *Transamerica* at 24, n.14).

Restitution does not include compensation for any investment losses as a result of a fraud or other misconduct by the adviser, including a violation of section 206 of the Act by the adviser.[629]

E. Recordkeeping Requirements

Rule 204-2 requires that advisers maintain a comprehensive set of records supporting their investment adviser activities. The records must be kept current, reflecting transactions, communications, or other events as they occur or shortly thereafter.[630]

The SEC generally requires a registered adviser to maintain two types of books and records: (i) general business records that any business would normally keep; and (ii) certain additional records the SEC believes necessary in light of the adviser's fiduciary duties and the regulatory requirements of the Act and SEC rules. The requirement to keep records does not turn on the medium in which a document is created or maintained.[631] Thus, electronic documents, including emails, must be maintained if they meet the required record described below.

1. *General Business Records*

   a. All checkbooks, bank statements, and reconciliations.

   b. All written agreements entered into by the adviser with any client, including all investment advisory contracts and powers of attorney.

   c. Any agreements relating to the business of the adviser, *e.g.*, rental and service agreements, mortgages, employment contracts, advisory contracts.

   d. All invoices or statements relating to the adviser's business.

   e. All cash receipts and disbursement journals, other journals, appropriate ledger accounts, all trial balances, financial statements, and internal audit working papers relating to the business of the adviser.

2. *Additional Records*

   a. A detailed memorandum of each order given by the adviser for the purchase or sale of any security and any instruction from the client concerning such purchase and sale.

[629] *L.W. Laird v. Integrated Res., Inc.*, 897 F.2d 826, 841–42 (5th Cir.1990) (investor could not rescind contracts for sale or purchases of securities made in violation of Advisers Act).

[630] Rule 204-2(a). Section 204 of the Act gives the SEC broad authority to require advisers to maintain books and records .

[631] Rule 204-2(g) (permitting records to be maintained in electronic format, subject to procedures designed to maintain their integrity).

b. Copies of each securities transaction and holdings report made by an access person under the adviser's code of ethics.

c. Documents supporting an adviser's decision to approve an access person's personal securities transactions.

d. A list of all persons who currently are "access persons" and who have been access persons within the last five years.

e. A cross reference of securities held by client and by issuer.

f. All written communications received and copies of all written communications sent by the adviser relating to:

   (1) any recommendation made or proposed to be made, and any advice given or proposed to be given;

   (2) any receipt, disbursement, or delivery of funds or securities; or

   (3) the placing or executing of any order to purchase or sell any security.[632]

   (4) the performance or rate of return of managed accounts or securities recommendations.[633]

   This requirement is broadly construed by the SEC staff to include communications to clients about advice as well as internal communications among personnel of the adviser about advice to be given to clients. As a result, the adviser must retain such communications. To adhere to this requirement many advisers preclude associated persons from using personal email to communicate with clients.[634]

g. Copies of all circulars, advertisements, newspaper articles, etc., sent to 10 or more persons.

h. A list of all accounts over which the adviser has discretionary authority.

i. A copy of each brochure and brochure supplement prepared in compliance with the brochure rule and any amendments.

j. Clients' acknowledgement of receipt of a solicitation agreement.

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[632] Rule 204-2(a)(7). If recommendations made as to specific securities in a communication that does not state the reasons for the recommendation, a separate memorandum explaining the reasons must be created and maintained kept. Rule 204-2(a)(11).

[633] This last provision was added by the SEC in 2016. Advisers Act Rel. No. 4509, *supra* note 164.

[634] *See Retirement Investment Advisors, Inc.*, Advisers Act Rel. No. 4237 (Oct. 21, 2015) (adviser failed to preserve personal emails).

k. Documents substantiating any performance information[635] provided to any person.

This provision and the communications retention requirement above in (f)(3) were recently expanded by the SEC from a requirement to retain and substantiate communications distributed to 10 or more persons to those provided to any person.[636]

l. Certain additional records if the adviser has custody or possession of clients' cash or securities.[637]

m. Copies of the code of ethics and amendments thereto.

n. Records of violations of the code by supervised persons and of any actions taken against violators of the code of ethics.

Rule 204A-1 requires, among other things, that an adviser's code of ethics prohibit an adviser from violating the Federal securities laws.[638] *The SEC examination staff have taken the position that advisers are therefore required to keep a deficiency log of all violations of the Federal securities laws.*

o. Copies of each supervised person's written acknowledgment of receipt of a copy of the code of ethics.

p. Copies of the adviser's compliance policies and procedures, and copies of any records document the adviser's annual review of its compliance policies.

q. Certain additional records regarding political contributions and advisory services to any government entity.[639]

3. *Time, Place and Manner of Retention*

a. *General.* All books and records required to be kept by the rule must be maintained and preserved in any easily accessible place for a period of no less than five years.[640]

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[635] Rule 204-2(a)(16). *See* Advisers Act Rel. No. 1135 (Aug. 17, 1988) (adopting paragraph (a)(16). S*ee also* *Salomon Brothers Asset Mgmt. Inc.* SEC Staff No-Action Letter (July 23, 1999) (explaining that records needed to be retained to substantiate performance). In addition, rule 204-2(e)(3)(ii) provides that advisers that had relied on the exemption from registration under section 203(b)(3) of the Act before July 21, 2011 (the private adviser exemption) will not be subject to the requirement of maintaining records to support their calculation of the performance, or rate of return, of the accounts they managed or securities they recommended for any period prior to their registration with the SEC, provided that they continue to preserve any records in their possession that pertain to such performance or rate of return.

[636] Advisers Act Rel. No. 4509, *supra* note 164.

[637] Rule 204-2(a)(17)(iii) and (b).

[638] Rule 204A-1(a)(2).

[639] Rule 204-2(a)(18) and (h).

b. *Third Party Recordkeepers.* An adviser may delegate record creation and retention responsibilities to a third party, but the adviser continues to be responsible for compliance with the recordkeeping requirements.[641] The SEC has held third party recordkeepers responsible under the Act for causing the adviser to fail to maintain accurate records.[642]

c. *Electronic Records.* Records required to be kept may be maintained or stored electronically using various media, provided that the adviser establishes and maintains procedures:

(1) to preserve the records and safeguard them from loss, alteration or destruction;

(2) that limit access to authorized personnel; and

(3) that reasonably assure that any reproduction of paper records onto electronic media is accurate.[643]

Electronic records must be arranged and indexed in a way that permits easy location, access, and retrieval of each record; provided to the SEC staff promptly in the medium and format in which it is stored (or, if requested, printed out); and (to prevent their loss) a duplicate copy of the record must be stored (in electronic format) at a separate location.[644]

Electronic records are considered "easily accessible" regardless of where they are actually maintained if the adviser has essentially immediate access to them through a computer located at an appropriate office of the adviser.[645]

4. *Applicability to Non-U.S. Advisers*

a. *Non-Resident Advisers.* A non-resident adviser must either (i) maintain a set of its books and records in the United States, or (ii) submit a written undertaking to the SEC to furnish a copy of (or a portion of) its records, within 14 days upon request.[646] Because of the burdens associated with maintaining two sets of records most advisers choose the second option.

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[640] Rule 204-2(e). The first two years, the records must be kept in the offices of the adviser.

[641] *First Call*, *infra note 639; National Regulatory Services*, SEC Staff No-Action Letter (Dec. 2, 1992). *See also Anthony Fields, CPA, et al.*, Advisers Act Rel. No. 3348 (Jan. 4, 2012) (adviser violated section 204 of the Advisers Act and rule 204-2 by utilizing several email and online communication providers, each of which routinely deleted emails and online communications after six months).

[642] *Wilmington Trust Company*, Advisers Act Rel. No. 2261 (July 12, 2004).

[643] Rule 204-2(g)(3). Records may be kept electronically regardless of how they were originally created.

[644] Rule 204-1(g)(2).

[645] *First Call Corporation*, SEC Staff No-Action Letter (Sept. 6, 1995).

[646] Rule 204-2(j). A non-resident adviser is defined in rule 0-2(b) as (i) an individual who resides in any place not subject to the jurisdiction of the United States; (ii) a corporation that is not incorporated in or has its principal

b. *Non-U.S. Registered Advisers.* A registered adviser with a principal place of business not subject to U.S. jurisdiction is not required to maintain most records required by rule 204-2 as to their non-U.S. clients, including off shore private funds in which U.S. persons invest.[647]

c. *Foreign Private Advisers.* Exempt reporting advisers, including foreign private advisers, are not subject to any of the recordkeeping requirements under the Advisers Act.[648]

d. *Language*. There is no requirement that an adviser maintain its records in English, and an adviser may provide them to the SEC in the language in which they are maintained, *i.e.*, there is no obligation to have them translated.[649]

If the records are maintained in English, they should be provided to the SEC in English.

F. Administrative Oversight

The staff of the of the SEC's Office of Compliance, Inspections and Examinations located in the SEC's 11 regional offices and the Washington headquarters conducts compliance examinations of advisers registered with the SEC.[650] The primary purpose of these examinations is to determine: (i) whether the adviser is in compliance with the Advisers Act and other federal securities laws; (ii) whether the adviser is adhering to disclosures it has made to its clients and reported to the SEC; and (iii) the effectiveness of the adviser's compliance controls.[651]

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office and place of business in any place not subject to the jurisdiction of the United States; (iii) a partnership or other unincorporated organization that has its principal office and place of business in any place not subject to the jurisdiction of the United States. A non-resident adviser makes the required undertaking when it signs the non-resident investment adviser execution page of Form ADV.

[647] *See* Advisers Act Rel. No. 3222, *supra* note 117 at n.515 ("[W]e do 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 Commission." In the case of a private fund, the fund would be treated as the client. The SEC staff has provided guidance in a series of no-action letters regarding the recordkeeping obligations of registered advisers that are located offshore. Under this guidance, the registered adviser must, in order to rely on the letters, comply with the Act's recordkeeping rules, other than (i) rules 204-2(a)(3) and (7) with respect to transactions involving offshore clients that do not relate to advisory services performed by the registered adviser on behalf of United States clients or related securities transactions; and (ii) rules 204-2(a)(8), (9), (10), (11), (14), (15) and (16) and 204-2(b) with respect to transactions involving, or representations or disclosures made to, offshore clients. *See*, *e.g.*, *Royal Bank of Canada*, SEC Staff No-Action Letter (June 3, 1998).

[648] The SEC has not implemented its statutory authority to adopt such rules. Release 3221, *supra* note 90 at n.164.

[649] An exception, set forth in staff letters, is for records provided upon request by a non-U.S. participating affiliate. *See supra* note 162.

[650] For more detailed information, *see* *Examinations by the Securities and Exchange Commission's Office of Compliance Inspections and Examinations* (Feb. 2012).

[651] *Examination Information for Broker-Dealers, Transfer Agents, Clearing Agencies, Investment Advisers and Investment Companies*.

The SEC staff annually publishes a list of current examination priorities.[652]

1. *Advisers Subject to Compliance Examinations*

The SEC has the authority to examine *all* advisers subject to the Advisers Act other than three types of advisers eligible for exemption from the registration requirements of the Act:

a. Intrastate advisers;

b. Insurance company advisers; and

c. Foreign private advisers.[653]

The SEC has announced, however, that it will not conduct routine examinations of exempt reporting advisers.[654]

2. *Records Subject to Examination*

All records of a registered adviser (and not only those required to be created or maintained pursuant to SEC rule) are subject to examination by SEC staff.[655]

a. *Records of Private Funds*

The records of any private fund advised by a *registered* investment adviser are deemed to be the records of the adviser and thus subject to SEC examination.[656]

This provision, added by the Dodd-Frank Act, resolves disagreements that occasionally have occurred between SEC examiners and advisers to private funds as to whether certain records were "advisory records" subject to SEC examination.

b. *Client Custodial Records*

Persons having custody of "securities, deposits or credits" of an advisory client are subject to SEC examination. If the custodian is a U.S. regulated bank, it may

[652] OCIE's Examination Priorities for 2017 was posted on January 12, 2017.

[653] Section 204(a). Each of these types of advisers is specifically exempt from registration under section 203(b)(3) of the Act. Exempt reporting advisers are exempt from registration under sections 203(l) or (m). *See* Release 3221, *supra* note 90 at n. 190.

[654] Release 3221, *supra* note 90, at Section II.B.2.

[655] *See* section 204(a) ("All records (as so defined) of such investment advisers are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations." (emphasis added)), and Advisers Act Release No. 2333 (Dec. 2, 2004) at n. 217.

[656] Section 204(b)(2), as amended by section 404(2) of the Dodd-Frank Act.

satisfy any examination request by the SEC staff by providing a list of the client securities, deposits, or credits it holds.[657]

This provision of the Act provides the SEC with examination authority over persons who are not investment advisers. Enacted as part of Dodd-Frank Act (and subsequent to the Madoff scandal), it responds to SEC staff concerns that the SEC could not always determine whether client assets were properly accounted for if held by institutions over which it had no regulatory authority.

c. *Attorney-Client Privilege*

An adviser may decline to provide SEC examiners with documents subject to the attorney-client privilege. Generally, these are communications made in confidence to an attorney by the adviser for the purpose of seeking legal advice.[658] The SEC staff will request a "privilege log," a list and a description of documents the adviser is not turning over in reliance on the privilege.

The SEC will not recognize attorney-client privilege as extending to the work of an adviser's chief compliance officer merely because the chief compliance officer is a lawyer. A chief compliance officer who also serves as a lawyer for the advisers will need to take care to separate the functions in order to preserve the privilege.[659]

Care should be taken during an examination when determining whether to voluntarily turn over privileged documents, which may cause the adviser to waive the privilege for purpose of an SEC enforcement action or any other proceeding against the adviser.[660]

d. *Confidentiality*

The SEC and its staff are prohibited from publicly disclosing the existence of an examination or any information collected in the course of an examination, except (i) in a public enforcement action, or (ii) pursuant to a request from Congress.[661] The provision does not, however, prevent the SEC from being compelled to provide examination information under the Freedom of Information Act (FOIA)

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[657] Section 204(d), as amended by section 929Q(b) of the Dodd-Frank Act.

[658] *See* SEC, Division of Enforcement, Enforcement Manual (Oct. 9, 2013).

[659] *See In re Kellogg Brown & Root, Inc., et al*, (D.C. Cir. June 27, 2014) (attorney-client privilege applies in the case of an internal investigation when obtaining legal advice was "a primary purpose of the communication" even when required by government regulation).

[660] Rule 502(a) of the Federal Rules of Evidence, which applies to civil litigation as well as a federal agency proceeding.

[661] Section 210(b). Broad protections for examination information were enacted in section 929I of the Dodd-Frank Act, but subsequently repealed in P.L. 111-257 (Oct. 5, 2010).

or by a court subpoena.[662] The SEC will generally resist divulging examination information pursuant to a FOIA request, asserting, among other things, broad exemptions for proprietary information.[663]

Advisers responding to requests for information from the SEC should consider requesting confidential treatment, which will provide greater assurances that the SEC will be successful in preventing third parties from obtaining examination data. All of the SEC's enforcement actions are public and will result in disclosure of information gathered in an examination.

3. *Types of Examinations.*

The staff is currently conducting four types of examinations:

a. *Routine Examinations*. The SEC staff conducts on-site exams of SEC-registered advisers based on an assessment of compliance risk associated with the adviser. If the SEC staff has concerns about an adviser's internal controls, or if the adviser engages in activities the staff considers presents higher risk to clients (such as taking custody of client assets) exams will be more frequent.[664] Advisers with stronger control environments may be examined less frequently.

The SEC staff no longer attempts to schedule examinations based upon a cycle, e.g., once every five years.

b. *Sweep (Targeted) Examinations*. The SEC staff conducts exams for the purpose of evaluating a perceived problem (*e.g.*, retirement advice[665]) or to educate itself on current industry practices in a particular area prior to developing a regulatory solution (*e.g.*, cybersecurity) or a combination of both (*e.g.*, soft dollar practices).

c. *Cause Examinations.* These may be based on receipt of a complaint from a client or a competitor, press reports of problems, rumors, or anonymous tips.[666]

d. *Presence Examinations.* Beginning in 2012 the staff conduct focused examinations of certain investment advisers to private funds that were required to

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[662] *Aguirre v. SEC*, 551 F. Supp.2d 33 (D.D.C. 2008); *Putnam Investment Mgmt., LLC*, Admin. Proceeding Rel. No. 614 (Apr. 7, 2004) (ALJ order denying SEC staff motion to quash subpoena for examination materials), *motion to vacate order denied on other grounds*, Exchange Act Rel. No. 50039 (July 20, 2004).

[663] Section 204(a)(10), which defines "proprietary information" to include sensitive non-public information regarding the adviser's investment or trading strategies, analytical or research methodologies, trading data, computer hardware or software containing intellectual property, and any other information the SEC determines to be proprietary.

[664] *See Equitas Capital Advisors*, *supra* note 393 (adviser examined by SEC staff in 2005, 2008 and 2011; SEC ultimately brought enforcement action against adviser and CCO for multiple compliance failures).

[665] See Risk Alert: Retirement-Targeted Industry Reviews and Examinations Initiative.

[666] The Dodd-Frank Act added a new section 204(b)(6)(A) to the Advisers Act, which also authorizes the SEC to conduct examinations for the purpose of assessing systemic risk by the FSOC.

register with the SEC in response to the Dodd-Frank Act.[667] Although the formal program is completed, it is understood that the staff continues to conduct these examinations.

4. *Examinations of Non-U.S. Advisers*

An adviser with its principal offices and business outside the United States that is registered with the SEC is subject to examination by SEC staff.[668] The SEC staff examines non-U.S. based advisers registered with the SEC, albeit less frequently than domestic advisers.

a. *On-Site Examination.* The SEC staff will usually be accompanied by staff of the regulators of the country in which the adviser (or the office of the adviser) being examined is located.[669]

b. *Correspondence Examinations*. The SEC staff will request documents from the adviser, which may lead the staff to conduct an on-site examination, either from information the staff learns from the documents or the adviser's failure to respond.[670]

c. *Reciprocal Examinations.* In some cases, the SEC staff may request that a local national regulator provide it with information about a firm doing business outside the United States, which may result in the local regulator conducting an examination of the adviser and sharing the results with the SEC. Where an adviser is doing business in multiple countries the SEC may coordinate with multiple national regulators for the purpose of developing an overall assessment of the adviser's practices.

The SEC has entered into memoranda of understanding with the European Union, the United Kingdom, Hong Kong and many other national regulators in which the

[667] *See* Letter to Newly Registered Advisers from Drew Bowden, Deputy Director, Office of Compliance Inspections and Examinations (Oct. 9, 2012).

[668] The Dodd-Frank Act added section 214 (b) to the Act, which specifically provides extraterritorial jurisdiction to U.S. federal courts regarding actions or proceedings brought by the Commission or the United States for violation of section 206 of the Act involving (i) conduct within the United States even if the violation is committed by a foreign adviser and involves only foreign investors; or (ii) conduct occurring outside the United States that has a foreseeable substantial effect within the United States, *e.g.*, affects a client that is a U.S person.

[669] *See* Anita Raghavan, *Wielding Broader Powers, S.E.C. Examines Hedge Funds in London, New York Times*, Sept. 17, 2013 ("[SEC] employees are set to fan out across upscale Mayfair, home to some of London's biggest hedge funds, this week, paying visits to more than a dozen hedge fund managers registered with the SEC to determine whether they are in compliance with American regulations. . . The SEC has . . . teamed up with the Financial Conduct Authority, Britain's chief financial regulator, to cooperate in overseeing the cross-border operations and activities of managers of alternative investment funds, like hedge funds.").

[670] Targeting IC/IA Examinations, Report by SEC Inspector General (Sept. 29, 2004) at n.17 (urging OCIE to make greater use of such exams).

regulators agree to permit on-site visits, share information, and provide other types of reciprocal assistance to each other with respect to advisers.[671]

5. *Obligations of an Adviser Subject to an Examination*

a. *Furnish Records*

Upon request, an adviser must (i) *promptly* provide to SEC examiners copies of records, in the medium and format in which they are stored; and (ii) in the case of electronic records, the means to access and print them.[672]

Promptly Provide. The SEC has stated that the "promptly" standard imposes no specific time limit, but it expects that a fund or adviser could delay furnishing electronically stored records for more than 24 hours only in unusual circumstances. It expects, however, that in most cases advisers will be able to (and thus must) provide records "immediately or within a few hours of request."[673] A similar standard is applied to paper records.

In the case of larger document requests, SEC staff is often willing to agree to production schedules under which some documents are provided immediately and those that are not immediately available are provided to the staff on a delayed basis.[674]

b. *Truthful and Accurate Records and Statements*

The records advisers furnished the SEC must be "true, accurate and current."[675] The SEC has instituted several enforcement actions against advisers that failed to provide accurate records, withheld records or otherwise sought to impede an examination.[676]

On occasion the staff of an adviser will alter or create false records to cover up a deficiency or violation of the law. Such cover-ups are viewed by the SEC staff as

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[671] *See*, *e.g.*, "Memorandum of Understanding Concerning Consultation, Cooperation and the Exchange of Information Related to Market Oversight and the Supervision of Financial Services Firms between the SEC and the Financial Services Authority of the United Kingdom," (Mar. 14, 2006).

[672] *Wells Fargo Advisers*, *supra* note 441 (Delay of more than 6 months in production of requested records constituted violation of Section 204(a), which makes all records of an investment adviser subject to SEC examination).

[673] *Electronic Recordkeeping by Investment Companies and Investment Advisers*, Advisers Act Rel. No. 1945 (May 24, 2001).

[674] *Id*.

[675] Rule 204-2(a). The SEC has stated that the recordkeeping requirements of the Act implicitly require that the records be true and accurate. *Anthony A. Adonnino*, 56 SEC 1234 (2003); *David Henry Disraeli*, *supra* note 101.

[676] *See EM Capital Mgmt., LLC and Seth Richard Freeman*, Advisers Act Rel. No. 3502 (Nov. 20, 2012) (adviser and its principal failed to timely respond to SEC staff requests for documents).

worse than the underlying violation and could turn a deficiency letter into an enforcement referral.[677]

All statements by the adviser and its personnel to SEC examiners should similarly be truthful and accurate. It is a federal criminal offense to make a false statement to an SEC compliance examiner or other agent of the federal government.[678]

6. *Focus of Examinations*

During routine examinations, examiners look particularly for evidence of the following:

a. safekeeping of client assets;

The SEC staff will seek to independently verify client account balances by contacting custodians, clients and other persons. OCIE has developed a standard form, which it will provide to such persons.[679] OCIE currently seeks to verify assets under management with respect to both advisers that report they have custody as well as those who do not.

b. whether the adviser or its personnel is front-running client trades;

c. whether the adviser is engaging in undisclosed brokerage practices that are not in clients' best interests (*e.g.*, failure to obtain best execution; undisclosed soft dollar arrangements, unfair order allocations, payments for client referrals);

d. whether the advice given to clients is suitable;

e. whether the disclosure given to clients conforms to the adviser's actual practices;

f. whether the adviser engages in deceptive advertising (particularly performance advertising) or any other problematic marketing practices;

g. whether the adviser is eligible for SEC registration (*e.g.*, whether the adviser really meets the asset thresholds);

h. whether the adviser's system of compliance policies and procedures is adequate;

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[677] *Wells Fargo Advisers, LLC*, *supra* note 441; *Seth Richard Freeman*, Advisers Act Rel. No. 3502 (Nov. 20, 2012); *The Buckingham Research Group, Inc.*, Advisers Act Rel. No. 3109 (Nov. 17, 2010). In one case, the SEC staff discovered from document meta data that the adviser's annual compliance memorandum had been created after the adviser had received notice that it would be examined. *Parallax Investments, LLC*, Advisers Act Rel. No. 4159 (Aug. 6, 2015). Destruction, alteration or falsification of records with the intent to impede or obstruct an SEC examination is a criminal offence. *See* 818, U.S.C. 1519.

[678] 18 U.S.C.1001. *See*, *e.g.*, *SEC v. Fredrick D. Scott*, Lit. Rel. No. 22962 (Apr. 2, 2014) (adviser sentenced by court to 63 months in prison for, among other things, making false statements to SEC compliance examiners); *U.S. v. Hart*, Case No. 1:15-cr-0084 (S.D.N.Y. Filed Feb.13, 2015) (portfolio managers criminally charged with obstruction of justice and perjury for making false statements made to SEC examiners).

[679] S*ee* OCIE Routine Account Information Confirmation.

i. whether the adviser maintains proper recordkeeping.

One of the focus of recent SEC staff examinations has been on the effectiveness of advisers' cybersecurity compliance and controls.[680]

7. *Results of Examination*

Generally, there are three possible results from an examination.

a. The SEC staff finds no problems and sends the adviser a letter stating that the inspection is finished (a rare event!).

b. The SEC staff sends a "deficiency letter" informing the adviser of any violations or possible violations found and requests the adviser to promptly take any necessary corrective steps and notify the SEC staff of the corrective actions taken. The deficiency letter will require the adviser to respond in writing, addressing the deficiencies identified.

   Failure to take corrective actions in response to a deficiency letter is cited frequently as a contributing factor in the SEC's decision to bring an enforcement action.[681] *That being said, sometimes a deficiency identified by staff will not be based on a correct application of the law or a misunderstanding of facts, and some "deficiencies" amount to suggestions rather than statements of legal obligations. Advisers responding to these letters are well-advised to consult with counsel.*

   The Dodd-Frank Act amended the Exchange Act to require the SEC to provide such a letter within 180 days after the later of (i) the date the SEC staff completes the on-site portion of the examination, or (ii) receives all records requested from the adviser.[682] *When the on-site portion of the examination is completed remains at the discretion of the SEC examiners and thus it is unclear whether this provision will have any effect on the promptness with which the SEC will conclude an open examination.*

c. If serious or recurring deficiencies or violations of law are discovered,[683] the SEC staff refers the inspection to the SEC's Division of Enforcement for further

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680 National Exam Program Risk Alert, Vol. Issue 2 (Apr. 15, 2014). The Exam Alert is accompanied by a sample of questions OCIE may pose during an examination. *See also* Examination Priorities for 2016.

681 *See, e.g.*, *Royal Alliance Associates, Inc.*, Advisers Act Rel. No. 4351 (Mar. 14, 2016).

682 Section 4E(b) of the Exchange Act, as amended by section 929U of the Dodd-Frank Act. Section 4E(b) includes an exception in the case of certain complex examinations.

683 In a number of enforcement cases, the SEC identifies the failure of the adviser to address deficiencies identified during multiple examination. *See, e.g.*, *Du Pasquier & Co., Inc.*, Advisers Act Rel. No. 4004 (Jan. 21, 2015) (recurring violations identified in multiple examinations); *Consultiva Internacional, Inc.*, Advisers Act Rel. No. 3441 (Aug. 3, 2012) (same).

> consideration and possible commencement of a civil enforcement proceeding, or (less frequently) referral to criminal authorities for prosecution.[684]
>
> *The SEC staff will not make public the deficiency letter, but clients and prospective clients may ask for a copy or ask for information about deficiencies discovered by regulators. While the adviser is under no obligation to provide this information, providing false or misleading information about any deficiencies discovered is a violation of the Act's anti-fraud provisions.*[685]

Self-Regulatory Organization. Section 914 of the Dodd-Frank Act required the SEC to conduct a study of approaches to improve the frequency of examination of investment advisers. In January 2011, the SEC submitted a staff study that asserted that the SEC's examination program requires a source of funding that is adequate to permit the SEC to meet the new challenges it faces, and sufficiently stable to prevent adviser examination resources from periodically being outstripped by growth in the number of registered investment advisers. To accomplish this, the staff recommended that Congress consider the following three approaches to strengthen the SEC's investment adviser examination program:

1. Authorize the SEC to impose user fees on SEC-registered investment advisers to fund their examinations by OCIE;

2. Authorize one or more SROs to examine, subject to SEC oversight, all SEC-registered investment advisers; or

3. Authorize FINRA to examine dual registrants (*i.e.*, firms registered with the SEC as both advisers and broker-dealers) for compliance with the Advisers Act.[686]

Competing legislation was introduced in 2012 to authorize the SEC to designate an SRO for investment advisers,[687] and to authorize the SEC to fund adviser examinations through user fees.[688] Neither was enacted.

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[684] Violation of the federal securities laws, including the Advisers Act, is punishable both by civil and criminal penalties. *See* section 217 of the Advisers Act (any person willfully violating the Advisers Act or any rule adopted by the SEC may be fined not more than $10,000 and imprisoned for not more than five years). Bernard Madoff pled guilty, among other things, to violations of the Advisers Act. *See* count two of the Criminal Information filed by U.S. Attorney for the Southern District of New York. The SEC does not have authority to bring criminal charges, but will assist the U.S. Justice Department or U.S. Attorney's Offices to prosecute criminal cases against advisers or other persons who violate the Advisers Act.

[685] *See Equitas Capital Advisor, LLC*, *supra* note 393 (adviser failed to disclose deficiencies in response to questions in RFPs and due diligence questionnaires); *CapitalWorks Investment Partners, LLC*, Advisers Act Rel. No. 2520 (June 6, 2006) (adviser falsely stated that SEC staff examination did not result in any deficiencies).

[686] *Study on Enhancing Investment Adviser Examinations*.

[687] H.R. 4624, The Investment Adviser Oversight Act of 2012.

[688] H.R.1627, The Investment Adviser Examination Improvement Act of 2013.

Appendix A

Applicability of Provisions and Rules

	Registered Advisers	Exempt Reporting Advisers	Unregistered Advisers[1]
Fiduciary Obligations	Yes	Yes	Yes
Principal Trade Restrictions	Yes	Yes	Yes
Agency Cross Transactions	Yes	Yes	Yes
Advertising Rule	Yes	No	No
Custody Rule	Yes	No	No
Cash Solicitation Rule	Yes	No	No
Proxy Voting Rule	Yes	No	No
Duty to Supervise	Yes	Yes	Yes
Compliance Rule	Yes	No	No
Code of Ethics Rule	Yes	No	No
Pay to Play Rule	Yes	Yes	Yes[2]
Fraud Against Investors in Pooled Investment Vehicles	Yes	Yes	Yes
Insider Trading Policies and Procedures	Yes	Yes	Yes
Form ADV	Yes	Yes	No
Brochure Rule	Yes	No	No
Systemic Risk Reporting on Form PF	Yes	No	No
Privacy Rule	Yes	No	No[3]
Recordkeeping Rule	Yes	No	No
SEC Examination	Yes	No[4]	No
Beneficial Reporting on Schedules 13D and G	Yes	Yes	Yes
Institutional Investor Reporting on Form 13F	Yes	Yes	Yes
Large Trader Reporting on Form 13H	Yes	Yes	Yes
Contractual Requirements (including performance fee restrictions)	Yes	No	No
Whistleblower Protections	Yes	Yes	Yes

1 State laws may impose similar obligations on advisers registered with a state.

2 Except state-registered advisers. *See supra Section VI.B.5.*

3 Both exempt reporting advisers and unregistered advisers are subject to similar CFPB Rules.

4 SEC has stated that it will not conduct regular or periodic examinations of exempt reporting advisers. As a matter of policy, it does not examine state-registered advisers. *See supra Section VI.F.1.*