Proskauer

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

Robert E. Plaze
Partner

June 2018

TABLE OF CONTENTS

Page

I. Introduction 1

II. Who is an Investment Adviser?...2

A. Definition of Investment Adviser 2

1. *Compensation* 2
2. *Engaged in the Business*..3
3. *Advising about Securities* 3
4. *Advising Other Persons*...5

B. Exclusions from Definition...6

1. *Banks and Bank Holding Companies*..6
2. *Lawyers, Accountants, Engineers, and Teachers*..7
3. *Brokers and Dealers*...7
4. *Publishers*...10
5. *Government Securities Advisers*..11
6. *Credit Rating Agencies*...11
7. *Family Offices* 12
8. *Governments and Political Subdivisions*..13
9. *Non-U.S. Advisers* 13
10. *Exemptive Authority* 14

III. Which Investment Advisers Must Register Under the Advisers Act? 14

A. State/SEC Registration..14

1. *Securities Portfolios* 15
2. *Continuous and Regular Supervisory or Mangagement Services*...............15
3. *Operation of Section 203A of the Advisers Act* 16
4. *Exceptions to Prohibition*..17
5. *State Law Still Applicable to SEC-Registered Advisers*............................19
6. *Federal Anti-Fraud Law Still Applicable to State-Registered Advisers* 20

B. Exemptions from Registration 20

1. *Intrastate Advisers*..21
2. *Advisers to Insurance Companies* 21
3. *Foreign Private Advisers*...21
4. *Charitable Organizations and Plans*..24
5. *Commodity Trading Advisors*...24
6. *Private Fund Advisers* 25
7. *Venture Capital Advisers*..28
8. *Advisers to Small Business Investment Companies (“SBICs”)*.................29

IV. Who Must Register Under the Advisers Act? 29

A. The Advisory Firm...29

B. Affiliates....30

1. *Integration of Affiliates* 30
2. *Richard Ellis Test* 30
3. *Participating Affiliates* 31
4. *Umbrella Registration for Advisers to Private Funds* 32

V. How Does an Investment Adviser Register Under the Advisers Act or Report as an Exempt Reporting Adviser? 33

A. Registration as an Investment Adviser....33

1. *Denial of Registration* 34
2. *Qualifications* 34

B. Reporting as an Exempt Reporting Adviser 34

1. *Qualifications.* 34
2. *Becoming an Exempt Reporting Adviser* 35
3. *State Law* 35

C. Form ADV 35

1. *Part 1A* 36
2. *Part 2* 37
3. *Exempt Reporting Advisers* 37

D. Electronic Filing....37

E. Public Availability 38

F. Withdrawal....38

1. *Registered Advisers* 38
2. *Exempt Reporting Advisers* 38

G. Successor Registrations....39

1. *Succession by Application* 39
2. *Succession by Amendment* 39
3. *Exempt Reporting Advisers* 39

VI. What Are the Requirements Applicable to an Investment Adviser? 39

A. Fiduciary Duties to Clients 40

1. *Full Disclosure of Material Facts* 41
2. *Suitable Advice* 42
3. *Reasonable Basis for Recommendations* 43
4. *Best Execution* 43
5. *Proxy Voting* 48

B. Substantive Requirements (Advisers Act) 48

1. *Client Transactions* 48
2. *Advertising*....55

3. *Custody of Client Assets* 64
4. *Use of Solicitors* 68
5. *Pay to Play (Political Contributions)* 70
6. *Proxy Voting* 75
7. *Duty to Supervise* 76
8. *Compliance Programs* 78
9. *Codes of Ethics/Gifts and Entertainment Policies* 83
10. *Fraud Against Investors in Pooled Investment Vehicles* 88
11. *Misuse of Non-Public Information* 89
12. *Brochure Rule* 92
13. *Systemic Risk Reporting on Form PF* 94

C. Substantive Requirements (Other Security Laws) 96

1. *Privacy of Client Information* 96
2. *Identity Theft Red Flags (Regulation S-ID)* 103
3. *Beneficial Ownership Reporting on Schedules 13D and 13G* 104
4. *Institutional Investor Reporting on Form 13F* 107
5. *Large Trader Reporting on Form 13H* 108
6. *Broker-Dealer Registration* 109
7. *Whistleblowers* 111

D. Contractual Requirements 115

1. *Advisory Fees* 115
2. *Assignments of Advisory Contracts* 118
3. *Hedge Clauses* 121
4. *Termination Restrictions* 122
5. *Rescission Rights* 122

E. Recordkeeping Requirements 123

1. *General Business Records* 123
2. *Additional Records* 123
3. *Time, Place and Manner of Retention* 125
4. *Document Destruction Policies* 126
5. *Applicability to Non-U.S. Advisers* 127

F. Administrative Oversight 128

1. *Advisers Subject to Compliance Examinations* 128
2. *Records Subject to Examination* 128
3. *Types of Examinations* 130
4. *Examinations of Non-U.S. Advisers* 131
5. *Obligations of an Adviser Subject to an Examination* 132
6. *Focus of Examinations* 133
7. *Results of Examination* 134

Appendix A Applicability of Provisions and Rules 136

Appendix B Associated Persons and Similar Terms Used 137

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?

---

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).

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:

- 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

---

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 on 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. Ogale*, 378 Fed.Appx. 959 (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 himself 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 funds, limited partnerships, and interests in commodity pools. The SEC staff has

---

10 Release 1092, *supra* note 5.

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. 27, 1998).

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]asset allocation advice;[24] and 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

---

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). *See* SIX Financial Information USA Inc., Advisers Act Rel. No. 4780 (Sept. 28, 2017) (securities valuation service "acted as an investment adviser under Section 202(a)(11) of the Advisers Act because it was engaged in the business of advising other as to the value of securities for compensation.")

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.

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."); *SEC v. Saltzman*, 127 F.Supp.2d 660 (E.D. PA Dec. 29, 2000). 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.

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 Other Persons.* A person is not subject to the Act if he is managing his own securities portfolio.[30] 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.[31]

   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.[32]

   b. A trustee is considered advising others and is an adviser unless eligible for another exception.[33] Accordingly, many trust companies that are not eligible for the exception for banks register as investment advisers.[34]

---

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 *See* *Thomas S. Baldwin*, SEC Staff No-Action Letter (Feb. 11, 1971) (advice to closely held company owned by parents).

31 *Touche Holdings, Inc.*, SEC Staff No-Action Letter (Nov. 30, 1987). The letter, while correctly stating the principle, contains some dictum suggesting that two persons pooling their resource and jointly exercising control over the pool would both be subject to the Act. This is inconsistent with the "investment club" letters the SEC staff has issued under both the Advisers Act and Investment Company Act.

32 *U.S. v. Ogale*, 378 Fed. Appx. 959 (11th Cir. 2010); *SEC v. Haligiannis*, 470 F.Supp.2d 373 (S.D.NY 2007).

33 *Joseph J. Nameth*, SEC Staff Letter (Dec. 30, 1982) (distagreeing with *Selzer v. Bank of Bermuda Ltd.*, 385 F. Supp. 415, 420 (S.D.N.Y. 1974)(Advisers Act not applicable because "the trustee does not advise the trust, which then takes action pursuant to its advice, rather the trustee acts himself as principal"); *SEC v. Smith*,U.S. Dist. LEXIS 22352 (1995).

34 *See Certain Thrift Institutions Deemed Not to Be Investment Advisers*, Advisers Act Rel. No. 2232 (Apr. 30, 2004), which proposed to except from the definition of "investment adviser" certain thrift institutions regulated by the Office of Thrift Supervision ("OTS) that were not eligible for the bank exception. Title III of the Dodd-Frank Act abolished the OTS and made the thrifts subject to bank regulation (and thus eligible for the bank exception). The proposed rule thereby became moot and was never adopted.

c. A wholly-owned corporate subsidiary exclusively advising the parent or another wholly-owned corporate subsidiary would not generally be considered advising "others."[35]

d. A member of an investment club who gives advice about securities in which the club invests may be advising others.[36]

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.[37]

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.[38] The SEC staff has stated that the exclusion is not available to non-U.S. banks,[39] credit unions, and investment adviser subsidiaries of banks or bank holding companies.[40]

Bank Advisers to Registered Investment Companies. Banks and bank holding companies are not eligible for this exclusion (and must register under the Act) if they 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

---

[35] *See* *Zenkyoren Asset Mgmt. of America Inc.*, SEC Staff No-Action Letter (June 30, 2011). *Lockheed Martin Investment Mgmt. Co.*, SEC Staff No-Action Letter (June 5, 2006); *MEAG Munich ERGO*, SEC Staff No-Action Letter (Feb. 14, 2014); *Allianz of America, Inc.*, SEC Staff No-Action Letter (May 25, 2012). This issue became important after the enactment of the Dodd-Frank Act (discussed below) before which a person who might be deemed an adviser as a result of providing advice to a parent or subsidiary company could rely on the exemption from registration in Section 203(b)(3) for advisers with fewer than 15 clients.

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

[37] *See* Release 3221, *infra* note 94, 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).

[38] Section 202(a)(11)(A). The term "bank" is defined in section 202(a)(2) of the Act.

[39] *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).

[40] *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).

itself, is deemed to be the investment adviser.[41] The effect of this provision is to make the bank exclusion unavailable to banks advising registered investment companies, while shielding most operations of such banks from SEC regulation and oversight.

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.[42] 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.[43]

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 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.[44] 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."[45] 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.

   The SEC has identified three non-exclusive circumstances in which a broker-dealer would not be providing incidental advisory services:

   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.

41 The phrase "separately identifiable department or division" is defined in section 202(a)(26).

42 Section 202(a)(11)(B).

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

44 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.

45 Certain Broker-Dealers Deemed Not To Be Investment Advisers, Advisers Act Rel. No. 2376 (Apr. 12, 2005) ("Release 2376"), at note 49. *Accord* *Thomas v. Metropolitan Life Insurance Company*, 631 F.3d 1153 (10th Cir. 2011) (rejecting interpretation that advice is "incidental" only if it is inconsequential or of lesser value than brokerage services).

b. *Discretionary Investment Advice.* Broker-dealer discretionary accounts (unless discretion is granted on a temporary or limited basis) must be treated as advisory accounts.[46]

c. *Financial Planning.* Broker-dealer-provided advisory services in connection with financial planning services may not be considered incidental to brokerage services.[47]

Special Compensation. Generally, to avoid receiving "special compensation," a broker or dealer relying on this exclusion must receive only commissions, markups, or markdowns.[48]

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 (*i.e*., a "wrap fee") receives "special compensation."[49]

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.[50]

---

46 *Interpretive Rule under the Advisers Act Affecting Broker-Dealers*, Advisers Act Rel. No. 2652 (Sept. 24, 2007) ("Release 2652"). In this release the SEC proposed an interpretive rule under the Advisers Act. While the rule was never adopted, the guidance is the most recent provided by the SEC.

47 In 2005 the SEC adopted a rule that would, among other things, deem financial planning services as not incidental to brokerage services. Release 2652, *supra* note 46. For unrelated reasons, in 2007 the rule was vacated by a federal appeals court. *Financial Planning Association v. SEC*, 482 F.3d (D.C. Cir. 2007) ("FPA v. SEC"). The SEC decided not to address the question of financial planning in the interpretive release it subsequently proposed because of the difficulty of determining when a broker-dealer is providing financial planning services. *Id.* Given this history and the statements the SEC made in Release 2652, it may be advisable to (and this outline does) treat financial planning services as not incidental to brokerage.

48 *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 do not receive special compensation. *Koyen, Clarke & Associates*, SEC Staff No-Action Letter (Nov. 9, 1986).

49 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 on their receipt of special compensation. The rule was vacated for other reasons by a federal court in March 2007. *FPA v. SEC*, *supra* note 47. *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).

50 *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 46.) 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).

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.[51]

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 differences in the relationship.[52] The SEC later withdrew the letter without comment.[53]

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 afforded by regulation under the Exchange Act, is available only to a broker-dealer that is registered under the Exchange Act.[54]

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.[55]

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

---

[51] Release 626 at section V, *supra* note 50. In 2007, the SEC proposed to codify this interpretation in a rule. *See Interpretive Rule under the Advisers Act Affecting Broker-Dealers*, *supra* note 46.

[52] 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.").

[53] *See* Release 2652, *supra* note 46 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).

[54] *Citicorp*, SEC Staff No-Action Letter (Sept. 14, 1986).

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

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.[56] 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.[57]

Current Developments. In April 2018, the SEC issued a proposed interpretation of an adviser's fiduciary duty under the Act that reflects advisers' current obligations to clients developed by caselaw and SEC administrative actions.[58] At the same time, the SEC proposed Regulation BI, which would impose quasi-fiduciary obligations on broker-dealers advising with respect to the advice that they provide retail customers regarding the purchase and sale of securities.[59] The SEC did not, however, propose to revise the scope of the broker-dealer exception to the Advisers 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);[60] (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

---

56 *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.

57 *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).

58 *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers*. Advisers Act Rel. No. 4889 (Apr. 18, 2018).

59 *Regulation BI*, Exchange Act Rel. No. 83062 (Apr. 18, 2018). The rule was proposed pursuant to Section 913 of the Dodd-Frank Act, which directed the SEC to conduct a study of current standards and authorized the SEC to adopt rules that address the standards of care for broker-dealers and investment advisers when providing advice to retail customers. The SEC submitted to Congress a study in January 2011 recommending, among other things, adoption of a "uniform" fiduciary standard of conduct for broker-dealers and investment advisers "when providing personal investment advice about securities to retail customers." *Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*. The recommendation sought to close the difference in standards to which broker-dealers and investment advisers are held. *See*, *Thomas v. Metropolitan Life Insurance Company*, 2009 WL 2778663 (W.D. Okla. 2009) *affd. 631 F.3d 1153 (2011)* (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).

60 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).

circulation (rather than issued from time to time in response to episodic market activity).[61]

Books and Other Publications. 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.[62] 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.[63]

Index Providers. Index providers rely on the exception to publish securities indexes the use of which they licensed to third parties, including advisers to funds such as ETFs to create passive securities portfolios. The SEC staff has recently questioned, however, whether the publishers' exception is available for publishers of a bespoke or a "narrowly focused index" used by a single fund.[64]

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.[65] 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.[66]

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."[67]

---

61 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).

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

63 *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.

64 Speech by Dalia Blass, Director Division of Investment Management. *Keynote Address, ICI 2018 Mutual Funds and Investment Management Conference*, Mar. 19, 2018. The concern expressed appears to be whether the advice would be truly be "impersonal" or more like the advice provided in the *Weiss Research* matter discussed, *supra* note 60.

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

66 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).

67 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).

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[68] to the public as an investment adviser.[69]

   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.[70]

   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.[71]

   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 which key employees may invest in opportunities connected to the family office.[72]

   d. *Multi-Family Offices*. The rule is *not* available to a family office that serves multiple families.[73] In this regard, the SEC staff has stated that if several unrelated families established separate family offices staffed with the same or

---

68 *See* Section II.A.2 of this outline for a discussion of "holding out."

69 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.

70 Rule 202(a)(11)(G)-1(d)(4).

71 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 deeming them not to be investment advisers despite 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).

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

73 Advisers Act Rel. No. 3220, *supra* note 71.

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.[74]

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.[75]

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).[76] The SEC does not accept "home state registration" of non-U.S. advisers in lieu of SEC registration.[77]

   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.[78] An adviser must assess whether a person is "in the United States" at the time the person becomes a client or, in the case of an investor in a private fund, each time the investor acquires securities issued by the fund.[79]

   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.[80] Such an

---

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

75 Section 202(b).

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

77 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."

78 The SEC has not adopted any definition of "U.S. person" of general applicability under the Act. In has, however, adopted two rules that define the term for purposes of implementing two registration exemptions created by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 932, 124 Stat. 1376, 1872-83 (2010) "Dodd-Frank Act"). *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.

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

80 *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

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.[81]

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.[82]

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

A firm that meets the definition of "investment adviser" (and does not qualify 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.[83] 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.[84]

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.[85] Today, most small advisers and "mid-sized advisers" are subject to state regulation of advisers and are

certain conditions, including recordkeeping requirements, discussed *infra* at note 704. The SEC has adopted the staff approach. Advisers Act Rel. No. 3222, *infra*, note 129 at n.515.

81 *Gim-Seong Seow*, *supra* note 37; *Double D. Mgmt.*, SEC Staff No-Action Letter (Dec. 30, 1982).

82 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.

83 Section 203(a).

84 *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).

85 *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 78**Error! Bookmark not defined.** . Most of the provisions mending the Advisers Act to allocate regulatory responsibilities between the SEC and state governments have been codified in section 203A.

prohibited from registering with the SEC.[86] Most large advisers (unless an exemption is available) must register with the SEC.[87] State adviser laws are preempted for SEC-registered advisers.[88]

Most advisers prefer registration with the SEC because it permits them to avoid registration and regulation of their advisory activities under multiple state laws. In most cases, the choice is not the adviser's but is determined by application of Section 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" ("RAUM"), which is the sum of the value of all "securities portfolios for which the adviser provides continuous and regular supervisory or management services."

1. *Securities Portfolios.* An account is a "securities portfolio" if at least 50% of the value of the portfolio consists of securities or cash and cash equivalents. For each account that meets the 50% test, include the entire value of the assets for which the adviser provides continuous and regular supervisory or management services.

   Private Funds. In the case of a client that is a "private fund," (i) treat the fund as a securities portfolio regardless of the nature of its assets (the 50% test does not apply), and (ii) include the value of any uncalled capital commitments.

   Misc. Accounts. Treat as a securities portfolio (i) family and proprietary accounts; (ii) accounts for which the adviser is uncompensated, (iii) accounts of clients that are not U.S. persons.

2. *Continuous and Regular Supervisory or Mangagement Services*. 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.[89]

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

---

86 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).

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

88 203A(b) (preemption of state law).

89 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.

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.[90]

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

a. *Small Advisers.* Advisers with less than $25 million of RAUM must register with and be regulated by states in which they do business in accordance with state law.[91] Such an adviser may not register with the SEC (even if it is exempt from registration in each state) unless an exemption is available as discussed below.

b. *Mid-Sized Advisers*. Advisers with between $25 million and $100 million of RAUM must also generally register in the states in which they do business and may not register with the SEC.[92] There are two exceptions, the availability of which both turns on state law:

(1) *Registered under State Law*. If the adviser is not registered with the state in which it has its principal office and place of business because, for example, it has taken advantage of an exemption from state registration, it must register with the SEC.[93] As a result, a mid-sized adviser must register with either one or more state securities authorities or the SEC, unless exemptions are available from registration in both.

(2) *Subject to Examination.* If the adviser is not "subject to examination" by the securities authority of the state in which it has its principal office and place of

90 Rule 203A-3(c).

91 Section 203A(a)(1) provides for an exception in the case of an adviser that has its principal office and place of business in a state (or territory) that has *not* enacted a statute regulating advisers. Under this provision, the SEC was responsible for registration and regulation of some small advisers until April 2017 when Wyoming became the last state to enact a statute regulating advisers in that state. Wyo. Stat. Ann. § 17-4-403 (2016). The SEC amended Forms ADV and ADV-W to reflect the new Wyoming law. *Technical Amendments to Form ADV and Form ADV-W*, Advisers Act Release No. 4698 (May 4, 2017).

92 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 state 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.

93 In the case of a small adviser, the prohibition against registration with the SEC turns on whether the adviser is *regulated or required to be regulated* as an investment adviser in the state in which it maintains its principal office and place of business. The SEC interprets this provision to mean the prohibition applies if the state in which the adviser maintains its principal office and place of business has enacted an investment adviser statute. *See 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. In contrast, the prohibition on mid-level advisers registering with the SEC applies only where the mid-sized adviser is *required to be registered* with the state securities authority in which it has its principal office and place of business. Section 203A(2)(B)(i).

business, it must register with the SEC.[94] Currently, only a mid-sized adviser with its principal office and place of business in New York is not "subject to examination" in the state and therefore must register with the SEC, unless one of the exemptions discussed below is available.[95]

c. *Large Advisers*. Advisers with more than $100 million of RAUM 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 of assets they have under management.[96] Accordingly, a non-U.S. adviser giving advice to U.S. persons[97] 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).[98]

4. *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.[99] The exception is not available to an adviser that simply gives advice about investing in investment companies.[100]

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.[101]

---

94 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").

95 *See* Instructions for Item 2 of Part 1A of Form ADV; Division of Investment Management: Frequently Asked Questions ("FAQs") Regarding Mid-Sized Advisers. Since the FAQ was published, Wyoming enacted a statute regulating advisers in that state and established an examination program. As a result, a mid-level adviser with a principal office and place of business in Wyoming may no longer register with the SEC unless an exemption is available.

96 *See* Release 1633, *supra* note 93 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.

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

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

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

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

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

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).[102]

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.[103] 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."[104]

e. *Advisers Expecting to be Eligible for Commission Registration.* 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.[105] 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.[106] 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.[107]

g. *Internet Advisers.* An adviser that provides advice exclusively through an interactive web site may register with the SEC, even though it has no assets under

---

102 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 for breaching 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).

103 Rule 203A-2(b).

104 Release 1633, *supra* note 93 at n.65.

105 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).

106 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).

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

management.[108] 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.

5. *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, *i.e.*, a notice filing, as the document is called;[109]

c. Pay state licensing and renewal fees; and

d. License certain of the adviser's "supervised persons" who are also "investment adviser representatives," *i.e.*, personnel who (i) have a place of business in the state,[110] and (ii) primarily deal directly with individual clients.

(1) "Supervised person" is a partner, officer, director or employee of an adviser or other person (*e.g.*, independent contractor) who provides advice on behalf of the adviser and is subject to the supervision and control of the adviser.[111]

(2) "Investment adviser representative" is a supervised person who (i) has five or more clients who are natural persons, and (ii) more than 10% of whose clients

108 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).

109 SEC-registered advisers can comply with state requirements that they provide states with notice filings, pay state registration fees, and license advisory personnel (in most states) through the electronic filing system (IARD) discussed below.

110 Section 203A(b)(1)(A). This provision precludes a state from requiring, as some did before 1997, the licensing of all advisory personnel of an adviser registered in the state even if the person does not do business in the state.

111 Section 202(a)(25). The definition of "supervised person," added by Congress in NSMIA in 1996, reflected the longstanding position of the SEC that "persons associated with an adviser" include independent contractors whose activities are supervised and controlled by the adviser. Advisers Act Rel. No. 1000 (Dec. 3, 1985). A person who provides advisory services *not* subject to the supervision and control of the adviser may have an independent registration obligation. *Id.*

are natural persons.[112] For purpose of both tests, certain high net worth individuals may be excluded, *i.e.*, those clients with whom an adviser may enter into advisory contracts that may be charged a performance fee under rule 205-3.[113] Also excluded are supervised persons who provide only "impersonal advice" and persons who have limited direct contact with clients.[114]

Place of Business. An investment adviser representative has a "place of business" in each state in which he has (i) an office at which he regularly provides advisory services, solicits, meets with or otherwise communicates with clients, and (ii) any other location held out to the public as a location at which he conducts such activities.[115]

6. *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.[116]

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.[117] 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 regulators.[118]

---

112 The definition originally included only a 10% test, but was revised in 1998 to add the "five client test" in order to permit personnel of institutional advisers who may have only a few large clients to accept so-called accommodation clients without being subject to state licensing requirements. *Exemption for Advisers Operating in Multiple States*, *supra* note 107.

113 Rule 203A-3(a)(1). As a result of the link between the "high net worth individuals" and rule 205-3, the thresholds in Rule 205-3 will from time to time be adjusted by the SEC for inflation causing some advisory personnel to be subject to state licensing requirements. *See* discussion at VI.D.1. of this outline. Advisers may rely on the definition of "client" in rule 203(b)(3)-1 to count clients, except that clients who are not U.S. residents need not be counted. Rule 203A-3(a)(3) and (4).

114 Rule 203A-3(a)(2).

115 Rule 203A-3(b). Note that the "place of business" of an investment adviser representative may be different from an adviser's "principal place of business" used in other rules.

116 *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.

117 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 61. 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.

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

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 do not give advice about securities traded on any national exchange.[119] The exemption is not, however, available to an adviser that advises a private fund.[120]

2. *Advisers to Insurance Companies*

Available to an adviser whose only clients are insurance companies.[121]

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.[122] 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) on which a non-U.S. adviser could rely to avoid registration while establishing a limited presence in the United States. 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.[123] It includes an office in which the adviser manages money or conducts research, but not one in which the adviser provides solely administrative

[119] 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).

[120] The limitation was added by Section 403(1) of the Dodd-Frank Act.

[121] 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).

[122] 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.

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

services or back-office activities that are not "intrinsic to providing advisory services."[124]

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 to (i) clients who are U.S. persons, and (ii) investors in private funds it advises who are U.S. persons.[125]

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:[126]

(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,[127]

(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.[128]

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

---

124 Release 3222, *infra* note 129 at Section II.C.4.

125 Section 202(30)(C).

126 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).

127 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).

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

master-feeder arrangement may be deemed to be the investors of the master fund.[129]

(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 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.[130]

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,[131] or hires a person to solicit clients on his behalf. [132]

(1) *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.[133]

(2) *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) *Disclaimer.* The adviser's website includes a prominent disclaimer making it clear that its web site 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

---

129 *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.

130 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).

131 *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).

132 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 web site that is accessible only by accredited investors).

133 Rule 202(a)(30)-1(d).

U.S. persons (*e.g.*, obtaining residency information before sending further information).[134]

4. *Charitable Organizations and Plans*

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.[135]

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.[136]

This first exemption is of limited utility for many CTAs because, on its face, it requires the CTA's business to not consist primarily of acting as an investment adviser at all times.[137]

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.[138]

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

[134] *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.

[135] 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).

[136] 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 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).

[137] 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).

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

thus did not become predominantly advice about securities after the enactment of the Dodd-Frank Act).[139]

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, and (ii) one or more small business investment companies (SBICs) (discussed below).[140] An adviser that has any other type of client is not eligible for the exemption.[141]

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.[142]

(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.[143]

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.[144] In 2013, the SEC adopted amendments to Regulation D that permitted issuers including private funds, subject to certain conditions, to make general solicitations.[145] 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

---

139 *See* Investment Management Staff Issues of Interest.

140 Section 203(m)(1) of the Advisers Act and rule 203(m)-1. 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 SEC subsequently amended rule 203(m)-1 to reflect the amendment to the Act. *Exemptions from Investment Adviser Regulation for Advisers to Small Business Investment Companies*, Advisers Act Rel. No. 4839 (Jan. 5, 2018).

141 Two nominally separate but related advisers may be considered to be one adviser (and their clients combined) if they do not operate sufficiently independent of one another. An adviser ostensibly relying on the private adviser exemption could thus be deemed to have, for example, a separate account client of the other adviser, making it ineligible for the exemption. *See* discussion *infra* note 171.

142 Section 202(a)(29) of the Advisers Act.

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

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

145 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.

engaged in certain "disqualifying conduct" during the past 10 years.[146] 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 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.[147]

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.[148]

(2) *Non-U.S. Advisers.* An adviser with a principal office and place of business outside the United States (i) must include only assets managed at a "place of business" in the U.S.,[149] 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[150]

(B) management activities in the United States are limited to $150 million of private fund assets.[151]

A non-U.S. adviser's non-U.S. clients will not count in determining whether it qualifies for the private fund adviser exemption 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

[146] 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.

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

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

[149] 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 if management decisions are made outside of the U.S. Release 3222, *supra* note 129 at 93. Back office services are also unlikely to be considered management activities.

[150] 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.

[151] 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.

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 commitments.[152] 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.[153]

(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.[154] 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.[155] 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[156] and is subject to examination. Other provisions of the Act and SEC rules

---

152 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).

153 *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 129 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 RAUM. *Id*. at n.365.

154 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.

155 *Unibanco*, *supra* note 80. 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).

156 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.

applicable only to registered advisers do not apply.[157] *See* Appendix A. The SEC refers to these advisers as "exempt reporting advisers."

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).[158]

a. *Venture Capital Fund*. To qualify as a "venture capital fund," a fund must be a "private fund"[159] that:

(1) represents to investors that the fund pursues a venture capital strategy;[160]

(2) does not provide investors with redemption rights;[161]

(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 buyout transaction).[162]

---

157 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.

158 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 129. Section 203(l) was amended in 2015 by Section 74001 of the FAST Act, *supra* note 140, to treat a SBIC as a "venture capital fund" for purpose of section 203(l). The SEC subsequently amended rule 203(m)-1 to reflect the amendment to the Act. *Exemptions from Investment Adviser Regulation for Advisers to Small Business Investment Companies*, Advisers Act Rel. No. 4839 (Jan. 5, 2018).

159 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).

160 Rule 203(l)-1(a)(1).

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

162 For purposes of determining whether an investment is a qualifying investment, a fund may disregard a wholly owned intermediate holding company formed solely for tax, legal or regulatory reasons to hold an investment. Release 3222, *supra* note 129 at n.217 and accompanying text. The SEC staff has issued guidance describing circumstances in which a venture capital fund may utilize various structures to hold investments without causing an adviser to the fund to lose the exemption. IM Guidance Update No. 2013-13 (Dec. 2013).

(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).[163]

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.[164] Thus, all of an adviser's clients, including non-U.S. clients, must be venture capital funds.[165]

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,[166] 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.[167]

Note: An adviser that solely provides advice to an SBIC is exempt from registration as an adviser and the requirements attendant to registration. An adviser to an SBIC that also advises one or more private funds or venture capital funds must rely on those exemptions and thus would be treated as an exempt reporting adviser required, among other things, to file Form ADV.[168]

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*

---

163 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.

164 Release 3222, *supra* note 129.

165 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 129.

166 Rule 204-2.

167 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 140.

168 *See* IM Guidance Update No. 2016-03 (Mar. 2016); *Exemptions from Investment Adviser Regulation for Advisers to Small Business Investment Companies, supra* note 140.

other persons under its control and supervision (*e.g.*, officers, independent contractors), provided that their advisory activities are undertaken on the adviser's behalf.[169]

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.[170] For example:

- An adviser managing $200 million of private fund assets could not simply reorganize as two commonly controlled advisers each of which purport to rely on the private fund adviser exemption from registration.[171]

- An adviser that utilizes controlled limited partnerships that are themselves investment advisers to manage a hedge funds, may be unable to avoid the obligations of the Advisers Act with respect to the hedge funds.[172]

2. *Richard Ellis Test*

Whether an adviser and a separately created affiliate are sufficiently independent to avoid integration is a facts and circumstances determination, and turns on the application of Section 208(d) of the Advisers Act, which prohibits any person "indirectly or through or by any other person" from doing any act or thing which it would be unlawful for such person to do directly under the Act.[173] The SEC has traditionally applied a five-factor test set forth in the *Richard Ellis* no-action letter, to evaluate whether a separately formed adviser may be regarded as having a separate existence and function independent of its parent. These factors ask whether the affiliate:

---

[169] 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).

[170] Release 3222, *supra* note 129.

[171] Release 3222, *supra* note 129, at Section II.D. *See TL Ventures*, Advisers Act Rel. No. 3859 (June 20, 2014) (advisers under common control shared employees, had significantly overlapping operations, cross-marketed services, and failed to have any policies and procedures designed to keep the entities separate). *See also Bradway Financial, LLC*, Advisers Act Rel. No. 4733 (July 25, 2017) (advisers were owned by the same individual and shared employees and technological systems).

[172] *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).

[173] *Richard Ellis*, SEC Staff No-Action Letter (Aug. 18, 1981). *See also Price Waterhouse*, SEC Staff No-Action Letter (July 16, 1987).

a. Is adequately capitalized;[174]

b. Has a buffer between the subsidiary's personnel and the parent, such as a board of directors, a majority of whose members are independent of the parent;

c. Has employees, officers, and directors who, if engaged in providing advice in the day-to-day business of the subsidiary, are not otherwise engaged in the investment advisory business of the parent;

d. Itself makes the decisions as to what investment advice is to be communicated to, or is to be used on behalf of, its clients and has and uses sources of investment information not limited to its parent, and

c. Keeps its investment advice confidential until communicated to its clients.

3. *Participating Affiliates*

The *Richard Ellis* factors, and in particular the requirement that affilates have separate personnel in the United States, presented problems for muli-national advisers who could be expected to draw on the expertise of non-U.S. personnel when providing advice to U.S. persons, and would otherwise be required to duplicate that expertise in the United States. In a 1992 report, the SEC staff recommended that the test be relaxed for non-U.S. firms to facilitate operations in the United States.[175]

Under conditions set forth in the *Unibanco Letter* issued in 1992, a non-U.S. adviser (the "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.[176] A participating affiliate arrangement 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 Unibanco and subsequent staff letters.[177] The conditions include:

a. The unregistered participating affiliate and the registered adviser are separately organized;

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

[174] The *Richard Ellis* letter did not provide any guidance regarding the adequacy of capital necessary to meet this factor. A subsequent letter explained that the SEC was concerned that the affiliate might be an undercapitalized shell company formed to limit the parent's liability. *Price Waterhouse*, SEC Staff No-Action Letter (Oct. 1, 1987).

[175] Protecting Investors: A Half Century of Investment Company Regulation (1992) at 233.

[176] See *Unibanco*, *supra* note 80. "Through an affiliate" means that all advice must be transmitted through the registered adviser.

[177] *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.

c. All personnel of the participating affiliate involved in U.S. advisory activities are deemed "associated persons"[178] of the registered affiliate; and

d. The SEC has 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.[179]

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 include 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.[180]

4. *Umbrella Registration for Advisers to Private Funds*

Under limited conditions, a registered adviser to one or more private funds (and ccertain parallel accounts) may file a single Form ADV on behalf of itself ("Filing Adviser") and multiple related advisers ("Relying Advisers"). The conditions are designed to limit umbrella registration to advisers that collectively operate a single business through multiple firms.[181] Advisers to private funds that may be integrated under the *Richard Ellis* tests may be able to take advantage of umbrella registration to avoid maintaining multiple Form ADVs.

Conditions for Use

a. The Filing Adviser and each Relying Adviser adviser *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.[182]

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.

---

[178] *See* Section V.A.1 and Exhibit B to 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.

[179] *See id*. In addition, the adviser must undertake to have records requested by the staff translated into English. These undertakings have typically been included in the participating affiliate agreement. The SEC staff has recently suggested that they may be submitted to the SEC via an email address. IM Information Update (March 2017). The staff guidance also provides detail on the representations the staff believes "addresses most clearly the concerns raised" in the staff letters.

[180] The SEC has affirmed the staff no-action positions. Release 3222, *supra* note 129, at Section II.D.

[181] 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. In addition, the SEC adapted Form ADV to umbrella registration by adding a new Schedule R, which collects information about relying advisers.

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

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."[183]

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.

f. The Filing Advisers completes a Schedule R to its Form ADV on behalf of earch Relying Adviser

Limitations

a. Umbrella reporting is not available to multiple reated exempt reporting advisers, which are not registered under the Advisers Act. Nonetheless, exempt reporting advisers may use Form ADV to report a Relying Adviser that is a special purpose entity.[184]

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.

Special Purpose Vehicles

A special purpose vehicle ("SPV") established solely to act as a general partner to a private fund may register with the SEC subject to a narrower set of conditions.[185]

V. How Does an Investment Adviser Register Under the Advisers Act or Report as an Exempt Reporting Adviser?

A. Registration as an Investment Adviser

Applicants for registration under the Act must file Form ADV with the SEC.[186] Within 45 days the SEC must grant registration or institute an administrative proceeding to determine whether registration should be denied.[187]

183 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. *See supra at* note 80 and accompanying text.

184 Advisers Act Rel. No. 4509, *supra* note 181. *See* FAQs on Form ADV and IARD (Mar. 2012).

185 An adviser will not have to complete Schedule R with respect to such SPVs. *See* FAQs on Form ADV (Schedule R). Instead, SPVs are reported as related persons of the Filing Adviser in response to Item 7 of Form ADV. Not all general partners of private funds may be investment advisers required to register under the Act. *See e.g.*, Thompson Advisory Group L.P. (Sept. 26, 1995).

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 an 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.[188]

   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.[189] 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.

   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.[190]

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 place of business. Instead, advisers must disclose to clients the background and qualifications of certain of their personnel.[191]

B. Reporting as an Exempt Reporting Adviser

An investment adviser relying on Section 203(m) (a "private fund adviser") or 203(l) (a "venture capital adviser") may, instead of registering, operate as an "exempt reporting adviser" by filing reports with the SEC on Form ADV.

1. *Qualifications.* There is no application process; an adviser must simply meet the requirements of either of the two exemptions. The SEC has no legal authority to deny the ability of an otherwise eligible adviser to take advantage of the exemptions.

---

186 Form ADV can be found here.

187 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.

188 Sections 203(c)(2) and (e).

189 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) and Appendix B to this outline.

190 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).

191 Form ADV, Item 2 of Part 2B.

2. *Becoming an Exempt Reporting Adviser*. An exempt reporting adviser must file Form ADV within 60 days of beginning to rely on one of the exemptions.[192] For example, a new adviser (not otherwise exempt from registration) to a private fund must file Form ADV within 60 days of admitting third-party investors to the fund.[193]

   Regulatory Assets Under Management. The 60 day rule operates differently for an adviser whose SEC registration obligation turns on the amount of its RAUM. A state-registered adviser is not obligated to register under the Advisers Act until it reports more than $110 million of RAUM on its annual updating amendment to Form ADV ($25 million in New York), typically the amendment filed the following March 31.[194] Such an adviser, if it is eligible to take advantage of the private fund adviser exemption or the venture capital adviser exemption, has an additional 60 days to file Form ADV in order to avoid registration by becoming an exempt reporting adviser.

3. *State Law.* Because it is not registered under the Act, an exempt reporting adviser is subject to regulation under state law, *i.e.*, states could require advisers taking advantage of the exemption from the Advisers Act to register under state law. Many states, however, exempt from state registration advisers that advise only private funds (and thus may be exempt reporting advisers under federal law).[195] In such cases state law may permit filing of the same abbreviated Form ADV as permitted by SEC reporting advisers.[196]

C. Form ADV

Form ADV sets forth the information that the SEC requires registered advisers to provide in an application for registration. It is also used by exempt reporting advisers to report to the SEC.[197] Once registered, an adviser must update the form at least once a year within

192 Rule 206(4)-4; General Instruction 13 of Form ADV.

193 Until a fund has admitted a third-party investor, the adviser to the fund would not be providing advice to an "other person," and the fund would thus presumably not be treated as a client. There is, however, no clear guidance on when the 60-day period would begin to run in this example.

194 Rule 203A-1(a)(1).

195 Many of the state exemptions are based on the NASAA Registration Exemption for Investment Advisers to Private Funds (2011). The facing page of Form ADV allows an adviser to identify itself as an "exempt reporting adviser" under state law, in which case the adviser may be an "exempt reporting adviser" both under federal and state law. Some state exemptions are narrower than federal law in which case an exempt reporting adviser under federal law may be required to register under state law. In such a case, the adviser would have a choice to register with the SEC (forgoing its private fund or venture capital fund adviser exemptions) or with the appropriate state securities regulators.

196 *See, e.g.,*19 CCR § 260.204.9(b)(1) (California). Note, however, that General Instruction 3 to Form ADV states that exempt reporting advisers registering with any state securities authority must complete Form ADV in its entirety. State law should be consulted on this question.

197 Rule 204-4.

90 days of the end of its fiscal year,[198] and more frequently if required by instructions to the form.[199] Form ADV consists of two parts.[200]

1. *Part 1A.* Part 1A 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 1A is organized in a check-the-box, fill-in-the-blank format. It includes several supplemental schedules that must also be completed.

   - Schedule A requires information about direct owners of the adviser.
   - Schedule B requires information about indirect owners, *i.e.*, owners of direct owners.
   - Schedule C is used by advisers filing on paper to update Schedules A and B.
   - Schedule D is used to supplement responses to certain items in Part 1. Much of the data required to be reported about private funds and separate accounts is reported on Schedule D.
   - Schedule R is used to report information about relying advisers, as well as adding an additional relying adviser and deleting a Schedule R for a relying adviser no longer relying on an umbrella registration.[201]
   - Disciplinary Reporting Pages (or DRPs) require details about disciplinary events involving the adviser or its "advisory affiliates."[202] A DRP filing is triggered by an affirmative response to one of the questions in Item 11.

   Part 1B. Part 1B must be completed only by state-registered advisers. It contains three additional items and three additional DRP pages required by state regulators.

---

[198] The term "fiscal year" is not defined in Form ADV or the Act, and may be any twelve month accounting period, "provided that the period is 'fixed determinable and consistently used.'" It need not correspond to the accounting period used for tax purposes. Advisers Act Rel. No 1000, *supra* note 111.

[199] Rule 204-1(a). *See also* General Instruction 4 (form updating requirements). A similar updating regime applies to exempt reporting advisers.

[200] 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 Web site.

[201] *See, supra,* Section IV.B.4 of this outline for a discussion of umbrella registration. Use of a single Form ADV for multiple exempt reporting advisers is not available.

[202] A DRP, once filed, can be removed if (i) the DRP was filed for an advisory affiliate that is no longer associated with the adviser, (ii) the disciplinary event reported by the DRP is more than 10 years old, or was resolved in favor of the firm or the advisory affiliate, and (iii) the DRP was filed in error (*i.e.*, a clerical error).

2. *Part 2.* Part 2 is divided into Part 2A and Part 2B and sets forth information required in client brochures and brochure supplements.[203]

   Adviser Brochure. Part 2A sets forth requirements for the narrative "brochure," which is required to be provided to clients and prospective clients, including disclosure of the adviser's business practices, investment strategies, fees, conflicts of interest, and disciplinary information.

   Brochure Supplement. Part 2B sets forth the disclosure requirements for the "brochure supplement," which must contain information about each advisory employee that provides investment advice to clients, including her educational background, business experience, other business activities, and disciplinary history.

   To satisfy the "brochure rule" (discussed below),[204] an adviser 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.[205] In addition, an adviser must file its brochure, but not its brochure supplement, with the SEC to satisfy its registration requirements.[206]

3. *Exempt Reporting Advisers*. Exempt reporting advisers submit an abbreviated Form ADV and are not required to prepare or deliver a brochure to clients.[207]

D. Electronic Filing

IARD System. All applications for registration as an adviser with the SEC (and reports by exempt reporting advisers) must be submitted electronically through an Internet-based filing system called the Investment Adviser Registration Depository ("IARD").[208] The IARD is sponsored by the SEC and the North American Securities Administrators

---

[203] Part 2 is today the result of significant amendments to Form ADV adopted by the SEC in 2010. *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 web site at ("Part 2 FAQs").

[204] Rule 204-3.

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

[206] Rule 203-1(a); Rule 204-1(b)(1). State regulators require filing of brochure supplements by state registered advisers.

[207] General Instruction 3 to Form ADV. Many of the items not required to be completed relate to regulatory obligations to which exempt reporting advisers are not subject, *e.g.*, the custody rule. An exempt reporting adviser is required to identify its chief compliance officer only if it has one. Item 1.J(1).

[208] The IARD system is available Monday through Friday from 5:00 a.m. to 11:00 p.m. Eastern Time, and is not available on days the securities markets are closed in the United States. The IARD system closes for several days at the end of December.

Association (NASAA), and operated by the Financial Industry Regulatory Authority ("FINRA"), the broker-dealer self-regulator.[209]

FINRA Accounts. Before registering an adviser must have opened an IARD user account with FINRA by downloading and completing the IARD Entitlement Packet and mailing it to FINRA.[210] An adviser must also pre-fund the account to pay for a FINRA initial set up fee and any applicable state licensing and registration fees. Funds held in the FINRA account are debited to pay annual FINRA filing fees and all state filing and registration fees, and therefore must be replenished from time to time.[211] The same FINRA account may be used to support multiple adviser and broker-dealer registrations.

E. Public Availability

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

F. Withdrawal

1. *Registered Advisers.* Advisers withdraw from registration by filing Form ADV-W.[212] An adviser may withdraw from registration because it: (i) ceases to be an investment adviser; (ii) is entitled to an exemption 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).[213] 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.

2. *Exempt Reporting Advisers.* An exempt reporting adviser withdraws by amending its Form ADV when it ceases to be an exempt reporting adviser as a result of (i) ceasing to do business, (ii) no longer qualifying for the exemptions provided by section 203(l) or (m), (iii) relying on some other exemption to remain unregistered, or (iv) registering with the SEC as an adviser.[214]

---

209 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.

210 The packet is available at https://www.iard.com/pdf/secentitlementpacket.

211 Rule 203-1(b). FINRA charges advisers an initial set up fee and annual filing fees (at the time the annual updating amendment is filed) to defray the cost of maintaining and operating the IARD. *See* fee schedule.

212 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 (or for amending Form ADV to withdraw an exempt reporting adviser). Form ADV-W can be found here.

213 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).

214 Rule 204-4(f). The adviser marks a box on the facing page of Form ADV indicating that it is submitting a "final report."

G. 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 succession.[215] This provision is designed to facilitate the transfer of business between two or more entities and to permit the successor to operate without interruption.[216]

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.[217] This staff position is designed to deal with technical but not actual changes of control.

3. *Exempt Reporting Advisers.* All successions involving an exempt reporting adviser may be addressed by an amendment to Form ADV.

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.[218]

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.

---

[215] 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.

[216] 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).

[217] *Id.*

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

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 monetary loss.[219] 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.[220]

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."[221] An adviser must thus, at all times, serve the best interest of its clients and not subordinate its clients's interests to its own.[222]

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.[223] It is made enforceable by section 206 of the Act,[224] which contains the Act's anti-fraud provisions, and incorporated

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

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

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

[222] *SEC v. Tambone*, 550 F.3d 106, 146 (1st Cir. 2008); *SEC v. Moran*, 944 F. Supp. 286 (S.D.N.Y. 1996).

[223] *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).

[224] *Transamerica Mortg. Advisors v. Lewis*, *supra* note 84 ("[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); *Hollerich v. Acri*, No. 14 CV 10411, 2017 WL 1316259, at 6 (N.D. Ill. Apr. 10, 2017).

indirectly into the Act in various provisions and disclosure requirements discussed below.[225]

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."[226]

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.[227] 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.[228] 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."[229]

   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.'"[230]

   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

---

[225] *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.")

[226] *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 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.").

[227] *See* *Arleen W. Hughes*, *supra* note 223.

[228] Part 2 Adopting Release at n. 35, *supra* note 203, *citing* *SEC. v. Steadman*, 967 F.2d 636, 643 (D.C. Cir. 1992).

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

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

advisory relationship with the adviser, or take some action to protect himself or herself against the conflict.[231] A sincere belief that the adviser with a conflict is acting solely in the interest of the client is insufficient to excuse full disclosure.[232]

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.[233]

Disciplinary Events and Precarious Financial Condition. 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 commitments to clients;[234] and

b. certain disciplinary events of the adviser (and certain of its officers) occurring within the past 10 years, which are presumptively material.[235]

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.[236]

---

[231] Part 2 Adopting Release, *supra* note 203. *See also SEC v. Capital Gains Research Bureau, Inc.*, *supra* note 3 at 191-192 (1963).

[232] *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 may have in the transaction. . . . It is the client, not the adviser, who is entitled to make the determination whether to waive the adviser's conflict.").

[233] Advisers Act Rel. No. 3222, *supra* note 129 at n.434 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)").

[234] 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.

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

[236] *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

Institutional Clients. There is no exception to the obligation for institutional clients.[237] However, what is "suitable" for an institutional investor is typically determined by reference to 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 a stated investment objective or policy will be treated by the SEC as a violation of the anti-fraud provisions (and thus identical to a suitability violation).[238] In some cases, the SEC has looked to relevant laws governing investments by the client to determine the suitability of an investment.[239]

3. *Reasonable Basis for Recommendations*. An adviser's fiduciary duty to clients includes a duty of care, which requires that an adviser have a reasonable, independent basis for its recommendations.[240]

4. *Best Execution.* Where an adviser has responsibility to direct client brokerage, it has an obligation to *seek* best execution of clients' securities transactions.[241] 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.[242] 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

---

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).

237 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.

238 *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 Rel. No. 3526 (Dec. 12, 2012).

239 *See* *Gray Financial Group, Inc.*, Advisers Act Rel. No. 4812 (Nov. 22, 2017) (adviser recommended public pension fund clients invest in proprietary hedge funds that did not meet requirements of state pension law).

240 *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).

241 *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).

242 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).

provided. "The determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the [client]."[243]

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.[244]

b. *Mutual Funds.* The SEC has brought enforcement actions against advisers for failure to obtain best execution when the adviser selected higher cost classes of fund shares for clients, causing the client to pay a more expensive share class when a less expensive class was available.[245]

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.[246] When the adviser receives some benefit from the direction of the trade, additional disclosure may be required.[247]

Subject to Best Execution. It is not uncommon for advisers to disclose that they will direct trades to a broker-dealer "subject to best execution," in which case disclosure

---

[243] *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. 28, 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).

[244] *Portfolio Advisory Services, LLC*, Advisers Act. Rel. No. 2038 (June 20, 2002); *Delaware Mgmt. Company, Inc*., Exchange Act Rel. No. 8128 (July 19, 1967). Many of the SEC enforcement actions in this area have involved referral arrangements in which the adviser was using the client's commission to compensate the broker or an affiliated broker. S*ee, e.g.*, *Founders Asset Mgmt. LLC*, Advisers Act Rel. No. 1879 (June 15, 2000) referral), *Edgemont Asset Mgmt. Corp*., Advisers Act Rel. No. 1280 (June 18, 1991) (affiliate).

[245] *Sanford Michael Katz*, Advisers Act Rel. No. 4679 (Apr. 4, 2017); *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 one 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, in contrast, has fined member broker-dealers engaging in similar practices for violation of its "suitability" rule. *See* News Release, Dec. 19, 2005.

[246] 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.)

[247] *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 243. *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.").

about the risk that the adviser may be unable to obtain best execution for the client are unnecessary.[248] Such advisers should establish and implement policies and procedures designed to seek best execution in a manner consistent with this undertaking.[249]

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.[250] However, use of an affiliate involves a conflict of interest that must be disclosed to clients.[251] 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.[252]

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.[253]

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.

---

[248] Item 12.A.3.b. of Part 2 of Form ADV.

[249] *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).

[250] *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.).

[251] *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 with 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).

[252] *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).

[253] *Inspection Report on the Soft Dollar Practices or Broker-Dealers, Investment Advisers And Mutual Funds* (Sept. 22, 1988), *supra* note 253 at V.3.

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.[254]

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.[255] Accordingly, if properly disclosed to clients, an adviser may use client brokerage for purposes other than those permitted by section 28(e).[256] 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.[257]

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

[254] *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.

[255] 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).

[256] 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.

[257] *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)).

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 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.[258]

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.[259]

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,[260] and certain riskless principal transactions.[261]

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 recording "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. The SEC has stated that soft dollar credits are assets of the client rather than the adviser,[262] but it is not clear which client own

---

258 *See id*., 2006 Soft Dollar Release, *supra* note 254 at Section F, n. 148.

259 *Id*.

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

261 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).

262 *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).

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 section 28(e) safe harbor.[263] 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.[264] Part 2 of Form ADV specifies the types of disclosures the SEC expects advisers to make regarding soft dollar arrangements.[265]

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.[266]

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[267] 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

---

[263] 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).

[264] *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).

[265] Item 12 (Brokerage Practices).

[266] *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.

[267] The term "knowingly" requires that the adviser be aware of the transaction, but not that the transaction was effected on a principal basis in violation of Section 206(3). *See* *Tri-State Advisors, Inc.*, Admin. Proc. Rulings Rel. No. 1478 (Jun. 2, 2014) (ALJ opinion).

(or an affiliate) is acting and obtaining the client's consent before the "completion of the transaction."[268] The SEC staff has stated that notification and consent must be obtained separately for each transaction, *i.e.*, a blanket consent for transactions is not sufficient.[269]

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.[270]

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.[271]

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.[272] The SEC staff, however, believes that section 206(3) does not apply to a transaction between a client account and a pooled investment vehicle (*i.e.*, a cross-trade)

---

[268] 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).

[269] *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).

[270] Release 1732, *supra* note 268. *See also* Advisers Act Rel. No. 40, *supra, note 269* ("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).

[271] Release 1732, *supra* note 268. 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).

[272] *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).

where the investment adviser and/or its controlling persons, in the aggregate, own 25% or less.[273]

A trade between a proprietary account of an adviser to a pooled investment vehicle and the pooled investment vehicle would, however, constitute a principal trade regardless of the size of the ownership interest of the adviser in the pooled investment vehicle.

Under the *Goldstein* decision,[274] 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.[275] In such circumstances, some advisers seek the consent of fund investors or a committee of limited partners (often called "LPACs") established for such purposes.[276]

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.[277]

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.

---

273 *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.

274 *Goldstein v. SEC*, *supra* note 155.

275 The SEC suggested that it would regard such consents as ineffective in several enforcement action. *Clean Energy Capital, LLC*, Advisers Act Rel. No. 3785 (Feb. 25, 2014) (adviser made loans to a private fund it advised and thus "as an adverse party with a conflict of interest, could not consent to the loans on behalf of the [private] funds."); *Blackstone Mgmt. 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."); *Paramount Group Real Estate Advisor LLC*, Advisers Act Rel. No. 4726 (July 6, 2017) (adviser could not consent to transaction between two advised funds because it owed a fiduciary duty to both sides of the transaction and because it owned a larger percentage of one fund than the other).

276 The SEC has suggested approval of such an approach in some settled enforcement actions. *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 that specifically require client consent. *See e.g.*, section 205(a)(2) (assignments—discussed *infra*, section VI.D.2 of this outline) and *TGP Capital Advisors, LLC*, Advisers Act Rel. No. 4830 (Dec. 21, 2017) (adviser failed to disclose conflict to LPAC, to which the LPAC could have objected).

277 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."

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."[278] These types of transaction would include, for example, those placed by a client in response to recommendations made by the adviser in a newsletter or in a research report.

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.[279] 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.[280] 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 subsequently issued several exemptive orders that provide similar relief.[281]

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.[282]

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."[283]

Safe Harbor. The notice and consent requirements of section 206(3) made it impractical for advisers managing client assets on a discretionary basis to effect these transactions even at a discount. The principal concern of the section is that the adviser will use client assets to generate trades for itself or its broker-dealer

---

278 Rule 206(3)-1. Impersonal investment advice is advice, whether written or oral, that does not purport to meet the objectives or needs of specific individuals. Under the rule, the impersonal 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. *See also* Form ADV (Glossary)(definition of "impersonal advice).

279 *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).

280 *See supra*, note 49.

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

282 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 268.

283 Rule 206(3)-1, *supra*, note 278.

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

(3) A disclosure document and each confirmation conspicuously disclose that consent may be revoked at any time.[284]

c. *Cross-Trades.* Effecting cross-trades between clients (with a third-party broker-dealer or no broker-dealer) is not specifically addressed by the Act or SEC rules, but implicates the anti-fraud provisions of the Act.[285] All cross-trades involve potential conflicts of interest because the adviser could favor one client over another.[286]

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."[287] 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."[288]

---

[284] 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).

[285] *See* *Renberg Capital Mgmt., Inc., supra* note 242. 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).

[286] "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).

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

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

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, (including proprietary 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.[289]

Failure to Aggregate. Advisers are not *required* to aggregate trades. But if failure to aggregate would disadvantage clients (or benefit the adviser), the adviser may be required to explain the consequences of not aggregating to their clients.[290]

Allocation of Prices. Advisers that aggregate orders of securities face conflicts when they allocate the orders to client accounts. In some cases securities may have been acquired at the same prices. In such cases, advisers should have procedures in place that allocate prices fairly and equitably among clients, or in accordance with a fully disclosed policy.[291]

e. *Allocation of Client Trades.* Allocation of trades for the benefit of favored clients, including the adviser's proprietary accounts, is a breach of the Adviser's fiduciary obligations to its client.[292] 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.[293]

(1) *Cherry Picking*. This practice occurs most often when an adviser trades through an omnibus brokerage account and delays allocation of the trades

---

289 *Pretzel & Stouffer*, SEC Staff No-Action Letter (Dec. 1, 1995); 1986 Soft Dollar Release, *supra* note 243.

290 *Pretzel & Stouffer*, *supra* note 289.

291 *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 that 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).

292 *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* SEC Complaint in *SEC v. Strategic Capital Mgmt., LLC* (Jan 25, 2017).

293 Release 2204, *infra* note 422 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).

until it can determine the "winners" and "losers" and then allocates the winners to favored accounts or proprietary (house) accounts.[294]

(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 financially in a position to buy them or in accordance with disclosure made to clients.[295]

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.[296]

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.[297] 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.[298]

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

---

294 *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 its allocation practices when it failed to follow them. *See Tellone Management Group, Inc.*, Advisers Act Rel. No. 4701 (May 5, 2017); *TPG Advisors*, Advisers Act Rel. No. 4588 (Dec. 15, 2016).

295 *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).

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

297 *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).

298 *See* complaint in *SEC v. Charles J. Dushek*, Case No. 13-cv-3669. SEC enforcement actions have involved miss-allocation of trades based upon market movements on the same day of the trades. *See, e.g.*, *Valor Capital Asset Mgmt.*, Advisers Act. Rel. No. 4864 (Mar. 6, 2018).

placing a trade for a client.[299] Similarly, an adviser will not be entitled to keep any gains arising from errors or use the gains to offset losses the adviser caused.[300]

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,[301] but the issues become murkier when the error involves misjudgments or simply poor advice.[302] While there is a debate among lawyers about whether client disclosure of the adviser's policy of not reimbursing clients for their errors (or certain errors) will satisfy an adviser's fiduciary duties, the industry "best practice" is for the adviser to bear those losses.

Policies and Procedures. Many advisers establish trade error policies that define a trade error and establish protocols for determining their appropriate resolution.[303] Errors typically will include the purchase of securities not authorized for the account, the purchase or sale of the wrong or unintended amount of securities, the misallocation of securities, and the failure to tender the securities or otherwise benefit from some corporate action. Procedures will, among other things, identify the method of calculating client losses. The failure of an adviser to follow its own procedures will be viewed by the SEC as a failure to implement compliance policies and procedures.[304]

2. *Advertising*

The anti-fraud provisions of the Act apply with respect to both clients and *prospective* clients.[305] 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

299 *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").

300 The SEC may assert that the gains were compensation to which the adviser was not entitled to, unless the adviser adequately disclosed its practice. *See, e.g*., EBSA News Release (Feb. 4, 2013) (announcing Department of Labor settlement with adviser alleging retention of gains resulting from settlement errors resulted in the adviser receiving compensation in violation of ERISA).

301 *See, e.g*., *Michael T.* Jackson, Advisers Act Rel. No. 2374 (Apr. 6, 2005) (trader failed to recognize that position he sold had already been liquidated, creating a large short position and a resulting loss).

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

303 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* *Guggenheim Partners Inv. Mgmt., LLC*, Advisers Act Rel. No. 4163 (Aug. 10, 2015).

304 *See* *Foxhall Capital Mgmt., Inc.*, Advisers Act Rel. No 3590 (Apr. 19, 2013); *M&I Investment Mgmt. Corp.*, Advisers Act Rel. No. 1318 (June 30, 1992).

305 *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.").

fact or is otherwise misleading."[306] In addition, the rule contains several specific restrictions discussed below.

Advisers are not required to file proposed advertisements with the SEC, and the staff will not review them. As discussed in more detail below, registered advisers must maintain copies of advertisements in their records, which may be reviewed by SEC staff during an examination.[307]

a. *Specific Restrictions*

(1) *Testimonials.* An advertisement may not use or refer to testimonials,[308] which the SEC staff views as including any "statement of a client's experience with, or endorsement of, an adviser."[309] 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."[310] 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.[311]

Rankings and Ratings. Third party ratings and rankings may be testimonials when they reflect an implicit statement of client experience with the investment adviser, but the SEC staff has permitted their use if certain conditions are met that suggest their compilation and presentation are unbiased.[312]

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.[313]

---

306 Rule 206(4)-1(a)(5), discussed below in section VI.B.2.b.

307 The SEC staff has recently published a "Risk Alert" identifying common compliance deficiencies that the examination staff encounters. *Investment Adviser Use of Social Media*, National Examination Risk Alert, Vol. II, Issue 1 (Jan. 4, 2012).

308 Rule 206(4)-1(a)(1).

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

310 Advisers Act Rel. No. 121 (Nov. 2, 1961).

311 *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.

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

313 *Denver Investment Advisors, Inc.*, SEC Staff No-Action Letter (July 30, 1993) (full list); *Cambiar Investors, Inc.*, *supra* note 309 (partial list). A client list may, of course, not be presented in a way that is misleading. *See*

Social Media. The SEC staff has generally stated that public commentary (include those of clients) on an independent web site (*e.g.*, "likes" on the adviser's Facebook page) do not raise issues when the adviser has no ability to affect the commentary and the web site publishes all comments unedited.[314]

(2) *Past Specific Recommendations.* An advertisement may not refer to past specific recommendations that were or would have been profitable made by the adviser, unless the advertisement sets out a list of *all* recommendations made by the adviser during the preceding year.[315] Statements about current recommendations are not prohibited by the rule which, by its terms, only applies to "past specific recommendations."[316] The primary concern underlying the prohibition is that an adviser could "cherry pick" its profitable recommendations while omitting the unprofitable ones.[317]

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.[318]

Responses to Unsolicited Requests. A communication responding to an unsolicited request for information from a client, prospective client or consultant for specific information about the adviser's past specific recommendations would not be an advertisement, and thus not subject to the prohibition.[319]

Objective Non-Performance-Based Criteria. An adviser may, for example, use criteria, such as largest positions held, largest positions sold during the

---

Reservoir Capital Mgmt. Inc., Advisers Act Rel. No. 1717 (Apr. 24, 1998)("representative list" of clients was not representative).

314 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.

315 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 an SEC enforcement action alleging a violation of this provision, *see* *Navigator Money Mgmt., Inc.*, Advisers Act Rel. No. 3767 (Jan. 30, 2014).

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

317 *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.

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

319 *Id.*

period without disclosing all of the securities recommended during the period.[320]

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."[321]

(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;[322] and

(4) *Free Stuff.* An advertisement cannot refer to any report, analysis, or service as free, unless it really is.[323]

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.[324] Common SEC enforcement actions against advisers for false and misleading advertisements include overstating performance of client accounts (discussed below), inflating the number of clients or amount of assets under management,[325] and exaggerating the qualifications or achievements of principals.[326]

c. *Performance Advertising*

---

320 *Franklin Management, supra* note 316.

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

322 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).

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

324 *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).

325 *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").

326 *See, e.g.*, *Source Financial Advisors, LLC*, Advisers Act Rel. No. 4702 (May 5, 2017); *FreedomTree Mutual Funds et al.*, Advisers Act Rel. No. 3095 (Sept. 30, 2010).

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.[327] SEC rules do not require advisers to calculate or present the performance of client accounts in any particular way.[328] Performance data in advertisements is evaluated based on whether it is false or misleading.[329] Thus, the adequacy of disclosure accompanying performance data 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.[330] However, advisers may present performance results reflecting both gross and net of fees, if presented with equal prominence.[331]

(2) *Index Comparisons.* When account performance is compared to an index of securities, the index should reflect the reinvestment of dividends or accompanying disclosure should explain the effect on the results of the failure to do so.[332]

(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 that client accounts appreciated by

---

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

328 Thus in an enforcement proceeding, the SEC staff must demonstrate that the performance advertised was false or misleading and not merely incorrectly calculated. *See* *Michael R. Pelosi*, Advisers Act Rel. No. 3805 (Mar 27, 2014) (SEC opinion) (staff demonstrated only that supervised person modified performance provided by his employer).

329 If the adviser's performance claims rely 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).

330 *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).

331 *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 materially misleading.

332 *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.

25% during the time period would be misleading if it did not also disclose that markets generally appreciated by 40% during the same period.[333]

(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).[334]

(5) *GIPS Standards*. The Global Investment Performance Standards are voluntary standards and principles published by the CFA Institute.[335] False claims of compliance with GIPS standards violate the advertising rule regardless of whether the performance data is otherwise accurate.[336]

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.[337]

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.

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.[338] 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,

---

[333] *Clover Capital Mgmt., Inc.*, *supra* note 330.

[334] *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).

[335] *See* Global Investment Performance Standards Handbook (3rd Ed. 2012).

[336] *ZPR Investment Mgmt. Inc. v. SEC*, No. 15-15322 (11th Cir. 2017) ("[T]he status of being 'GIPS compliant' is important to investors."); *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.").

[337] *Clover Capital Mgmt., Inc.*, *supra* note 330. *See* *Modern Portfolio Mgmt., Inc.*, Advisers Act Rel. No. 3702 (Oct. 23, 2013) (adviser failed to reflect its advisory fee in model performance).

[338] *See, e.g.*, *Arlington Capital Mgmt., Inc.*, Advisers Act Rel. No. 4885 (Apr. 6, 2018). (model was adjusted when failed to perform as expected; backtest performance was based on newest version of model the performance of which was often superior to actual results of model in effect at the time).

ranging from failure to disclose performance was actually back-tested performance[339] to failure to disclose the limitations inherent in or aspects of back-tested performance.[340]

Raymond J. Lucia Company, Ltd. v. SEC. A recent federal appeals court decision upheld an SEC opinion that an adviser violated Section 206 when, among other things, it failed to apply its own strategy and assumptions when back-testing performance, was unable to replicate the back-tested reports, and could not document support for its results.[341] The court 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) portfolio managers 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;

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

---

339 *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).

340 *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).

341 *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 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).

(5) The advertisement includes all relevant disclosures, including that performance results were from accounts managed by another entity.[342]

An adviser that uses its predecessor's performance must have access to records substantiating the performance (discussed below).[343]

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."[344] The practical effect of the rule is to preclude an adviser from advertising performance data it cannot substantiate.[345]

(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.[346]

(2) *Safe Harbor*. The rule does not specify what records must be kept, but provides a safe harbor if the adviser 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.[347]

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

---

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

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

[344] 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." Advisers Act Rel. No. 4509, *supra* note 181. 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.

[345] *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.

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

[347] *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).

more than one person that offer advisory services.[348] 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.[349] Whether a communications constitutes an advertisement depends on all facts and circumstances,[350] and has been very broadly applied.

(1) *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 the adviser received multiple requests for the same information, *e.g.*, in multiple RFPs.[351]

(2) *Reports to Clients.* Generally, an advertisement includes both a communication offering advisory services to new clients and one designed to maintain existing clients.[352] 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.[353]

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

(4) *Social Media*. Use of internet postings, including communications through social media to communicate with clients and prospective clients implicates rule 206(4)-1.[354]

Compliance Considerations. Use of social media by an adviser raises special compliance controls for advisers.

(5) *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 existing clients of the adviser.[355] The SEC staff has not yet

---

348 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. . . .").

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

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

351 *Id.*

352 *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).

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

354 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).

355 *Id.*

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.[356]

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.[357] These requirements were most recently amended in December 2009.[358]

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).[359]

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, for

---

[356] *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. . ."). 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.

[357] 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).

[358] *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.

[359] 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).

example, it authorizes the adviser to withdraw funds or securities. The SEC staff has stated that an adviser "need not comply" with the custody rule (or report than it has custody on Form ADV) as long as the adviser (i) is not a party to the agreements, (ii) does not have a copy of the agreement, (iii) does not know, or have reason to know whether the custody agreement would give the adviser custody; and (iv) there is no other basis for the adviser having custody.[360]

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.[361] An adviser may not comingle its clients' funds or securities with its own.[362]

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.[363]

---

360 FAQs on the custody rule (FAQ II.11). (Updated June 4, 2018) Alternatively, the 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. IM Guidance Update 2017-01 (Feb. 2017). An adviser with custody cannot merely disclaim it. *Id.*

361 Rule 206(4)-2(a)(1).

362 *See SEC v. Sentinel Mgmt. Group, Inc., et al.*, 2012 WL1079961, (N.D. Ill. 2012) (adviser comingled its clients' assets 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).

363 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.[364]

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.[365] 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.[366]

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.[367] If the accountant finds a "material discrepancy" during the examination, it must report the discrepancy to the SEC within one business day.[368]

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.[369]

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.[370]

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

---

364 A 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 358.

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

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

367 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).

368 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).

369 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.

370 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.

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"),[371] and the audited statements are distributed to the pool's investors:[372]

(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.[373]

(2) *Surprise Examination Approach.* If the investment adviser cannot (or does not wish to) comply with the audit approach, the adviser:

(A) Must obtain a surprise examination for the pooled investment vehicle; [374]

(B) Must provide notice to clients of custody, and form a reasonable belief 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

---

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

372 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 358 at n. 45.

373 Rule 206(4)-2(b)(4).

374 Rule 206(4)-2(a)(5) and (a)(4).

States,[375] (ii) the adviser is an exempt reporting adviser, or (iii) the adviser is a foreign private adviser.[376]

g. *Adviser or "Related Person" as Custodian.*[377] 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;[378] 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.[379]

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.[380]

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.[381]

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.[382]

---

375 Advisers Act Rel. No. 3222, *supra*, note 129 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 80; *Goldstein v. SEC*, *supra* note 155 (treating fund as client).

376 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 *supra* in Section VI.B.3.a(3) of this outline.

377 A "related person" includes any person, directly or indirectly, controlling or controlled by the adviser, and any person that is under common control. *See* Exhibit B to this outline. A person that owns more than 25% of the voting shares of a corporation is presumed to control the corporation. Rule 206(4)-2(d)(1).

378 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).

379 Rule 206(4)-2(a)(6).

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

381 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).

This is one of several "bad boy" provisions in the federal securities laws, which are most frequently 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.[383]

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.[384]

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 conflicts arising from the arrangement, including any effect on the adviser's ability to obtain best execution.[385]

---

[382] *See supra* note 190 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).

[383] 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.

[384] 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).

[385] *Jamison, Eaton and Wood, Inc.*, *supra* note 243; *Portfolio Advisory Services LLC*, *supra* note 242; *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).

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.[386]

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.[387] 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,[388] and foreign private advisers, who provide investment advisory services, or are seeking to provide investment advisory services, to state and municipal government entities.[389]

a. *Two-Year Time Out after a Political Contribution*

An investment adviser may not receive compensation for providing advice to a state or local government entity (either directly or indirectly through a "covered investment pool") for two years after a political contribution is made by the adviser *or* by any of its "covered associates" to a "government official" who can influence the award of advisory business.[390]

386 *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.5 of this outline regarding solicitation of government clients.

387 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 unsuccessful. *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. 2015).

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

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

390 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 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.

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.[391]

(1) *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.[392] 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.[393]

(2) *Departing Covered Associates*. The time out continues to run even if the covered associate making the political contribution leaves the firm.[394]

Government Officials. A government official is a person who, at the time of the contribution, is (i) an incumbent, (ii) a candidate,[395] or (iii) a 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.[396] The time out is triggered by a contribution to a candidate for federal office only if the candidate is, at the time of the contribution, serving as a "government official" of a state or municipality.[397]

---

[391] Rule 206(4)-5(f)(2). Note that a covered associate does not include the spouse (or other family member) of the adviser's executive officers, although a contribution by a spouse can trigger the rule if the contribution is deemed to be indirectly made by the executive officer.

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

[393] Pay to Play Release *supra* note 387 at n. 217. The look-back provision applies regardless of whether the adviser is aware of the covered person's contributions so an adviser should consider requiring full disclosure of candidates' relevant political contributions as it would other business activities that might present conflicts.

[394] Pay to Play Release *supra* note 387 at n. 206.

[395] The term "candidate" is not defined in the rule, and it is unclear whether state laws can be relied upon to identify a person who is a candidate. In one settled enforcement action, the contribution was made to a person who had filed papers to run for office but did not obtain sufficient votes to get on the ballot. *Pershing Square Capital Mgmt. L.P.*, Advisers Act Rel. No. 4608 (Jan 17, 2017).

[396] Rule 206(4)-5(f)(6). *See Alta Communications, Inc.*, Advisers Act Rel. No. 4614 (Jan. 17, 2017) (state treasurer who sat on the board of a state pension fund and could appoint one other member of a state pension fund's board); *Aisling Capital LLC*, Advisers Act Rel. No. 4616, *supra* note 388 (borough president who served on a pension board that selected investment advisers and pooled investment vehicles for the pension plan); *The Banc Funds Company, L.L.C.*, Advisers Act Rel. No. 4609 (Jan. 17, 2017) (governor who had authority to appoint six members of a public pension board that had influence in selecting advisers and pooled investment vehicles for the pension fund); *Adams Capital Mgmt. Inc.* Advisers Act Rel. No. 4617 (Jan. 17, 2017) (candidate for governor (which appointed six members of the state pension fund board) who at the time was the state's Treasurer (and 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).

[397] For example, a contribution to the Trump/Pence presidential campaign in 2016 may have triggered the two-year ban with respect to Indiana because Mr. Pence continued to serve as governor of Indiana during the campaign.

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.[398]

De Minimis Contributions. Individuals may make contributions without triggering the two-year time out of up to $350 per election to an elected official or 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 is not entitled to vote.

Exemptive Authority. The SEC can exempt advisers from the two-year time out if, among other things, the adviser (i) adopted and implemented policies and procedures reasonably designed to prevent violations of the rule, (ii) did not have actual knowledge of the contribution, and (iii) made reasonable efforts to obtain return of the contribution.[399]

b. *Payments to Third Party Solicitors*

An investment adviser and any of its covered associates may not directly or indirectly provide or agree to provide payments to any third party (*i.e.*, other than the firm's own personnel) to solicit government clients unless such person is a "regulated person."[400]

Regulated Person. Regulated persons are:

(1) 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;

(2) Registered broker-dealers; and

(3) Municipal advisers.[401]

---

398 *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.").

399 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's 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 Rels. No. 3957 (Oct. 22, 2014) (notice), and 3969 (Nov. 18, 2014) (order).

400 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.

401 Rule 206(4)-5 limits broker-dealers and municipal advisers to those subject to a pay to play rule adopted by FINRA or the MSRB that the SEC has found by order to be "substantially equivalent or more stringent than"

Payments include any gift, subscription, loan, advance, or deposit of money or anything of value. A payment can include a *quid pro quo* arrangement whereby the adviser agrees to hire the third party for some unrelated purpose in return for making a contribution to a government official.[402]

This provision covers payments to traditional solicitors for advisers as well as "placement agents" hired by private funds to find investors, typically broker-dealers.[403] 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.

c. *Ban on Soliciting or Bundling Contributions*

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 is providing or seeking to provide investment advisory services to a government entity.[404] The prohibition on bundling includes hosting fundraising events for a candidate.[405]

d. *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.

e. *Covered Investment Pools*

---

the SEC rule. The SEC has issued orders finding that FINRA rule 2030 and MSRB amendments to its rule G-37 were "substantially equivalent or more stringent than" rule 206(4)-5. *See* Exchange Act Rel. No. 78683 (Aug. 25, 2016) (FINRA) and Advisers Act Rel. No. 4531 (Sept. 20, 2016) (MSRB).

402 Rule 206(4)-5(f)(7); Pay to Play Release *supra* note 387 at n.254.

403 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).

404 Rule 206(4)-5(a)(2)(ii).

405 *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 candidate by co-hosting a fundraising event for a covered official).

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, (ii) private fund (*e.g.*, hedge funds and private equity funds[406]), or (iii) bank sponsored collective investment trust.[407] The rule applies even if the government entity was already invested in the covered investment pool at the time of the contribution. The covered investment pool is not required to redeem the interests of the government entity in the fund if the fund's adviser waives or rebates a portion of the fees attributable to the government entity.[408]

f. *Political Action Committees*

The rule applies to some contributions to some types of political action committees (PACs). A PAC pools contributions it receives and contributes funds to campaigns for or aginst candidates, ballot initiatives, or legislation. Rule 206(4)-5 does not apply to contibutions to PACs that do not make contributions to political candidates, *i.e.*, are dedicated solely to pursuing ballot initiatives, legislation or public policy issues. The rule may apply to PACs that make campaign contributions.

(1) *Contributions by PACs.* A contribution by a PAC that is controlled *by* the adviser or any of its covered associates is treated as a contribution by the adviser or covered associate such that the contribution if made by them would trigger the two-year time out.[409]

(2) *Contributions to PACs.* The rule does not treat a contribution to a PAC as a contribution to a "government official." Accordingly, such contributions only trigger the two-year time out if the PAC operates as a means for the contribution to be "funneled" to a government official. Such PACs include (i) PACs established by or for a government official, or which permits contributors to direct the PAC to a government official and the advisor or covered associate so directs a contribution, and (ii) PACs for which funds are being solicited for a limited number of candates. A contribution to a PAC that can be expected to contribute to a number of government officials as part

406 *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).

407 Rule 206(4)-5(f)(3).

408 Pay to Play Release *supra* note 387 at 111.

409 Rule 2026(4)-5(f)(2)(iii). The SEC regards an adviser or covered associate to have "control" of a PAC if the adviser or covered associate has the ability to direct or cause the direction of the governance or operations of the PAC. The SEC has not provided guidance on when a political contribution by an affiliate of the adviser (or a covered person of such affiliate) might trigger the two year time out, but has alluded to MSRB guidance on the subject. Question II.4 of the Pay to Play FAQs.

of a larger purpose of supporting like-minded candidates would not trigger the two-year time out.[410]

g. *Political Parties*

(1) *Contributions to Political Parties.* Similarly to PACs, the two-year time out is not triggered by a contribution to a political party unless there is an indication to whom the collected funds will be disbursed, or where it is understood that contributions will be distributed to a limited number of candidates such that a contribution to the party amounts to an indirect contribution to a candidate.[411]

(2) *Solicitations for Political Parties*. Rule 206(4)-5 specifically prohibits any adviser subject to the rule and its covered associates from soliciting for payments or coordinating payments (*i.e*., bundling) to political parties of a state or municipality where the adviser is providing or seeking to provide advisory services to the government.[412]

e. *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.[413]

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 how 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 responsibility to vote proxies, the SEC has stated that an adviser's fiduciary obligation requires it to monitor corporate action and vote client securities.[414]

---

410 Similarly, an adviser's contribution to a trade association PAC that made a contribution to a government official would not trigger the two-year time out unless the adviser had the ability to direct or cause the direction of the contribution to the government official. Question II.5 of the Pay to Play FAQs.

411 Pay to Play Release *supra* note 387 at n.163.

412 Rule 206(4)-5(a)(2)(ii); Pay to Play Release *supra* note 387 at n.332.

413 Rule 204-2(a)(18).

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

The SEC's position is not that an adviser need vote every security, but that it 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, or 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."[415] 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.[416] 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.[417]

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.[418]

7. *Duty to Supervise*

An adviser has a continuing responsibility to supervise all persons acting on its behalf.[419] The SEC may sanction the adviser or any of its management personnel

---

[415] *Id.*

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

[417] *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).

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

[419] 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 291 (adviser failed reasonably to supervise employee and did not have policies and procedures designed to detect and prevent

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."[420]

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.[421] 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.[422] 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.[423]

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

---

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").

420 Section 203(e)(6).

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

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

423 *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 the same.

determine whether an employee is engaging in unlawful conduct[424] and, if they are, to prevent further violations.[425] 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.[426] For example, supervisors have been held liable for not acting effectively when they have merely relied on "unverified representations of employees."[427]

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.[428]

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.[429]

a. *Chief Compliance Officer*. Each adviser must designate a chief compliance officer.[430] The CCO must be knowledgeable about the Act and have the authority to develop and enforce appropriate compliance policies and procedures for the adviser.[431]

---

424 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).

425 The SEC believes that "supervisory obligations imposed by the federal securities laws require a vigorous response even to indications of wrongdoing." *John H. Gutfreund*, *supra* note 423.

426 *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).

427 *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).

428 Section 203(e)(6). *See Dawson-Samberg Capital Mgmt., Inc.*, *supra* note 257 (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 426.

429 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 422.

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

431 *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

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,[432] or may be a third party (*i.e.*, one not employed by the adviser) specifically engaged to be the adviser's CCO.[433] Regardless, the SEC will hold the adviser to 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.[434] 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,[435] failed to cooperate with the SEC[436] 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.[437]

---

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.

432 Release 2204, *supra* note 422 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).

433 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).

434 *See, e.g.*, *LKL Investment Counsel LLC*, Advisers Act Rel. No. 4836 (Jan. 3, 2018); *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).

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

436 *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).

437 *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 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.

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.[438] Several involved the failure of a CCO to implement compliance controls,[439] sometimes in the face of deficiencies previously identified by SEC examiners.[440]

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.[441] 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.[442] The SEC staff performs these types of tests as part of a compliance examination.[443]

(3) Correct promptly any violations that have occurred.

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).

438 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 245.

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

440 *See, e.g.*, *Southwind Associates of NJ Inc.*, Advisers Act Rel. No. 4834 (Dec. 22, 2017).

441 Rule 206(4)-7(a).

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

443 *See Welhouse & Associate, Inc.*, *supra* note 292 (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 amount of the principal's profit 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.[444]

Scope of Policies and Procedures. The policies must be tailored to the operations of the adviser. The SEC has stated 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.[445]

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;

(7) Marketing advisory services, including the use of solicitors;

---

444 *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).

445 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 436; *Feltl & Company, Inc.*, Advisers Act Rel. No. 3325 (Nov. 28, 2011).

(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.[446]

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.[447]

Annual Review. The adviser must review the adequacy and effectiveness of its policies no less frequently than annually.[448] 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),[449] or (iii) changes in applicable laws or regulations.[450] 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.[451] 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.

---

446 Release 2204, *supra* note 422.

447 *See, e.g.*, *Envision Capital Mgmt. Ltd., supra note* 439*;* *Comprehensive Capital Mgmt., Inc.*, *supra* note 357 (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 337.

448 Rule 206(4)-7(b).

449 *Feltl & Co., Inc.*, *supra* note 445 (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").

450 Release 2204, *supra* note 422 at Section II.B.1.

451 The SEC has held CCOs responsible for conducting the annual review personally responsible for failing to do so in accordance with the adviser's policies and procedures. *See, e.g.*, *Equitas Capital Advisors, LLC*, *supra* note 437.

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) "material compliance matters" that occurred.[452]

Recordkeeping. While the recordkeeping rule requires only that the adviser maintain any records it creates in the course of conducting an annual review,[453] the SEC examination staff typically looks for such records as evidence that an annual review has been conducted. Requests for such documents, often at the outset of an examination, have created a *de facto* recordkeeping obligation on the part of advisers.

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.[454] The adviser's code of ethics must (or should, as discussed) cover several of the following matters set out below.

a. *Standard of Conduct.* The code must set forth a minimum standard of conduct for all supervised persons. 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."[455]

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" (defined below) 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

[452] Rule 38a-1(a)(4)(iii).

[453] Rule 204-2(a)(17)(ii).

[454] *See Consulting Services Group, LLC, and Joe D. Meals*, *supra* note 436 (adviser failed to timely adopt and accurately document ethics code).

[455] *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.[456]

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;[457] and (iii) that would duplicate information in account statements or confirmations.[458]

Brokerage Statements. Access persons can satisfy the transaction report by directing their broker-dealers to deliver account statements to the investment adviser.[459]

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 to 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.[460] 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.[461]

---

456 Rule 204A-1(b) (1) (holdings reports), and (2) (transaction reports).

457 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).

458 Rule 204A-1(b)(2)(ii). The exceptions are not available for holdings reports.

459 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).

460 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*.

461 An adviser may need to treat as access persons service providers (and related persons) whose participation in the business activities of the adviser suggest they function as employees. *See Federated Global Invst. Mgmt. Corp.*, Advisers Act Rel. No. 4401 (May 27, 2016) (long-tenured consultant with access to confidential information).

(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.[462] 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) *Clerical Employees.* Administrative, technical, and clerical employees may also be access persons if their functions or duties give them access to nonpublic information.

(3) *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.[463]

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.[464] 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.[465] "This approach, while not required, offers certainty as to whether reports are required from a given individual."[466]

---

[462] 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).

[463] 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). The SEC interprets the term "spouse" to include an individual married to a person of the same sex. Commission Guidance Regarding the Definition of Spouse & Marriage Following Supreme Court's Decision in United States v. Windsor, Advisers Act Rel. No. 4122 (June 12, 2015).

[464] *Investment Adviser Codes of Ethics*, Advisers Act Rel. No. 2256 (July 2, 2004) ("Code of Ethics Adopting Release) at Section II.B.2.

[465] 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.

[466] Code of Ethics Adopting Release, *supra* note 464 at n.27. Pre-approval policies typically identify who has authority to approve a trade, the length of time an approval is valid, how an approval may be revoked, and procedures for verifying post-trade reports (or confirmations) against the log of approvals. *Id.*

Reportable Securities. Access persons must report holdings of all reportable securities, *i.e.*, securities, other than: (i) direct obligations 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 control relationship with the adviser); or (v) shares of a (U.S.) unit investment trust that invests exclusively in an unaffiliated mutual fund.[467]

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.[468] 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."[469]

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.

d. *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."[470] 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

---

467 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) and *Manufacturers Adviser Corp.*, SEC Staff No-Action Letter (Sep. 10, 2002) (similar approach to applying rule 17j-1 under the Investment Company Act with respect to Canadian-based adviser).

468 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).

469 *Code of Ethics Adopting Release*, *supra* note 464 at Sec. II.G. 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).

470 Section 203(e)(6) discussed, *supra* Section VI.B.7 of this outline.

protects the interests of the adviser and its clients.[471] A gifts and entertainment policy, 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 giver's employer.[472] 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."[473] 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.[474]

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.[475] These include employees who are in a position to influence the selection of broker-dealers to effect transactions for the investment company, including portfolio managers.[476] 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.[477]

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

471 The acceptance by advisory personnel of excessive gifts and entertainment 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).

472 FINRA Rule 3220 (Influencing or Rewarding Employees of Others). FINRA has proposed to increase the de minimis amount to $175.

473 *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."

474 *See Jeffrey Slocum & Associates*, Advisers Act Rel. No. 4647 (Feb. 8, 2017); *Guggenheim Partners Inv. Mgmt.*, *supra* note 303.

475 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 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).

476 *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).

477 *Id.*

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 matter, treats gifts and entertainment as "not substantial" if the annual aggregate value of gifts to any single person is less than $250.[478]

e. *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,[479] and (iv) the ongoing supervision of such activities.[480]

f. *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.

g. *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.

h. *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.[481] 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

---

478 Department of Labor, Field Assistance Bulletin No. 2008-01 (Feb. 1, 2008).

479 Disclosure of a supervised person's outside business activities may be required in the adviser's brochure supplement by Item 4 (Other Business Activities) of Part 2 of Form ADV.

480 *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 303 (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).

481 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.[482]

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.[483]

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.[484] 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.[485] In adopting the rule, the SEC explained that rule 206(4)-8 would 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.[486]

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-public information by the adviser or any of its associated persons,[487] including

---

[482] *Goldstein v. SEC*, *supra* note 155.

[483] *See, e.g.*, *F-Squared Investments, Inc.*, Advisers Act Rel. No. 3988 (Dec. 22, 2014) (misleading performance information).

[484] *See* *Western Asset Mgmt.*, Advisers Act Rel. No. 3762 (Jan. 27, 2014).

[485] 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).

[486] 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. *See* *Visium Asset Mgmt. Co.*, Advisers Act Rel. No. 4909 (May 8, 2018) at n.2. (offshore unregistered feeder and master funds considered "pooled investment vehicles").

[487] Section 204A was added to the Advisers Act by the Insider Trading and Securities Fraud Enforcement Act, Pub. L. No 100-704, 102 Stat. 4677. The SEC has brought enforcement proceedings against advisers for failing to maintain insider trading policies and procedures. *See* *Wells Fargo Advisors, LLC*, Advisers Act Rel. No. 3928

the misuse of material, non-public information about the adviser's securities recommendations and client securities holdings and transactions.[488] The provision applies to *all* advisers, including state-registered and unregistered advisers.[489]

a. *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.[490] Insider trading by advisers to hedge funds has been a significant focus of the SEC, as well as criminal authorities.

   Expert Networks. Use of so-called "expert networks" may expose advisers to liability for insider trading. Expert networks are firms that connect large investors, including advisers, with outside subject matter experts. When those networks rely on MNPI, the information provided to the adviser will have been "tipped," and the adviser may be held liable if it knows or should know that there has been a breach of a fiduciary duty or obligation arising from a similar relationship of trust and confidence. In some cases, for example, the SEC has alleged that experts have been current or former employees who provided information in breach of their duties to the company.[491] While the use of expert networks to inform investment decision making is not itself unlawful, advisers that employ them avoid potential liability by carefully scrutinizing the firms they employ and developing policies and procedures to guard against receiving insider information.

   The SEC staff has suggested that these controls might include:

   (1) Review of the terms of agreement with the expert witness;

   (2) Review and evaluation of the expert's insider trading policies;

   (3) Pre-approval of conversations with an expert;

   (4) "Chaperoning" by compliance officers of conversations with experts;

(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).

488 *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 transactions.").

489 *Marwood Group Research, LLC*, Advisers Act Rel. No. 4279 (Nov. 24, 2015) (state-registered adviser).

490 Moreover, the adviser may be subject to disgorgement of profits from the illegal trading even though all of the benefits from the trading accrued to its clients. *SEC v. Contorinis*, 743 F.3d 296 (2nd Cir. 2014).

491 *See* SEC Complaint in *SEC v. Longoria, et al.*; SEC Complaint in *SEC v. CR Intrinsic Investors*.

(5) Avoidance of experts who are employees of public companies;

(6) Testing of trades of portfolio managers.[492]

b. *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.[493] These often include:

(1) 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;[494]

(2) 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;

(3) 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

(4) Educating employees about insider trading and their obligations under the firm's policies and procedures governing MNPI.[495]

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 are likely to receive.[496] Information barriers are likely to work better for larger firms while firm-wide trading

---

[492] Carlo di Florio, Remarks at the IA Watch Annual IA Compliance Best Practices Seminar (Mar. 21, 2011). Such or similar practices may be required by the compliance rule.

[493] Rule 10b-5-1(c)(2) under the Exchange Act.

[494] The information barrier procedures require legal or compliance personnel to police the barriers and 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).

[495] *See* Staff Summary Report on Examinations of Information Barriers (Sept. 27, 2012).

[496] *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 487 (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).

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.[497] 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.[498]

(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.[499] Accordingly, many advisers include additional information in their brochures.

(2) *Multiple Brochures.* An adviser *may* prepare and deliver different brochures to different groups of clients if "substantially different" advisory services will be provided, omitting from one brochure information that is material only to the recipients of the other brochure.[500]

(3) *Wrap Fee Brochures.* Sponsors of wrap fee programs *must* deliver a brochure that is separate and distinct from the adviser's other brochure(s), which meets the requirements of Appendix 1 of Part 2A of Form ADV.[501]

(4) *Exceptions to Delivery Obligation.* Advisers are not required to deliver a brochure to clients (i) that are registered investment companies, or (ii) for whom they provide only impersonal services for less than $500.[502]

(5) *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.[503] 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

---

497 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.

498 Rule 204-3(b)(1)&(2). Delivery must be made at least once every 12 months, although it need not occur at the same time each year. Advisers Act Rel. No 1000 (Dec. 5, 1985), *supra* note 111.

499 Instruction 3 to Part 2 of Form ADV.

500 Rule 204-3(e).

501 Rule 204(-3(d).

502 Rule 204-3(c).

503 Release 3222, *supra* note 129 at n. 504 and accompanying text.

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.[504]

(6) *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.[505] The practical effect of this provision is to require that hedge fund brochures be available on the SEC's web site.[506]

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.

(7) *Electronic Delivery.* Advisers may deliver brochures electronically with client consent.[507]

(8) *Interim Updates.* Brochures must be updated (and filed with the SEC) between annual amendments *promptly* whenever any information in the brochure becomes materially inaccurate.[508] An adviser's obligations under the anti-fraud provisions of the Act may require it to provide the updated information to clients for which the information is material.[509]

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.[510]

---

504 *Goldman Sachs & Co.*, SEC Staff No-Action Letter (June 20, 2013).

505 *Goldstein v. SEC*, *supra* note 155.

506 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. Part 2 Adopting Release, *supra* note 203.

507 *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).

508 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.

509 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.

510 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.

(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.[511]

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).[512]

(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.[513]

(3) *Electronic Delivery*. Advisers may deliver brochure supplements electronically to clients who have consented.

13. *Systemic Risk Reporting on Form PF*

Each registered investment adviser with at least $150 million in "private fund assets under management" must submit periodic reports on Form PF.[514] Advisers must file 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.[515]

a. *Determining Private Fund Assets under Management*

Private Fund Assets. For purposes of Form PF, private fund assets (or, "RAUM") 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

---

511 *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 203.

512 Instruction 6 to Part 2 of Form ADV.

513 Rule 204-3(c)(2).

514 Rule 204(b)-1

515 *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.

out). Accordingly, borrowings to provide leverage will not reduce the amount of private fund assets.[516]

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.[517]

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.[518] They must file annually within 120 days of the end of their fiscal year.[519]

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.

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

---

516 Instruction 5.b(4) and (5) to Form ADV.

517 Instruction 5 of Form PF.

518 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.

519 Rule 204-1(b). The SEC recently settled enforcement actions against 13 advisers for failure to file Form PF. *See, e.g.*, *Bachrach Asset Mgmt. Inc.*, Advisers Act Rel. No. 4919 (June 1, 2018). The SEC is able to identify the failure of advisers to properly file Form PF by using functionality of the IARD system add the amount of assets under management of private funds reported on Schedule D of Form ADV and compare the names of advisers who adviser private funds with more than $150 million of assets with those who have filed Form PF on the same system.

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, 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.[520]

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.[521]

---

[520] General Instruction 1 (last paragraph) to Form PF.

[521] 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

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.[522]

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.[523] 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.[524]

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 information,[525] and the downloading of customers data by a departing employee to use to solicit clients to move to a new firm,[526] and sharing customer information with a third party in connection with opening unauthorized brokerage accounts.[527]

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.

522 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").

523 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.

524 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 422 ("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).

525 *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).

526 *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*.

527 *Gilford Securities, Inc.*, Exchange Act Rel. No. 65450 (Sept. 30, 2011).

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.[528]

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 led to misappropriation of the data by an employee.[529] Although the adviser ultimately discovered the data breach, the SEC asserted that the adviser failed to audit its user controls or monitor for suspicious activities.

Cybersecurity. The SEC has brought enforcement actions against advisers for failing to take adequate precautions to prevent unauthorized access to electronic client records.[530] Examination of advisers' cybersecurity compliance and controls is currently a priority for the SEC staff,[531] 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.[532] Subsequently, the Division of Investment Management issued guidance that 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;

528 *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.

529 *Morgan Stanley Smith Barney*, Advisers Act. Rel. No. 4415 (June 8, 2016). According to the SEC, the employee exploited holes in the adviser data controls that permitted him to download the data to a home computer despite having no legitimate business need for the information. 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). He was subsequently barred from the industry. *Galen J. Marsh*, Advisers Act Rel. No. 4414 (June 8, 2016).

530 *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 525.

531 "Examination Priorities for 2017," Office of Compliance Inspections and Examinations,

532 "Cybersecurity Examination Sweep Summary," Office of Compliance Inspections and Examinations (Feb. 13, 2015).

(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.[533]

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.[534]

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.[535] 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.[536]

(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.[537] The initial notice must be provided no later than when the client enters into an advisory

[533] "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 530.

[534] *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.

[535] 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.

[536] *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). As a result, uregistered and state-registered advisers may comply with SEC rules.

[537] Rules 248.4(a).

contract.[538] Notices must be clear and conspicuous, *i.e.*, reasonably understandable and designed to call attention to the nature and significance of the notice.[539]

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 have 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).[540]

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.[541]

(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.[542] A client's decision to block information sharing is effective until it is revoked in writing.[543] A client's decision to consent to disclosure may be revoked at any time.[544]

"*Non-public personal information*" includes "personally identifiable financial information" and any list, description, or other grouping of clients derived such information, *e.g.*, a client list.[545] 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.[546]

---

538 Rule 248.4(a), (c)(3)(iii).

539 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.

540 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 140, to circumscribe the circumstances under which advisers must provide each client an annual privacy notice.

541 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").

542 Rule 248.10.

543 Rule 248.7(g).

544 Rule 248.7(f).

545 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 541.

546 *See* Rule 248.3(v).

"*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.[547]

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, in which case the affiliate may disclose the information only to the extent the adviser could under its own policies;[548]

(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;[549] or

(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.[550]

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 consent was first obtained.[551] 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.[552]

c. *Proper Disposal of Client Information*

---

[547] 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.

[548] Rule 248.11(b)(1).

[549] 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.

[550] Rule 248.13.

[551] *See*, e.g., *Stephen Derby Gisclair*, Advisers Act Release No. 3703, *supra*, note 526; *David C. Levine*, Exchange Act Release No. 64222, *supra*, note 526; *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).

[552] *Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Personal Information*, Advisers Act Rel. No. 2712 (Mar. 4, 2008).

A registered adviser must adopt written procedures reasonably designed to protect client records and information, and to dispose of such records properly.[553] The records covered by this provision include only records that identify individuals.

d. *Affiliated Marketing Rule (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.[554] Unlike Regulation S-P, Regulation S-AM does not restrict the ability of the adviser to share information; instead, it limits the ability of an adviser's affiliate to use "eligibility information" received from the adviser to make a "marketing solicitation" to the client.[555]

(1) *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.[556] These are the same affiliates that Regulation S-P permits advisers to share non-public personal financial information with without client consent.

(2) *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.[557] It excludes general advertisements.

(3) *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.[558]

---

553 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 530; *J.P. Turner & Company, LLC*, Initial Decision Rel. No. 395 (May 19, 2010) (customer records left on curbside).

554 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.

555 Unlike Regulation S-P, there is a private right of action under the Fair Credit Reporting Act (FCRA), 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.

556 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.

557 Rule 248.120(o).

558 Rule 248.120(j); Section 603(d) of the FCRA.

While the definition of "Eligibility Information" 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.

(4) *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.[559]

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.[560]

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.[561]

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").[562]

a. *Scope of Rule*. The Red Flags Rules apply only to registered advisers that are either "financial institutions" or "creditors,"[563] and only as to "covered accounts."[564]

---

559 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.

560 Rules 248.121(a), 122(b) and 122(c).

561 Rule 248.121(c).

562 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).

563 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).

(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.[565] "Consumers" are defined as individuals, and thus an adviser without individual clients is not a "financial institution."[566] 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.[567]

(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.[568]

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: [569]

(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."[570]

(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 (and funds they advise) 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

---

564 Rule 248.201(b)(3).

565 Rule 248.201(b)(7) (defining "financial institution" by reference to Section 603(t) of the FCRA).

566 *See* definition of "Consumer" in Section 603(b) of the FCRA.

567 Rule 248.201(b)(5) (defining "creditor" by reference to Section 615(e)(4) of the FCRA).

568 Rule 248.201(b)(3).

569 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.

570 Rule 248.201(b)(10).

on a U.S. securities exchanges other than ETFs[571]) 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%.[572] The requirement is designed to notify the company and markets that an investor has accumulated a substantial amount of voting securities and, in the case of Schedule 13D, the intentions of the investor. Schedules 13D and G must be filed electronically, via the SEC's EDGAR system rather than the IARD system.[573]

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.[574] 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.[575] An adviser must aggregate these holdings to determine whether it has a* filing obligation, and thus may have a filing obligation even if each of its clients do not.[576]

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.[577]

---

571 ETF are traded on securities exchanges, but are not generally reported in reliance on an SEC no-action letter that analogized them to mutual funds (that are not subject to reporting requirements) inasmuch as they trade at or near net asset value. *PDR Services LLC*, SEC Staff No-Action Letter (Dec. 14, 1998).

572 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.

573 The SEC has brought several settled enforcement actions 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).

574 Rule 13d-3.

575 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).

576 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.

577 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*

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 or 13G even if each member of the group owns less than 5%.[578] No formal agreement to act is necessary; a group may be inferred by conduct.[579]

Schedule 13G. SEC-registered advisers are "Qualified Institutional Investors" ("QII) under SEC rules and may, in lieu of Schedule 13D, submit a report on Schedule 13G.[580] Schedule 13G is a short-form statement requiring requires little information other than the amount of beneficial ownership of the filer. It is generally not required to be filed until 45 days after the end of the calendar year in which the adviser becomes a 5% beneficial owner.[581] Only holdings that exceed the 5% threshold as of the end of the calendar year must be reported.[582] Most advisers that are not activist (and those who advise manage funds that are not activisit) seek to file on Form 13G and remain eligible.

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.[583] Once eligibility is lost (as a result, for example, of ceasing to hold securities for passive investment purposes only), the adviser must begin filing on Schedule 13D, and is subject to a 10-day freeze on acquiring any additional securities or voting securities it holds [584]

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 supra* section VI.B.11.b(1) of this outline.

578 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 typically satisfy the group's obligation by filing individually and reporing its own holdings, but disclaims overall group holdings.

579 *Wellman v. Dickinson*, 862 F.2d 355 (2nd Cir. 1982).

580 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 13G 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).

581 Rule 13d-2(b). If, however, the ownership interest exceeds 10% on the last day of any month (other than December), the adviser must make its initial filing within 10 days after the end of the month.

582 A separate filing is made with respect to each reportable position in a class of equity securities.

583 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 (such as acquiring shares to vote in a merger). There are gray areas when advisers engage in forms of shareholder activitism. *See* Zarb, Richman and Ingrassia, *When Passive Investors Drift into Activist Status* (June 2018).

584 Rule 13d-1(e). *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).

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 QII. 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.[585] If a person who is not a QII is included on the form, the most stringent filing requirements apply.

c. *Groups.* Formation of a group (discussed above) may undermine an adviser's eligibility for filing on Form 13G instead of 13D. This is because a group will ordinarily formed for a purpose other than passive ownership.

d. *Private Funds*. Private funds are not QIIs. 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.[586] An adviser filing as a passive owner may file jointly with the private funds they advise.

e. *Non-U.S. Advisers.* Advisers that are not U.S. persons are subject to the filing requirements.[587]

4. *Institutional Investor Reporting on Form 13F*

a. 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.[588] 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.[589]

b. *Control Persons.* A person controlling an adviser having discretionary authority over section 13(f) securities is deemed to have discretionary authority over such securities.[590] As a result, a person controlling multiple advisers may have an obligation to file Form 13F because it and the advisers it controls collectively

---

585 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).

586 Rule 13d-1(c).

587 *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).

588 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).

589 S. Rep. No. 94-75, 94th Cong., 2d Sess. 82-85 (1975).

590 Rule 13f-1(b).

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).

c. *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.[591] 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.[592]

d. *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.[593] The SEC also grants confidential treatment where the information might otherwise qualify for one or more exemptions under the Freedom of Information Act (FOIA), typically for trade secrets or other types of confidential commercial information.[594]

e. *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.[595]

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.[596] These requirements are designed to assist the SEC in both identifying, and obtaining trading

---

[591] "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.

[592] The Division of Investment Management has published a FAQ regarding Form 13F ("13F FAQs").

[593] Section 13(f)(4) of the Exchange Act.

[594] *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).

[595] *See* 13F FAQs *supra* note 592 at FAQ #4.

[596] Rule 13h-1 under the Exchange Act. *See* *Large Trader Reporting*, Exchange Act Rel. No. 34-64976 (July 27, 2011) (adopting rule 13h-1 and Form 13H) ("LTR Release"). Form 13H can be found here.

information on, market participants that conduct a substantial amount of trading activity.[597]

a. *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) two million shares or shares with a fair market value of $20 million during a calendar day; or (ii) twenty million shares or shares with a fair market value of $200 million during a calendar month.[598]

b. *National Market System Securities.* These securities include standardized options and equity securities (but not debt, futures or ETFs) listed on the NYSE and Nasdaq Stock Market and other regional exchanges.[599] The scope of securities that fall under this definition is narrower than those that trigger a requirement to file Form 13F.

c. *Form 13H.* 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 identifying activity level.[600] 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.[601]

d. *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.[602]

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."[603] A

---

[597] LTR Release. 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."

[598] Rule 13h-1(a)(1) and (a)(7). The SEC staff has issued a FAQ on large trader reporting requirements.

[599] *See* Regulation NMS, rule 600(b)(46), (47) and (82).

[600] 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*.

[601] *See* LTR Release, *supra*, note 596. 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*.

[602] 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*.

dealer is any person who is in the business of buying and selling securities for his own account, including through a broker.[604] 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;[605] (ii) does not have possession of its client's securities; and (iii) does no more than route the orders to an SEC-registered broker or a bank or trust company for execution.[606]

b. *Private Fund Distribution Activities.* Interests, including limited partnership 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.[607]

   Issuer Exemption. Under the issuers' exemption, an issuer (including a private fund) that sells only its own securities is not considered to be engaged in the business of buying and selling securities. Where the fund's employees or agents regulary market or solicit investors, they may be deemed to be broker-dealers, particularly if they accept commissions.[608] Rule 3a4-1 under the Exchange Act provides a "safe harbor" from broker-dealer registration for an associated person of an issuer. However, the conditions of the rule are narrow, prohibit the payment of transaction-based compensation to employees, and limit the frequency of an offering.[609] There is significant uncertainty about the availability of the issuer exemption for an adviser not using the services of a registered broker-dealer

---

603 Section 3(a)(4)(A) of the Exchange Act.

604 Section 3(a)(5) of the Exchange Act. The definition includes securities-based swaps, but excludes other swaps.

605 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 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.

606 *InTouch Global, LLC*, SEC Staff No-Action Letter (Nov. 14, 1995); *First Atlantic Advisory Corp*., SEC Staff No-Action Letter (Feb. 20, 1974).

607 Section 15(a) of the Exchange Act generally makes it unlawful for a person to "effect a transaction in securities" or "attempt to induce the purchase or sale of any security" unless the person is registered with the SEC as a broker-dealer.

608 *Paul Anka*, SEC Staff No-Action Letter (July 24, 1991).

609 *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).

(including "finders") to distribute shares of a private fund making a continuous offering must register as a broker-dealer.[610]

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 involved in such a transaction without the participation of a broker-dealer for failure to register as a broker-dealer.[611]

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 of Enron,[612] and were expanded by the Dodd-Frank Act to, among other things, cover investment advisers (whether or not registered).[613]

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.[614] The awards may range from between 10% to 30% 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.[615] However, information provided to the SEC at the direction of the adviser or after a request was made to the employee by an

---

610 *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.

611 *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 610.

612 Advisers that are public companies or that advise publicly offered investment companies may also be subject to the whistleblowing provisions of the Sarbanes-Oxley Act. *See* *Lawson v. FMR, LLC*, 134 S. Ct. 1158 (2014). This outline does not address those provisions, some of which are administered by the Department of Labor.

613 Section 922 of the Dodd-Frank Act.

614 Section 21F(a)-(c).

615 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).

SEC examiner or investigator is not considered "voluntary" and thus does not make the employee eligible for an award.[616]

(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.[617] An internal whistleblower will remain eligible for an award even if the adviser self-reports to the SEC.[618]

Limitations

(1) *Lawyers.* Information obtained by a person in a communication subject to attorney-client privilege or obtained as a result of legal representation is not considered "original information," making such persons ineligible in most cases for bounties.[619] This exception applies to both lawyers and non-lawyers who learn of the information through a confidential attorney client communication.

(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.[620] The 120 day period is designed to give the adviser an opportunity to investigate the matter and, if appropriate, self-report any misconduct.[621]

(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.[622] Becoming a whistleblower does not provide amnesty from an SEC enforcement action, and the SEC may take

---

616 Rule 21F-4(a)(3). An employee interviewed in an internal investigation, however, would be eligible for an award.

617 Rule 21F-4(b)(7).

618 Rule 21F-4(c)(3).

619 Rule 21F-4(b)(4)(i). There are narrow exceptions, such as when privilege is waived.

620 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).

621 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).

622 Rule 21F-8(c)(3). *See, e.g.*, *Paradigm Capital Mgmt., Inc.*, *supra* note 276 (whistleblower alleging unlawful trading was head trader of adviser).

the culpability of the informant into consideration in determining whether to bring an action and the penalties it seeks against the whistleblower.[623]

Anti-Retaliation Provisions. Advisers and other employers are prohibited from retaliating against a whistleblower *who provides information to the SEC.*[624] Unlike advisers subject to the Sarbanes-Oxley Act's anti-retaliation provisions, the Dodd-Frank Act's Act' anti-retaliation provisions do not protect an employee who reports misconduct only internally, although state and other laws may provide protections.[625]

The anti-retaliation protections apply regardless of whether the information provided would make the whistleblower eligible for an award from the SEC. The whistleblower is protectd 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.[626]

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. . . "[627] The first SEC enforcement action alleging retaliation involved an adviser that removed the whistleblower from his position as head trader.[628] 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 adopt firm-wide anti-retaliation policies.

---

623 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).

624 Rule 22F-2(b)(1).

625 SEC rules implementing the Dodd-Frank whistleblower provisions extended the anti-retaliations provisions to person who report violations internally. *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). This aspect of the rules was challenged and a split among the federal circuits was resolve by the Supreme Court, which held that the anti-retaliation protections under the Dodd-Frank Act apply only to individuals who have reported the alleged misconduct to the SEC. Digital Reality Trust, Inc. v. Somers., 138 S.Ct. 767 (2018). Because of the availability of state and local laws protecting whistleblowers that define "whistleblower" broadely, the practical effect of the decision is probably limited.

626 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).

627 Section 21F(h)(1).

628 *Paradigm Capital Management, Inc.*, *supra* n 276.

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.[629]

b. *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.[630] The enforcement or attempted enforcement of a nondisclosure or confidentiality agreement against an employee seeking to communicate with the SEC staff has been treated as an effort to impede a whistleblower.[631]

Non-Disclosure Agreements. The SEC has settled several enforcement actions in which it asserted that non-disclosure provisions alone in separation or internal investigation agreements with employees improperly impede whistleblowers, including provisions in agreements that require employees to waive "recovery incentives" for reporting misconduct.[632] Agreements to protect privileged communications are permitted. In 2016, the SEC staff issued a risk altert, suggesting that it views non-disclosure provisions in compliance manuals, codes of ethics, and *all* employment agreements as impeding whistleblowers, and has since been reviewing such documents during compliance examinations.[633]

As a result, many advisers are including in employee nondisclosure agreements a "savings clause" explicitly permitting disclosure of information to the SEC or other state or federal regulatory authority.[634]

c. *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.[635] The

---

629 Section 21(F)(h)(1)(B)-(C).

630 Rule 21F-17(a). *See e.g.*, *Homestreet, Inc.*, Exchange Act Rel. No. 79844 (Jan 19, 2017) (employer took actions to determine the indentity of whistleblower and suggested that the terms of an indemnification agreement could allow denial of payments).

631 *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 the language of which impeded employees from discussing their interviews without permission from KBR's law department).

632 *Blackrock, Inc.*, Exchange Act Rel. No. 79804 (Jan. 17, 2017).

633 Risk Alert, Vol. VI, Issue 1. (Oct. 24, 2016). The SEC staff has requested that advisers not only amend current agreeemts, but contact former employees to inform them that non-disclosure provisions in employment and other agreements do not preclude them from disclosing violations to the SEC or other regulatory authorities.

634 See *KBR, Inc.*, *supra* note 631 (savings clause added to new confidentiality agreement).

635 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).

anti-retaliation provisions, however, may not always be available to foreign nationals who experience retaliation outside the U.S.[636]

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. 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.[637] 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.[638]

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.[639] Congress included this provision in the Act because of its concern that a performance fee would encourage undue speculation with clients' investments.[640]

[636] *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 U.S. connection will be necessary for retailiation activities not to be "extraterritorial."

[637] 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.

[638] 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).

[639] 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.

[640] *See* H.R. Rep. No 2639, 76th Cong., 2d Sess. 29 (1940).

a. *Assets Under Management.* The commonly charged fee based on an amount of assets under management is specifically excepted.[641]

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.[642] 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."[643]

c. *Non-U.S. Clients.* The Act also excepts contracts with persons who are not residents of the United States.[644] 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:

(1) natural person or company that has at least $1 million under management with the adviser immediately after entering into the contract;[645]

(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,[646] or is a "qualified purchaser";[647] <u>or</u>

---

641 Section 205(b)(1).

642 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).

643 *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 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).

644 Section 205(b)(5).

645 Rule 205-3(d)(1)(i).

646 Rule 205-3(d)(1)(ii)(A). In 2016 the SEC increased the amount from $2 million to $2.1 million of RAUM. 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.

647 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.

(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.[648]

e. *Qualified Purchaser Funds*. The Act also excepts contracts with certain funds not registered under the Investment Company Act because they are offered only to certain wealthy or sophisticated investors.[649] 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.[650] 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.[651]

Non-U.S. Funds. An adviser to a fund organized outside the United States is not subject to restrictions on performance fees with respect to the fund even if investors are U.S. persons.[652]

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

648 Rule 205-3(d)(1)(iii).

649 Section 205(b)(4).

650 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).

651 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 $1 million of assets under management with each. *See* IM Guidance Update No. 2013-10 (Nov. 2013) and section IV.B.4 of this outline (discussing umbrella registration).

652 Advisers Act Rel. No. 1731 at n.9, *supra* note 650. The enactment of NSMIA in 1996, which made the restrictions on performance fees inapplicable to non-U.S. clients, superceded a SEC staff letter that took the position that an adviser to a non-U.S. fund must "look through" the fund to determine whether U.S. investors in the fund were qualified clients. *Lazard Frères Asset Mgmt.*, SEC Staff No-Action Letter (Feb. 12, 1996).

disclosure of false information and a violation of the anti-fraud provisions of the Act, *i.e.*, not merely a breach of contract.[653]

Some of the overbilling cases the SEC has brought against advisers involve schemes to misappropriate client assets,[654] while others simply involved back-office errors.[655] 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.[656] 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.[657]

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.[658] An assignment includes any direct or indirect transfer or hypothecation (*i.e.*, pledging) of

---

653 OCIE issued a "Risk Alert" in April 2018 in which it reviewed the most frequent compliance issues identified in examinations that involve the proper determination of fees charged (and expenses allocated to) clients. *Most Frequent Advisory Fee and Expense Compliance Issues* (Apr. 12, 2018).

654 *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).

655 *Marco Investment Mgmt. LLC*, Advisers Act Rel. No. 4348 (Mar. 2, 2016); *Equitas Capital Advisers*, *supra* note 437; *Guggenheim Partners Inv. Mgmt.*, *supra* note 303; *Envision Capital Mgmt.*, *supra* note 439.

656 *See, e.g.*, *Cornerstone Capital Mgmt*., Advisers Act Rel. No. 2855 (Mar. 20, 2009).

657 *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.

658 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 as a failure to implement compliance controls. Thus, it is not advisable, in practice, to draw the distinction the staff has drawn.

an advisory contract.[659] The provision is designed to restrict an adviser's sale of its fiduciary office.[660]

The requirements of section 205(a)(2) apply 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.[661] 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."[662] 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.[663] 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.[664] As a consequence, in some cases a change of effective control of a partnership may occur without

---

[659] Section 202(a)(1). An assignment does not occur as a result merely of a change of advisory personnel. *American Express Financial Corp.*, SEC Staff No-Action letter (Nov. 17, 1998) at note 10. The SEC staff has stated that a mere pledge of a controlling position of an equity in connection with a loan agreement should not be considered a hypothecation of a controlling block of voting securitries, unless it results in an change of actual control of management.. *Pilgrim America Group, Inc.*, SEC Staff No-Action Letter (Oct. 8, 1996).

[660] 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).

[661] Section 202(a)(1).

[662] 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.

[663] 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).

[664] Section 202(a)(1).

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.[665]

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.[666]

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.[667] *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.[668]

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.[669]

---

665 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.* SEC Staff No-Action Letter (Dec. 14, 1995).

666 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.

667 *Dean Witter, Discover & Co.; Morgan Stanley Group Inc*., SEC Staff 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. *See also* *Funds, Inc.* SEC Staff No-Action Letter (Apr. 21, 1972) (spin-off of an adviser from a publicly held company to its shareholders).

668 *See* discussion *supra* Section VI.B.1.a. of this outline regarding consent for principal transactions.

669 Instruction to Item 5 of Form ADV-W; *Jennison Associates Capital Corp.* SEC Staff No-Action Letter (Dec. 2, 1985) (60 days); *Hedberg & Gordon, Inc.*, SEC Staff No-Action Letter (Feb. 23, 1971) (reasonably specified period).

3. *Hedge Clauses*

The Act voids any provision of a contract that purports to waive compliance with a provision of the Act.[670] 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.[671]

Exculpatory Clauses. 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,[672] even if the hedge clause explicitly provides that rights under federal or state law cannot be relinquished.[673] 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."[674] The current approach of the staff thus permits culpability clauses based upon regular standards for establishing the scope of fiduciary duties when the obligation of full disclosure and consent is satisfied.

Culpability provisions do not, however, affect the SEC's ability to enforce violations of Section 206(2) of the Act, which has been interpreted to include negligent conduct.[675] Commonly included in advisory contracts, they operate primarily to limit an adviser's civil liability for breaches of duties to clients under state adviser statutes and other laws.

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.[676]

---

670 Section 215(a).

671 *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).

672 *Auchincloss & Lawrence Inc*., SEC Staff No-Action Letter (Feb. 8, 1974).

673 *Omni Mgmt. Corp*., SEC Staff No-Action Letter (Dec. 13, 1975); *First National Bank of Akron*, SEC Staff No-Action Letter (Feb. 27. 1976).

674 *Heitman Capital Mgmt., LLC, et al*., SEC Staff No-Action Letter (Feb. 12. 2007).

675 *SEC. v. Steadman*, *supra* note 227.

676 *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 (*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).

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.[677] 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.[678] 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),[679] unless the adviser is to receive a pre-determined amount upon termination for services already performed, and the client is provided adequate disclosure.[680]

5. *Rescission Rights*

Advisory contracts entered into in violation of the Advisers Act are void.[681] A client may sue for rescission of such contract,[682] and obtain restitution of any fees, commissions or other compensation paid to the adviser pursuant to the contract.[683] 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.[684]

---

677 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.

678 *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 advisory 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 contract 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).

679 *National Regulatory Services*, SEC Staff No-Action Letter (Dec. 2, 1992); *Caderet, Grant & Co., Inc.* Advisers Act Rel. No. 4736 (Aug. 1, 2017) (settled action alleging adviser failed to refund pre-paid advisory fees).

680 *BISYS Fund Services, Inc.*, SEC Staff No-Action Letter (Sept. 2, 1999).

681 Section 215(b).

682 *Transamerica Mortgage*, *supra note 84.* This is the only private right of action under the Act recognized by the courts. In order to sue under Section 215(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).

683 *Washington v. Baenziger*, 656 F. Supp. 1176, 1178 (N.D. Cal. 1987) (citing *Transamerica* at 24, n.14).

684 *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).

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.[685]

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.[686] Thus, electronic documents, including emails, must be maintained if they meet the requirements for records 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.

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.

---

[685] Rule 204-2(a). Section 204 of the Act gives the SEC broad authority to require advisers to maintain books and records.

[686] Rule 204-2(g) (permitting records to be maintained in electronic format, subject to procedures designed to maintain their integrity).

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;

(3) the placing or executing of any order to purchase or sell any security;[687] or

(4) the performance or rate of return of managed accounts or securities recommendations.[688]

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.[689]

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.

k. Documents substantiating any performance information[690] provided to any person.

---

687 Rule 204-2(a)(7). If recommendations are 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. Rule 204-2(a)(11).

688 This last provision was added by the SEC in 2016. Advisers Act Rel. No. 4509, *supra* note 181.

689 *See* *Retirement Investment Advisors, Inc.*, Advisers Act Rel. No. 4237 (Oct. 21, 2015) (adviser failed to preserve personal emails).

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

This provision and the communications retention requirement above in (f)(4) 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.[691]

l. Certain additional records if the adviser has custody or possession of clients' cash or securities.[692]

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.[693] The SEC examination staff has 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 documenting the adviser's annual review of its compliance policies.

q. Certain additional records regarding political contributions and advisory services to any government entity.[694]

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 an easily accessible place, the first two of which must be at the offices of the adviser.[695]

b. *Retention Periods*. Unless otherwise specified, required records must be maintained for a period of not less than five years from the end of the fiscal year during which the last entry was made on the record.

---

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.

691 Advisers Act Rel. No. 4509, *supra* note 181.

692 Rule 204-2(a)(17)(iii) and (b).

693 Rule 204A-1(a)(2).

694 Rule 204-2(a)(18) and (h).

695 Rule 204-2(e).

c. *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.[696] The SEC has held third party recordkeepers responsible under the Act for causing the adviser to fail to maintain accurate records.[697]

d. *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.[698]

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) the record must be backed-up at a separate location.[699]

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.[700]

4. *Document Destruction Policies*

Many advisers adopt a document destruction policy for business records designed to assure compliance with the Advisers Act's (and other regulatory or contractual) retention requirements, while limiting document storage costs.[701] The policies will identifiy time periods, authorize individuals to approve destruction, identify the means of destroying documents, and provide for a suspension of the the destruction of

---

[696] *First Call*, *infra* note 700; *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).

[697] *Wilmington Trust Company*, Advisers Act Rel. No. 2261 (July 12, 2004).

[698] Rule 204-2(g)(3). Records may be kept electronically regardless of how they were originally created.

[699] Rule 204-1(g)(2). The rule does not speak to storage of records on the "cloud," but the same principles should apply.

[700] *First Call Corporation*, SEC Staff No-Action Letter (Sept. 6, 1995).

[701] *See* SEC Office of Compliance Investigations and Examinations, *Questions Advisers Should Ask While Estalishing or Reviewing their Compliance Programs* (May 28, 2006) (stating that compliance policies should guard agains *unplanned* document destruction before end of retention period, and suggesting that policies may provide for destruction once the periods have passed).

documents (a “litigation hold”) in the event the adviser becomes aware of any threatened regulatory, civil or criminal action against the adviser.[702]

5. *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.[703] Because of the burdens associated with maintaining two sets of records most advisers choose the second option.

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.[704]

c. *Foreign Private Advisers.* Exempt reporting advisers, including foreign private advisers, are not subject to any of the recordkeeping requirements under the Advisers Act.[705]

---

[702] One court has explained that, "[w]hile a litigant is under no duty to keep or retain every document in its possession once a complaint is filed, it is under a duty to preserve what it knows, or reasonably should know, is relevant in the action, is reasonably calculated to lead to the discovery of admissible evidence, is reasonably likely to be requested during discovery, and/or is the subject of a pending discovery request." *Wm. T. Thompson Co. v. General Nutrition Corp.*, 593 F. Supp. 1443, 1455 (C.D. Cal. 1984). There is no clear test as to when a lawsuit or proceeding is "reasonably foreseeable," and thus an adviser shold err on the side of suspending destruction of documents potentially related to a lawsuit or regualtory proceeding.

[703] 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 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.

[704] *See* Advisers Act Rel. No. 3222, *supra* note 129 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 U.S. 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).

[705] The SEC has not implemented its statutory authority to adopt such rules. Release 3221, *supra* note 94 at n.164.

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.[706]

If the records are maintained in English, they should be provided to the SEC in English.

F. Administrative Oversight

The staff 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.[707] 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.[708]

The SEC staff annually publishes a list of current examination priorities.[709]

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.[710]

The SEC has announced, however, that it will not conduct routine examinations of exempt reporting advisers.[711]

2. *Records Subject to Examination*

---

706 An exception, set forth in staff letters, is for records provided upon request by a non-U.S. participating affiliate. *See supra* note 179.

707 For more detailed information, *see* *Examinations by the Securities and Exchange Commission's Office of Compliance Inspections and Examinations* (Feb. 2012).

708 *Examination Information for Broker-Dealers, Transfer Agents, Clearing Agencies, Investment Advisers and Investment Companies*.

709 OCIE's Examination Priorities for 2018 was posted on February 6, 2018.

710 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 94 at n. 190.

711 Release 3221, *supra* note 94, at Section II.B.2.

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.[712]

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.[713]

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 satisfy any examination request by the SEC staff by providing a list of the client securities, deposits, or credits it holds.[714]

This provision of the Act provides the SEC with examination authority over persons who are not investment advisers. Enacted as part of the 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.[715] 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

[712] *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.

[713] Section 204(b)(2), as amended by section 404(2) of the Dodd-Frank Act.

[714] Section 204(d), as amended by section 929Q(b) of the Dodd-Frank Act.

[715] *See* SEC, Division of Enforcement, Enforcement Manual (Nov. 28, 2017) (Section 4.3). The privilege protects communications with both in-house and outside counsel.

advisers will need to take care to separate the functions in order to preserve the privilege.[716]

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.[717]

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.[718] The provision does not, however, prevent the SEC from being compelled to provide examination information under the Freedom of Information Act (FOIA) or by a court subpoena.[719] The SEC will generally resist divulging examination information pursuant to a FOIA request, asserting, among other things, broad exemptions for proprietary information.[720]

Confidentiality Treatment. SEC rules permit advisers responding to requests for information from the SEC to request confidential treatment of the information.[721] Such a request must be made at the time the records are first produced and directed to the SEC's FOIA Office. Such a request will not guarantee that the information will be kept confidential. The SEC will, however, provide the adviser with notice if there is a request to access its records and provide it 10 days to substantiate its claim of confidentiality.

All of the SEC's enforcement actions are public and will result in disclosure of information gathered in an examination.

3. *Types of Examinations*

---

716 *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).

717 Rule 502(a) of the Federal Rules of Evidence, which applies to civil litigation as well as a federal agency proceeding.

718 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).

719 *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).

720 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.

721 Rule 83. Adviser must mark each page as "Confidential Treatment Requested by _____," and Bates-stamp each page.

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.[722] 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[723]) 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.[724]

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.[725] 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.[726]

---

722 *See Equitas Capital Advisors*, *supra* note 437 (adviser examined by SEC staff in 2005, 2008 and 2011; SEC ultimately brought enforcement action against adviser and CCO for multiple compliance failures).

723 *See* Risk Alert: Retirement-Targeted Industry Reviews and Examinations Initiative.

724 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.

725 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.

726 *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.").

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.[727]

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.[728] 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 other national regulators in which the regulators agree to permit on-site visits, share information, and provide other types of reciprocal assistance to each other with respect to advisers.[729]

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.[730]

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

727 Targeting IC/IA Examinations, Report by SEC Inspector General (Sept. 29, 2004) at n.17 (urging OCIE to make greater use of such exams).

728 Section 24(d) of the Exchange Act exempts the SEC from disclosing to third parties confidential information it obtains from a foreign securities regulator. In addition, the SEC may share its non-public examination and other records with a foreign securities regulator provided that the regulator agrees to keep the records confidential. Section 24(c) of the Exchange Act and rule 24c-1(b)(3) thereunder.

729 *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); Memorandum of Understanding Concerning Consultation, Cooperation and the Exchange of Information Related ot the Supervision of Cross-Boarder Regulated Entitites between the SEC and the Hong Kong Securities and Futures Commission (Jan. 2017).

730 *Wells Fargo Advisers*, *supra* note 487 (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).

(and thus must) provide records "immediately or within a few hours of request."[731] 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.[732]

b. *Truthful and Accurate Records and Statements*

The records advisers furnished the SEC must be "true, accurate and current."[733] The SEC has instituted several enforcement actions against advisers that failed to provide accurate records, withheld records or otherwise sought to impede an examination.[734]

On occasion the staff of an adviser will alter or create false records to cover up a deficiency or violation of the law. Similarly, on occasion an adviser will fail to fully produce all of the records the SEC staff has requested with similar result.[735] Such cover-ups are viewed by the SEC staff as worse than the underlying violation and could turn a deficiency letter into an enforcement referral.[736] 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.[737]

6. *Focus of Examinations*

---

731 *Electronic Recordkeeping by Investment Companies and Investment Advisers*, Advisers Act Rel. No. 1945 (May 24, 2001).

732 *Id*.

733 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 106.

734 *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); *Schield Mgmt. Co*., Advisers Act Rel. No. 2477 (Jan. 31 2006) (SEC Opinion) (adviser destroyed documents (including emails) and otherwise withheld requested document from SEC examiners).

735 *See, e.g.*, *LKL Invstment Counsel LLC*, Advisers Act Rel. No. 4836 (Jan 3, 2018) (adviser failed to produce records of private funds in which it was involved and in which clients had invested).

736 *Wells Fargo Advisers, LLC*, *supra* note 487; *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 offense. *See* 18, U.S.C. 1519.

737 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 to SEC examiners).

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.[738] 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;

i. whether the adviser maintains proper recordkeeping.

One of the focuses of recent SEC staff examinations has been on the effectiveness of advisers' cybersecurity compliance and controls.[739]

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.

---

[738] *See* OCIE Routine Account Information Confirmation.

[739] 2018 National Exam Program Examination Priorities at 9 ("Our examinations have and will continue to focus on, among other things, governance and risk assessment, access rights and controls, data loss prevention, vendor management, training, and incident response.").

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.[740] That being said, sometimes a deficiency identified by staff will be based on an incorrect 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.[741] *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,[742] the SEC staff refers the inspection to the SEC's Division of Enforcement for further consideration and possible commencement of a civil enforcement proceeding, or (less frequently) makes a referral to criminal authorities for prosecution.[743]

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.[744]

---

740 *See, e.g., Royal Alliance Associates, Inc.*, Advisers Act Rel. No. 4351 (Mar. 14, 2016).

741 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.

742 In a number of enforcement cases, the SEC identifies the failure of the adviser to address deficiencies identified during multiple examinations. *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).

743 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.

744 *See Equitas Capital Advisor, LLC*, *supra* note 437 (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).

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 of this outline.

[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 of this outline.

Appendix B

Associated Persons and Similar Terms Used

The Advisers Act and the rules and forms adopted under the Act use terms to denote persons subject to certain provisions of the Act *in addition to* the adviser. Below are the terms:

Persons Associated with an Investment Adviser (Section 202(a)(17))

- Partners, officers, directors (or persons performing like functions)
- Employees (except clerical employees)
- Persons who control the adviser (*e.g.*, parent companies)
- Persons who are controlled by the adviser (*e.g.*, subsidiaries)

Added to the Act in 1970 to permit the SEC to disqualify and sanction an adviser based on the actions of persons who control the adviser (e.g., owners), are controlled by the adviser (e.g., subsidiaries) and the executives and non-clerical employees of the adviser.

Advisory Affiliates (Form ADV Glossary of Terms)

- Same as "person associated with an investment adviser"

Term is used in Form ADV instead of "person associated with an investment adviser," probably because it is shorter and form also used by state regulators using their own terms.

Related Person (Form ADV Glossary of Terms)

- Advisory affiliates (parent companies and subsidiaries)
- Persons under common control with the adviser (*e.g.*, sister companies)

Term is used in certain items of Form ADV to expand required information from advisory affilates to include sister companies (common control affiliates) of advisers. It is also used in the custody rule and often used informally to identify an "affiliate" of the adviser.

Supervised Persons (Section 202(a)(25))

- Partners, officers, directors (or persons performing like functions)
- Employees and other persons who provide advice on behalf of the adviser and are subject to the supervision and control of the adviser.

Added in 1996 to identify the individuals employed by an SEC-registered adviser with respect to which state law is also preempted. Used in Form ADV and Code of Ethics Rule. Excludes persons controlling or controlled by the investment adviser unless the person provides advice on behalf of the adviser.[5]

[5] *Rule Implementing Amendments to the Investment Advisers Act of 1940*, Advisers Act Rel. No. 1601 (Dec. 20, 1996) at n.53.

Access Persons (Rule 204A-1)

- Partners, officers, directors (or persons performing like functions), if providing investment advice is the adviser's primary business
- Supervised persons who have access to non-public information regarding clients' purchase or sale of securities, if involved in making securities recommendations to clients, or have access to recommendations that are nonpublic

Used in Rule 204A-1, the rule requiring advisers to adopt a code of ethics. Access persons are required to report their personal securities transactions.[6]

[6] https://www.sec.gov/rules/final/ia-2256.htm#P95_21114

Proskauer.com

Beijing | Boca Raton | Boston | Chicago | Hong Kong | London | Los Angeles
New Orleans | New York | Newark | Paris | São Paulo | Washington, D.C.