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

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Note to Reader

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

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

I update this outline frequently, so please visit Stroock & Stroock & Lavan LLP’s 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@stroock.com.
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. 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.

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?

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1 This outline provides general information on the subject matter discussed, does not necessarily reflect the views of Stroock & Stroock & Lavan 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.


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.”

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.

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.

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. It is not necessary that a client “pay a discrete fee specifically earmarked

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


6 See, e.g., U.S. v. Miller, D.C. No. 1-13-cr-00451-001, (D.C. Cir., Mar. 15, 2016) avail. at http://www2.ca3.uscourts.gov/opinarch/152577p.pdf. (“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. File, 311 F. 3d 1 (1st Cir. 2002) (a person provides advice for compensation if it understands that successful investment will yield it a commission); U.S. v. Manyu Olympic, 2010 U.S. App. Lexis 9636 (11th Cir. 2010) (per curiam) (adviser to hedge fund who uses investor’s money to pay personal expenses receives compensation); Alexander V. Stein, Advisers Act Rel. No. 1497 (June 8, 1995) (a person who fraudulently converts client funds to its own use receives compensation).
as payment for investment advice.” The compensation element is satisfied even if payments cover only the cost of the services. The person receiving the advice or another person may pay the compensation.

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. 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.

3. **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, or hires a person to solicit clients on his behalf.

4. **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 commodity pools. The SEC staff has stated that advice about real estate, coins, precious metals, or commodities is not advice about securities. The more difficult questions arise with less specific advice, or advice that is only indirectly about securities. Advice about securities includes:

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

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

10 **Release 1092.**

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

12 For instance, the SEC staff would not view an employer providing advice to an employee in connection with an employer-sponsored employee benefit program to be in the business of providing advice; see *Letter to Olena Berg, Assistant Secretary, Department of Labor* (Feb. 22, 1996). See also *Zinn v. Parish*, 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”).


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 *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).

a. advice about market trends; \(^{17}\)

b. advice about the selection and retention of other advisers; \(^{18}\)

c. advice about the advantages of investing in securities versus other types of investments (e.g., coins or real estate); \(^{19}\)

d. providing a selective list of securities even if no advice is provided as to any one security; \(^{20}\)

e. advising about the value of securities; \(^{21}\)

f. asset allocation advice; \(^{22}\) and

g. advice about voting proxies. \(^{23}\)

5. **Advising Others.** A person is not subject to the Act if he is managing his own securities portfolio. Questions about whether a person advises “others” usually arise when a client is not a natural person. The SEC generally looks to whether there is an identity of interest between the adviser and the ultimate client. \(^{24}\)

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\(^{19}\) Release 1092, supra note 5.

\(^{20}\) *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.


\(^{22}\) *Maratta Advisory, Inc.*, supra note 17. See also *SEC v. Bolla*, supra note 18.

\(^{23}\) *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.

\(^{24}\) *Touche Holdings, Incorporated*, SEC Staff No-Action Letter (Nov. 30, 1987).
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.  

b. A wholly-owned corporate subsidiary exclusively advising the parent or another wholly-owned corporate subsidiary would not generally be considered advising “others.” 

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

6. 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.

7. 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 (although such advice may technically be about securities). Providing advice regarding the investment of the proceeds of the offering, however, may subject the person to the Act.

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. The SEC staff has stated that the exclusion is not


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

27 See Investment Clubs and the SEC. 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).

28 See Release 3221, infra note 83, 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).

29 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).

30 Id.

31 The term “bank” is defined in section 202(a)(2) of the Act. In 2001, the Act’s definition of “investment adviser” was amended so that banks and bank holding companies are not eligible for this exclusion to the extent that they serve or act as an investment adviser to a registered investment company. However, if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, the department or
available to non-U.S. banks, credit unions, and investment adviser subsidiaries of banks or bank holding companies.

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. 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.

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. 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.” If advice is not “solely incidental,” a broker-dealer is subject to the Advisers Act with respect to the account regardless of the form of compensation it receives.

In 2007, the SEC proposed a rule that identified two non-exclusive “situations” in which it would consider broker-dealers to not provide incidental advisory services. While the rule was never adopted, the guidance is most recent provided by the SEC.

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32 **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).**

33 **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).**

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

35 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.

36 **Certain Broker-Dealers Deemed Not To Be Investment Advisers, Advisers Act Rel. No. 2376 (Apr. 12, 2005) (“Release 2376”), at note 39. See also Thomas v. Metropolitan Life Insurance Company, infra note 48.**

37 **Interpretive Rule under the Advisers Act Affecting Broker-Dealers, Advisers Act Rel. No. 2652 (Sept. 24, 2007) (“Release 2652”).**
a. **Separate Contract of Fee for Advisory Services.** A broker-dealer that separately contracts or separately charges a customer for advisory services would provide non-incidental advice to that customer.

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

**Special Compensation.** Generally, to avoid receiving “special compensation,” a broker or dealer relying on this exclusion must receive only commissions, markups, or markdowns.38

a. **Bundled Fees.** The SEC has stated a broker-dealer that receives a fee based on a percentage of assets that compensates the broker-dealer for both advisory and brokerage services receives “special compensation.”39

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.40

**Broker-Dealer Agents.** The SEC staff has stated that a registered representative of a broker-dealer would be an adviser unless they can rely on the broker-dealer can rely on the exclusion 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.41

**Brokerage Customers.** The SEC has stated that a broker-dealer does not have to treat its brokerage customers to whom it provides investment advice as advisory clients simply

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

39 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. *Financial Planning Association v. SEC*, 482 F.3d (D.C. Cir. 2007). See also **National Regulatory Services**, SEC Staff No-Action Letter (Dec 2, 1992) at n.3; *Robert S. Strevel*, SEC Staff Interpretive Letter (Apr. 19, 1985).

40 **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 2632**, supra note 37.) 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).

41 *Brent Neiser*, SEC Staff No-Action Letter (Dec. 15, 1985).
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.42

Hat-Switching. As noted above, the brokerage exception is applied separately to each account rather than client, limiting the extent the Adviser’s Act will apply to a broker-dealer’s traditional brokerage activities. 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 a full-service brokerage account with respect to which it would not be subject to a fiduciary obligation (as well as restrictions on principal trading)? The SEC staff issued one expressing the view that such “hat switching” could be effective to limit application of the Advisers Act, but only if the adviser fully disclosed the nature of the change in the relationship.43 The SEC later withdrew the letter without comment.44

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.45

Non-U.S. Broker-Dealers. One consequence of this implied registration requirement is that a non-U.S. broker-dealer lawfully operating in the U.S. as an unregistered broker-dealer could not provide investment advice incidental to its U.S. brokerage activities without registering as an adviser. The SEC has stated that its staff would look favorably on requests for no-action relief from an unregistered non-U.S. broker-dealer that otherwise qualifies for the broker-dealer exemption from the Advisers Act but is not registered as a broker-dealer in reliance on rule 15a-6 under the Exchange Act.46 The staff has issued such letters, but so far only where the non-U.S. broker-dealer

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42 Release 626 at section V, supra note 40. In 2007, the SEC proposed to codify this interpretation in a rule. See Interpretive Rule under the Advisers Act Affecting Broker-Dealers, supra note 40.

43 One administrative law judge opinion appears to agree. Lawrence M. Labin, 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.”).

44 See Release 2652, supra note 37 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.”

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

46 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.
advisory activities were limited to furnishing research reports to U.S. institutional
investors.47

Study on Fiduciary Obligations. Section 913 of the Dodd-Frank Act required the SEC
to conduct a study to evaluate the differences between the fiduciary obligations of
advisers under the Advisers Act and broker-dealers who also give advice but qualify for
this exclusion (and may not, therefore, have such obligations48), and authorized the
SEC to adopt rules to harmonize their application to retail investors.49 In January
2011 the SEC submitted to Congress a study by its staff recommending that the SEC
adopt a uniform fiduciary standard of conduct for broker-dealers and advisers “when
providing personal investment advice about securities to retail customers.”50 The SEC
has not yet proposed any rules under this provision.51

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);52 (ii) is “bona fide,” (contains disinterested
commentary and analysis rather than promotional material disseminated by someone
touting particular securities); and (iii) is of general and regular circulation (rather than
issued from time to time in response to episodic market activity).53

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.54 Similarly, the SEC has expanded the exemption to include not only

47 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).
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).
49 Section 211(g), as added by Section 913(g) of the Dodd-Frank Wall Street Reform and Consumer Protection Act,
50 Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and
Consumer Protection Act.
51 In 2013 the SEC issued a release requesting data on the costs and benefits on alternative approaches it could
consider in exercising the new authority provided by Congress. Duties of Brokers, Dealers, and Investment Advisers,
52 “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).
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).
54 See, e.g., Gilbert L. Delugach, SEC Staff No-Action Letter (Sept. 18, 1986).
publishers, but also columnists whose work appears in publications that qualify for the publishers exception.\footnote{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.}

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.\footnote{Section 202(a)(11)(E).} The scope of the exception includes 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. The SEC staff has stated that advice about repurchase agreements collateralized by U.S. government securities does not fall within the exception.\footnote{J.Y. Barry Arbitrage Mgmt., Inc., SEC Staff No-Action Letter (Oct. 18, 1989). See also Rauscher Pierce Refines, Inc., et al., Advisers Act Rel. No. 1863 (Apr. 6, 2000) (“Because Rauscher’s advice was not limited to Treasury securities or other government securities as described in section 202(a)(11)(E), that provision did not operate to exclude Rauscher from the definition of investment adviser.”)}

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.”\footnote{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\footnote{See infra Section III.B.3.b. of this outline for a discussion of “holding out.”} to the public as an investment adviser.\footnote{Rule 202(a)(11)(G)-1(b) (defining “family office” for purpose of section 202(a)(11)(G), which was added to the Act by the Dodd-Frank Act). 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.}

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.61

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.62

c. **Multi-Family Offices.** The rule is **not** available to a family office that serves multiple families.63 In this regard, the SEC staff has stated that if several unrelated families established separate family offices staffed with the same or substantially the same employees, such employees would be managing a de facto multifamily office, so that the family offices could not rely on the exclusion.64

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.65

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).66 The SEC does not accept “home state registration” of non-U.S. advisers in lieu of SEC registration.67

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61 Rule 202(a)(11)(G)-1(d)(4). 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. Rule 202(a)(11)(G)-1(d)(8).

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

63 Advisers Act Rel. No. 3220, supra note 62.


65 Section 202(b).

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

67 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.”
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. 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.

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. Such an adviser would not, for example, need 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.

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.

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

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

70 Uniao de Bancos de Brasileiros, S.A., SEC Staff No-Action Letter (July 28, 1992) (“Unibanco”; Mercury Asset Mgmt., SEC Staff No-Action Letter (Apr. 16, 1993); Kleinwort Benson Investment Mgmt. Ltd., SEC Staff No-Action Letter (Dec. 15, 1993); Murray Johnstone Holdings Ltd., SEC Staff No-Action Letter (Oct. 7, 1994). To facilitate SEC monitoring the activities of a non-U.S. adviser that may affect its U.S. clients, the letters impose certain conditions, including recordkeeping requirements, discussed infra at note 592. The SEC has adopted the staff approach. Advisers Act Rel. No. 3222, infra, note 108 at n.515.

71 Gim-Seong Seo, supra note 28; Double D. Mgmt., SEC Staff No-Action Letter (Dec. 30, 1982).

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

A firm that falls within the definition of “investment adviser” (and is not eligible for one of the exclusions discussed above) must register with the SEC, unless it (i) is prohibited from registering under the Act because it is a smaller firm regulated by one or more of the states, or (ii) qualifies for an exception from the Act’s registration requirement. All advisers, registered or not, are subject to the Act’s anti-fraud provisions.

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. Today, most small advisers and “mid-sized advisers” are subject to state regulation of advisers and are prohibited from registering with the SEC. Most large advisers (unless an exemption is available) must register with the SEC. State adviser laws are preempted for SEC-registered advisers.

Assets under Management. As discussed below, in many cases the registration obligations of an adviser will turn on the amount of its “assets under management.” This is a defined term, both under the Act and SEC rules (which now use the term “regulatory assets under management”); the method of calculation prescribed differs from the traditional methods advisers have used to calculate their assets under management.

1. Operation of Section 203A of the Advisers Act

   a. Small Advisers. Advisers with less than $25 million of assets under management must register with and be regulated by states in which they do business (in accordance with state law) unless the state in which the adviser has its principal

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73 Section 203(a).
75 National Securities Markets Improvements Act of 1996 (“NSMIA”), Pub. L. No. 104-290, 110 Stat. 3416 (1996); Dodd-Frank Act, supra note 49. Most of the provisions amending the Advisers Act to allocate regulatory responsibilities between the SEC and state governments have been codified in section 203A.
77 See Sections 203(a) (registration required).
78 203A(b) (preemption of state law).
79 See section 203A(1)(3) (“securities portfolios with respect to which an investment adviser provides continuous and regular supervisory or management services”) and rule 203A-(d) (defining the term “assets under management” for purpose of section 203A of the Act by reference to instructions to Form ADV) and Instruction 5(b) of Form ADV (defining the term “regulatory assets under management”).

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

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

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

d. Non-U.S. Advisers. Advisers whose principal offices and places of business are outside the United States are treated as “large advisers,” regardless of the amount of assets they have under management. Accordingly, a non-U.S. adviser giving

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

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

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

83 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”).

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

85 See Release 1633, supra note 80 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.
advice to U.S. persons must register with the SEC (and thus may avoid registration with state regulators), unless an exemption from registration is available (in which case it may be subject to state registration requirements).

2. Exceptions to Prohibition

Section 203A and SEC rules carve out several exceptions from the assets under management tests.

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

b. Advisers to Business Development Companies. Advisers with at least $25 million of assets under management that advise a company which has elected to be a business development company pursuant to section 54 of the Investment Company Act must register with the SEC.

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

d. Related Advisers. Advisers that control, are controlled by, or are under common control of an SEC-registered adviser must register with the SEC if they have the same principal office and place of business.

e. Newly-Formed Advisers. Advisers that are not registered, and have a reasonable expectation that they will be eligible for SEC registration within 120 days of registering, may register with the SEC.

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86 See supra Section II.B.9 of this outline for a discussion of who is a “U.S. person.”
87 See Section III.B.3 of this outline for discussion of exemption from registration for foreign private advisers.
88 Sections 203A(a)(1)(B) and 203A(a)(2)(A).
89 See Instructions for Item 2 of Part 1A of Form ADV.
90 See also Item 2.A.(6) of Part 1A of Form ADV.
91 Rule 203A-2(a). In May 2005, the SEC staff published a report detailing concerns with conflicts of pension fund consultants who help pension managers evaluate money managers. See Staff Report Concerning Staff Examinations of Certain Select Pension Fund Consultants. Subsequently, the SEC instituted an administrative proceeding against a pension consultant that breached its fiduciary obligations by failing to disclose conflicts of interest. Yanni Partners, Inc., Advisers Act Rel. No. 2642 (Sept. 4, 2007) (pension consultant held itself out to be “independent” of money managers sold subscriptions to database to money managers it was evaluating).
92 Rule 203A-2(b). The SEC considers an SEC-registered adviser to have the same principal office and place of business if the principal office of the related adviser is in the “proximate geographic area as the principal office of the registered adviser.” Release 1633, supra note 80 at n.65.
f. **Multi-State Advisers.** Advisers that would otherwise be obligated to register with 15 or more states may register with the SEC.  


Note that some of the 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.

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

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

a. comply with state anti-fraud prohibitions;

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

c. pay state licensing and renewal fees; and

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

4. **Federal Anti-Fraud Law Still Applicable to State-Registered Advisers.** The SEC continues to institute enforcement actions against state-registered advisers charging violations of section 206 of the Act.
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.98 State regulatory laws are pre-empted for advisers voluntarily registering with the SEC. Advisers relying on these exemptions (other than an adviser to a SBIC), may be required to register with one or more state securities regulator.

1. *Intrastate Advisers*

Available to an adviser: (i) all of whose clients are residents of the state in which the adviser maintains its principal office and place of business; and (ii) that does not give advice about securities traded on any national exchange.99 The Dodd-Frank Act made this exemption unavailable to an adviser that advises a private fund.100

2. *Advisers to Insurance Companies*

Available to an adviser whose only clients are insurance companies.101

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.102

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97 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.

98 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 53. 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.

99 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).*

100 Section 403(1).

101 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).*

102 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.
The exemption for foreign private advisers was added by the Dodd-Frank Act and replaces the private adviser exemption (i.e., an exemption for any adviser with fewer than 15 clients), which was repealed. In implementing the new exemption, the SEC incorporated many of the rules that implemented the old exemption.

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

b. **Counting Clients**

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

   (A) a natural person; and (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 that receives investment advice based on its investment objectives (rather than the individual investment objectives of its owners), and two or more of these entities that have identical owners.

   (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 may treat as a single investor any person who is an investor in two or more of the adviser’s private funds.

   **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

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103 Rule 202(a)(3)-1(c)(ii), which references rule 222-1(a).
104 Release 3222, infra note 108 at Section II.C,4.
105 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).
106 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, Delacey & Co., Inc., SEC Staff No-Action Letter (Apr. 27, 1987).
107 Rule 202(a)(30)-1, note to paragraph (c)(2).
the exemption. For example, holders of the securities of any feeder fund in a master-feeder arrangement may be deemed to be the investors of the master fund. 108

(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. 109

c. 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, 110 or hires a person to solicit clients on his behalf. 111

(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. 112

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


109 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).


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

112 Rule 202(a)(30)-1(d).
(B) Procedures. The adviser implements procedures reasonably designed to guard against directing information about its advisory services to U.S. persons (e.g., obtaining residency information before sending further information).113

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.114

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.115

This first exemption is of limited utility for many CTAs because, on its face, it requires the CTA’s business to not consist primarily acting as an investment adviser at all times.116

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.117

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 staff has expressed a view that it is not available to an adviser to a private fund whose business was and is predominantly the

113 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.


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

116 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).

117 Section 203(b)(6)(B) of the Advisers Act (added by Section 403(4) of the Dodd-Frank Act).
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). An adviser that has any other type of client is not eligible for the exemption.

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.

(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.

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.” On July 10, 2013, the SEC adopted amendments to Regulation D that permitted issuers including private funds, subject to certain conditions, to make general solicitations and advertise offerings qualifying under a new rule 506(c). Private funds relying on new rule 506(c) to make general solicitations will not lose either of the two exclusions from the Investment Company Act (because the fund might otherwise be deemed to have publicly offered its shares). Private funds are,

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118 See Investment Management Staff Issues of Interest.
119 Section 203(m)(1) of the Advisers Act (added by the Dodd-Frank Act). The SEC adopted rule 203(m)-1 on June 22, 2011 to implement the section. See Release 3222, supra note 108.
120 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), avail. at https://www.sec.gov/investment/im-guidance-2016-03.pdf. The provisions are self-executing and are available notwithstanding the provisions of rule 203(m)-1.
121 Two nominally separate but related advisers may be considered to be one adviser (and their assets aggregated) if they do not operate sufficiently independent of one another. See discussion infra note 149.
122 See Section 202(a)(29) of the Advisers Act.
123 The term “qualified purchaser” is defined in section 2(a)(51) of the Investment Company Act.
124 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.
125 Id. at 48. See SEC Adopts New Private Placement Rules Allowing Issuers to Engage in General Solicitations, Stroock Special Bulletin.
however, permitted by rule 506 to continue to make traditional private placements without a general solicitation, an approach taken by most private funds.

**Bad Boy Restrictions.** A private fund is disqualified from making an offering in reliance on section 506 of Regulation D if, among other persons, an investment adviser to a private fund issuer (or certain of its directors and officers) has engaged in certain “disqualifying conduct” during the past 10 years. 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.127

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.128

2. **Non-U.S. Advisers.** An adviser with a principal office and place of business outside the United States must (i) include only assets managed at a “place of business” in the U.S.,129 and (ii) may exclude consideration 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 non-U.S. clients are not); and130

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126 Rule 506(d) under the Securities Act of 1933 adopted in Securities Act Rel. No. 9414 (July 10, 2013). The rule does not apply retroactively to disqualifying conduct occurring before the effective date of the rule. Rule 506(e). The SEC was required to adopt these amendments by section 926 of the Dodd-Frank Act.


128 Rule 203(m)-1(b). The rule essentially reads the words “in the United States” language out of Section 203(m).

129 The SEC has stated that whether assets are managed “in the United States” is an “inherently factual determination,” but it does not consider providing research or conducting due diligence activities on potential investments to be managing assets of management decisions are made outside of the U.S. Release 3222, supra note 108 at 93. Back office services are also unlikely to be considered management activities.

130 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.”
management activities in the United States are limited to $150 million of private fund assets.\(^{131}\)

A non-U.S. adviser managing private funds from outside the United States thus can manage an unlimited amount of assets of private funds in which U.S. persons invest under the private fund adviser exemption as an exempt reporting adviser. The exemption is available regardless of where the private fund is organized or the amount of assets contributed by U.S. investors.

(3) **Calculating Private Fund Assets.** Generally, advisers must include the value of all private funds managed, including the value of any uncalled capital commitments.\(^{132}\) 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.\(^{133}\)

(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.\(^{134}\) 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 Light.* 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, and most of the substantive provisions of which would be inapplicable to the adviser with respect to non-U.S. clients (including investment funds) under the *Unibanco* line of SEC staff no-action letters.\(^{135}\) This alternative

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\(^{131}\) 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.

\(^{132}\) 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).

\(^{133}\) *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 108 at nn.364–365 and accompanying text. Consistent with this good faith requirement, the SEC expects that an adviser that calculates fair value in accordance with GAAP or another basis of accounting for financial reporting purposes will also use that same basis for purposes of determining the fair value of its regulatory assets under management. *Id.* at n.365.

\(^{134}\) 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.

\(^{135}\) *Unibanco*, *supra* note 70. 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).
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 Report.** An adviser relying on the private fund adviser exemption must file an initial and annual report on Form ADV to the SEC\(^\text{136}\) and is subject to examination. Other provisions of the Act and SEC rules applicable only to registered advisers do not apply.\(^\text{137}\) 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).\(^\text{138}\)

a. **Venture Capital Fund.** To qualify as a “venture capital fund,” a fund must be a “private fund”\(^\text{139}\) that:

1. represents to investors that the fund pursues a venture capital strategy;\(^\text{140}\)
2. does not provide investors with redemption rights;\(^\text{141}\)
3. holds no more than 20% of its assets in non-”qualifying investments” (excluding cash and certain short-term holdings); and

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

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\(^{136}\) 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.

\(^{137}\) 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.4 of this outline.

\(^{138}\) 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 108. Section 203(l) was amended in 2015 by Section 74001 of the FAST Act, supra note 120, to treat a SBIC as a “venture capital fund” for purpose of section 203(l). See IM Guidance Update No. 2016-03, supra note 120.

\(^{139}\) 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).

\(^{140}\) Rule 203(l)-1(a)(1).

\(^{141}\) Rule 203(l)-1(a)(4) (the rule permits exceptions in extraordinary circumstances).
(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). ¹⁴²

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.¹⁴³ Thus, all of an adviser’s clients, including non-U.S. clients, must be venture capital funds.¹⁴⁴

c. Annual Reporting. An adviser relying on the venture capital adviser exemption must annually file a report on Form ADV to the SEC,¹⁴⁵ and is subject to examination. Other provisions of the Act and SEC rules applicable only to registered advisers do not apply. 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.¹⁴⁶

IV. Who Must Register Under the Advisers Act?

A. The Advisory Firm

Although many individuals who are employed by advisers fall within the definition of “investment adviser,” the SEC generally does not require those individuals to register separately as advisers with the SEC. The adviser’s registration covers its employees and other persons under its control and supervision (e.g., officers, independent contractors), provided that their advisory activities are undertaken on the adviser’s behalf.¹⁴⁷

¹⁴² 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.

¹⁴³ Release 3222, supra note 108.

¹⁴⁴ 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 108.

¹⁴⁵ Rule 204-2.

¹⁴⁶ 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 120.

¹⁴⁷ 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).
B. Affiliates

1. Integration. 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. For example:

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

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

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

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 staff letters. The conditions include:

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

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

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148 Section 208(d) of the Act. The determination of whether an advisory business of two separately formed affiliates may be required to be integrated is based on the facts and circumstances. Release 3222, supra note 108. See Richard Ellis, SEC Staff No-Action Letter (Aug. 18, 1981); Kenneth Leventhal & Co., SEC Staff No-Action Letter (Feb. 7, 1983). See also Price Waterhouse, SEC Staff No-Action Letter (July 16, 1987).

149 Release 3222, supra note 108, at Section II.D. See TL Ventures, Advisers Act Rel. No. 3859 (June 20, 2014) (settled enforcement action alleging two exempt reporting advisers under common control were “operationally integrated” and thus were not eligible to rely on exemptions. The advisers shared employees, had significantly overlapping operations, cross-marketed services, and failed to have any policies and procedures designed to keep the entities separate).

150 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).

151 See Unibanco, supra note 70; 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 must be deemed “associated persons”\(^{152}\) of the registered affiliate; and

d. the SEC must have adequate access to trading and other records of the unregistered adviser and to its personnel to the extent necessary to enable the SEC to monitor and police conduct that may harm U.S. clients or markets.\(^{153}\)

Participating affiliate arrangements (and hence conditions) are designed to permit a registered adviser with its own client relationships to draw upon advisory resources of its unregistered non-U.S. affiliates, which may including sharing personnel. In many respect, the non-US. personnel are treated as if they constituted an office of the registered adviser. The SEC has affirmed the staff no-action positions.\(^ {154}\)

3. **Joint Registration of Affiliates**

   a. **Special Purpose Vehicles.** The SEC staff takes the position that a special purpose vehicle ("SPV") set up by a registered investment adviser to serve as the general partner of a pooled investment vehicle (e.g., a hedge fund) does not have to separately register as an investment adviser if all of the activities of the SPV are subject to the registered adviser’s supervision and control, its employees are treated as “supervised persons” of the registered adviser and reported as such on its Form ADV, and the SPV is subject to examination by the SEC.\(^ {155}\) The SEC staff takes the view that this analysis is not limited to a registered adviser with a single SPV.\(^ {156}\)

   b. **Multiple Entities in Control Relationships.** The SEC staff has taken the position that an investment adviser may file (or amend) a single Form ADV on behalf of itself and each other adviser that is under common control with the filing adviser where the “filing adviser” and each “relying adviser” collectively conduct a “single advisory business.”\(^ {157}\)

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\(^{152}\) See Section V.A.1 of this outline for the definition of “person associated with an investment adviser.” As a result, the associated persons of the non-U.S. adviser would be subject to the registered adviser’s code of ethics, including the provisions requiring reporting of personal securities transactions.

\(^{153}\) See *id.* The adviser must undertake to have records requested by the staff translated into English.

\(^{154}\) *Release 3222, supra* note 108, at Section II.D.


\(^{156}\) *American Bar Association Subcommittee on Hedge Funds, SEC Staff Letter (Jan. 18, 2012)* (“ABA Letter 2012”) Question 2. Similarly, under certain circumstances, the staff has indicated that an exempt reporting adviser to which a private fund’s day-to-day management responsibility has been delegated may satisfy the Form ADV reporting obligations of one or more special purpose entities. See *FAQs regarding Reporting to the SEC as an Exempt Reporting Adviser* (“ERA FAQs”).

\(^{157}\) See *id.* Question 4 (outlining the circumstances under which a filing adviser and one or more relying advisers would, in the staff’s view, collectively conduct a single advisory business absent other factors suggesting that they conduct different businesses). Likewise, under certain circumstances, the Staff has indicated that an exempt reporting adviser may satisfy the Form ADV reporting obligations of one or more special purpose entities under its control. See *ERA FAQs.*
Non-U.S. Relying Advisers. One of the conditions of the letter is that all of the substantive provisions of the Advisers Act will apply to each of the relying advisers dealings with all of its client’s including non-U.S. clients. As a consequence non-U.S. advisers registering jointly with a U.S. advisers cannot take advantage of the Unibanco letter and its progeny under which the SEC has not sought to 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.158

A relying adviser is a registered adviser and must comply with the Act and rules as if it had filed a separate Form ADV.

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

A. Procedure

Applicants for registration under the Act must file Form ADV with the SEC.159 Within 45 days the SEC must grant registration or institute an administrative proceeding to determine whether registration should be denied.160

1. Denial of Registration. The SEC may deny registration if the adviser is subject to a “Statutory Disqualification,” that is, if the adviser or any “person associated with the adviser” makes false or misleading statements in its registration application, has within the past 10 years been convicted of a felony, or if it has been convicted by a court or found by the SEC to have violated a securities-related statute or rule, or have been the subject of a securities-related injunction, or similar legal action.161

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.162 The SEC can deny registration if, for example, the parent company of an adviser has been convicted of securities fraud even if the adviser and its employees have not.

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158 See, supra Section II.B.9 of this outline.
159 Form ADV can be found here.
160 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.
161 Sections 203(c)(2) and (e).
162 Section 202(a)(17). For this purpose, a person associated with an adviser does not include a person under common control with the adviser, i.e., a sister company. In this respect the SEC’s authority to deny registration to an adviser is narrower than its authority regarding broker dealers. Compare Section 3(a)(18) of the Exchange Act (defining the term “person associated with a broker or dealer”). Form ADV and some SEC rules use the term “related person,” which includes persons who are under common control with the adviser. See, e.g., rule 206(4)-2(d)(7).
Non-U.S. Based Offenses. Statutory Disqualifications include convictions in non-U.S. courts, and by findings of violations by “foreign financial regulatory authorities” enforcing non-U.S. laws.\textsuperscript{163}

2. Qualifications. There are no “fit and proper,” educational or experience requirements for SEC registration as an investment adviser, although certain employees of the adviser may have to pass securities examinations in the states in which they have a principal place of business. Instead, advisers must disclose to clients the background and qualifications of certain of their personnel.\textsuperscript{164}

B. Form ADV

Form ADV sets forth the information that the SEC requires advisers to provide in an application for registration. Once registered, an adviser must update the form at least once a year, and more frequently if required by instructions to the form.\textsuperscript{165} Form ADV consists of two parts.\textsuperscript{166}

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

On June 22, 2011, the SEC amended Part 1A to expand the information collected, primarily from advisers to hedge funds and other private funds in order to improve the SEC’s ability to oversee registered advisers.\textsuperscript{167} Amended Part 1A requires advisers to provide additional information about three areas of their operations: (i) additional information about private funds they advise; (ii) expanded data provided by advisers about their advisory business (including the types of clients they have, their employees, and their advisory activities), as well as about their business practices that may present significant conflicts of interest; (iii) additional information about advisers’ non-advisory activities and their financial industry affiliations.

\textsuperscript{163} 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).

\textsuperscript{164} Form ADV, Item 2 of Part 2B.

\textsuperscript{165} Rule 204-1(a).

\textsuperscript{166} Both Part 1 and Part 2A of the Form ADV are filed by registered advisers through the IARD system and are available to the public through the SEC’s Investment Adviser Public Disclosure Website.

\textsuperscript{167} Release 3221, supra note 83.
2. **Part 2.** Part 2 is divided into Part 2A and Part 2B and sets forth information required in client brochures and brochure supplements.  

Brochure Part 2A requires an adviser to prepare a narrative “brochure” that includes plain English disclosures of, among other things, the adviser’s business practices, investment strategies, fees, conflicts of interest, and disciplinary information. Part 2B requires an adviser to prepare a “brochure supplement” that contains information about each advisory employee that provides investment advice to its clients, including her educational background, business experience, other business activities, and disciplinary history. To satisfy the “brochure rule” (discussed below), the 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. In addition, the adviser must file its brochure, but not its brochure supplement, with the SEC to satisfy its registration requirements.

**C. Electronic Filing**

All applications for registration as an adviser with the SEC must be submitted electronically through an Internet-based filing system called the Investment Adviser Registration Depository (“IARD”). The IARD is operated by the Financial Industry Regulatory Authority (“FINRA”), the broker-dealer self-regulator.

**D. Public Availability**

All current information from advisers’ Form ADVs filed with the SEC is publicly available through an SEC website: [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov).

**E. Withdrawal of Registration**

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

F. Successor Registrations

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.

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.

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

A. Fiduciary Duties to Clients

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

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176 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).

177 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). 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. Id. Item 4 of Form ADV asks whether the filing relates to a succession.

monetary loss. 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.

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.”

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. It is made enforceable by section 206 of the Act, which contains the Act’s anti-fraud provisions, and incorporated indirectly into the Act in various provisions and disclosure requirements discussed below.

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.”

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182 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).*

183 *Transamerica Mortg. Advisors v. Lewis*, supra note 74 (“[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).

184 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.”)

185 *Proxy Voting by Investment Advisers, Adv. Act Rel. No. 2106 (Jan. 31, 2003); Release 1092, supra 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)
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.\(^{186}\) 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.\(^{187}\)

   **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.’”\(^{188}\)

   Accordingly, an adviser must disclose all material facts regarding the conflict so that the client can make an informed decision whether to enter into or continue an advisory relationship with the adviser, or take some action to protect himself or herself against the conflict.\(^{189}\) A sincere belief that the adviser with a conflict is acting solely in the interest of the client is insufficient to excuse full disclosure.\(^{190}\)

   **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.\(^{191}\)

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\(^{186}\) See *Advisers Act Rel. No. 3222* at n. 369 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)).


\(^{188}\) See *Feesley & Wilcox Asset Mgmt. Corp. v. Advisers Act Rel. No. 2143* (July 10, 2003) (“In practical terms, when clients receive a recommendation from their investment adviser, that recommendation must be coupled with disclosure regarding any financial interest the adviser. . . It is the client, not the adviser, who is entitled to make the determination whether to waive the adviser’s conflict.”).


\(^{190}\) See *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.”).

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

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

b. commitments to clients; 192 and

c. certain disciplinary events of the adviser (and certain of its officers) occurring within the past 10 years, which are presumptively material. 193

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. 194

What is “suitable” for an institutional investor is often set forth in the advisory contract, limited partnership agreement (or is otherwise disclosed to clients) as an investment objective, strategy, or restriction, the failure of the adviser to follow will be treated by the SEC as a violation of the anti-fraud provisions (and thus identical to a suitability violation). 195 In some cases, the SEC has looked to relevant laws governing investments by the client to determine the suitability of an investment. 196

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192 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.

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

194 See Suitability of Investment Advice Provided by Investment Advisers, Advisers Act Rel. No. 1406 (Mar. 16, 1994). 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 recommended risky investment for customer’s individual retirement account, despite customer’s conservative investment objective and age).


3. **Reasonable Basis for Recommendations.** An adviser’s fiduciary duty includes a duty of care to clients, which requires that an adviser have a reasonable, independent basis for its recommendations.\(^{197}\)

4. **Best Execution.** Where an adviser has responsibility to direct client brokerage, it has an obligation to seek best execution of clients’ securities transactions.\(^{198}\) 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.\(^{199}\) In assessing whether this standard is met, an adviser should consider the full range and quality of a broker’s services when placing brokerage, including, among other things, execution capability, commission rate, financial responsibility, responsiveness to the adviser, and the value of any research provided. “The determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the [client].”\(^{200}\)

   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.\(^{201}\)

   b. **Mutual Funds.** The SEC has brought a recent enforcement action against an adviser for failure to obtain best execution where an adviser has selected higher cost classes of shares for clients, paying avoidable sales charges.\(^{202}\)

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\(^{199}\) 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).


\(^{202}\) Manarin Investment Counsel, Ltd., et al., Advisers Act Rel. No. 3686 (Oct. 2, 2013); Pekin Singer Stauss Asset Mgmt., Inc., Advisers Act Rel. No. 4126 (June 21, 2015). In a recent settlement, the SEC referred to the same practice as failing to disclose a conflict of interest. Royal Alliance Associates, Inc. Advisers Act Rel. No. 4351 (Mar
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. When the adviser receives some benefit from the direction of the trade, additional disclosure may be required.

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

**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. However, use of an affiliate involves a conflict of interest that must be disclosed to clients. For example, use of an affiliated broker may give the adviser incentive to “churn” the account or to fail to obtain best execution, and may result in

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14, 2016), FINRA has fined member broker-dealers for similar conduct for violation of its “suitability” rule. See News Release, Dec. 19, 2005.

203 Item 12.A.3.a. of Part 2 of Form ADV (If 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.)

204 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 200. 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.).

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

206 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).

207 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.).

208 Folger Nolan Fleming Douglas Capital Mgmt., Inc., Advisers Act Rel. No. 2639 (Aug. 23, 2007) (adviser entered into agreements with clients to direct trades to affiliated broker without disclosing commission rates were twice as high as non-directed trades). See also Advisers Act Rel. 1092, supra note 5 (if an investment adviser recommends that a client effect transactions through its broker-dealer employer, the anti-fraud provisions of the Advisers Act require that the adviser make full disclosure of the nature and extent of all adverse interests, including the amount of any compensation the advisers will receive from its broker-dealer employer in connection such transactions); Don P. Matheson, SEC Staff No-Action Letter (Aug. 2, 1976) (investment advisers that are also broker-dealers or registered representatives have a duty to inform their investment advisory clients of their ability to seek executions of transactions recommended through other broker-dealers firms).
violations of the adviser’s fiduciary responsibilities to its clients unless it implements effective policies and procedures.209

**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.210

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

Section 28(e) of the Exchange Act 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.211

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.212 Accordingly, if properly disclosed to clients, an adviser may use client brokerage for purposes other than those permitted by section 28(e).213 Soft dollars arrangements present adviser with a conflicts that arise from an adviser’s receipt of some benefit (e.g., research that it

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209 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).


212 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.8.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).

213 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.
would otherwise have to purchase with its own resources or produce itself) in exchange for directing brokerage for a client.\textsuperscript{214}

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

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

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

(3) Where a product or service has uses both inside and outside the safe harbor, the SEC believes that an adviser should make a reasonable allocation of the 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.\textsuperscript{215}

b. \textit{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.\textsuperscript{216}

\textsuperscript{214} 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)).


\textsuperscript{216} Id.
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,\(^{217}\) and certain riskless principal transactions.\(^{218}\)

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

*Soft Dollar Credits.* In a typical soft dollar arrangement, the broker will keep track of the amount of trading by issuing “soft dollar credits” that the adviser (or a client) can use to acquire research or other goods or services in what amounts to a barter arrangement. While the SEC has stated that soft dollar credits are assets of the client rather than the adviser,\(^{219}\) it is not clear which client owns 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.\(^{220}\) 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.\(^{221}\) Part 2 of Form ADV specifies the types of disclosures the SEC expects advisers to make regarding soft dollar arrangements.\(^{222}\)

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\(^{217}\) See *Carolina Capital Markets Inc., SEC Staff No-Action Letter (July 30, 2013).*

\(^{218}\) *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).*


\(^{220}\) 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).*

\(^{221}\) 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 benefits received 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).

\(^{222}\) Item 12 (Brokerage Practices).

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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.\(^\text{223}\)

B. Substantive Requirements (Advisers Act)

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

1. **Client Transactions**

   a. **Principal Transactions.** Section 206(3) of the Act prohibits an adviser (regardless of whether registered under the Act), acting as principal for its own account, from knowingly selling any security to or purchasing any security from a client for its own account, without disclosing to the client in writing the capacity in which it (or an affiliate) is acting and obtaining the client’s consent before the “completion of the transaction.”\(^\text{224}\) 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.\(^\text{225}\)

   **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

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\(^{223}\) *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.5 of this outline.

\(^{224}\) 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).

\(^{225}\) *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).
require that the adviser disclose additional facts necessary to alert the client to the adviser’s potential conflict of interest in the principal trade.\textsuperscript{226}

**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.\textsuperscript{227}

**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.\textsuperscript{228} The SEC staff, however, believes that section 206(3) does not apply to a transaction between a client account and a pooled investment vehicle of which the investment adviser and/or its controlling persons, in the aggregate, own 25\% or less.\textsuperscript{229}

Under the Goldstein decision,\textsuperscript{230} 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.\textsuperscript{231}

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\textsuperscript{226} Release 1732, supra note 224. See also Rocky Mountain Financial Planning, Inc., SEC Staff No-Action Letter (Feb. 24, 1983) ("While section 206(3) of the Advisers Act of 1940 requires disclosure of such interest and the client’s consent to enter into the transaction with knowledge of such interest, the adviser's fiduciary duties are not discharged merely by such disclosure and consent. The adviser must have a reasonable belief that the entry of the client into the transaction is in the client’s interest."). See also Advisers Act Rel. No. 40, supra, note 225 ("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).


\textsuperscript{228} ABA Letter 2005, supra note 155 at II.A.1. 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).

\textsuperscript{229} 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.

\textsuperscript{230} Goldstein v. SEC, supra note 135.

\textsuperscript{231} The SEC suggested that it would regard such consents as ineffective in a 2014 enforcement actions against an adviser involving loans the adviser made to a private fund it advised. Clean Energy Capital, LLC, Advisers Act Rel. No. 3785 (Feb. 25, 2014) (the adviser “as an adverse party with a conflict of interest, could not consent to the loans on behalf of the [private] funds.”). See also Blackstone Management Partners, Advisers Act Rel. No. 4219 (Oct. 7, 2015) (because of conflict of interest as a recipient of fees paid by private equity funds, the adviser "could not effectively consent to either of these practices on behalf of the fund it advised.").
In such circumstances, some advisers seek the consent of fund investors or a committee of independent investors established for such purposes. 232

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. 233

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

Impersonal Advice. Advisers that are registered broker-dealers (or are affiliated with registered broker-dealers) are exempt from the principal trading restrictions of section 203 with respect to trades in which the investment adviser has provided only “impersonal advice.” 234 These types of transaction would include, for example, those placed by a client in response to recommendations made by the adviser in a newsletter.

Rule 206(3)-3T. The SEC has adopted a temporary rule that permits 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. 235 The SEC staff has announced that the rule will be permitted to expire on December 16, 2016, and advisers requiring continued relief must seek an exemptive order from Commission. 236

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

233 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.”

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


Rule 206(3)-3T permits an adviser, with respect to a non-discretionary advisory account, to comply with section 206(3) of the Act by, among other things:

1. providing written prospective disclosure regarding the conflicts arising from principal trades;
2. obtaining written, revocable consent from the client prospectively authorizing the adviser to enter into principal transactions;
3. making certain disclosures either orally or in writing and obtaining the client’s consent before each principal transaction;
4. sending to the client confirmation statements disclosing the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorized the transaction; and
5. delivering to the client an annual report itemizing the principal transactions.

With certain limited exceptions, the rule generally is not available for principal trades of securities issued or underwritten by the investment adviser or a control person of the adviser.237

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.238

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.”239

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

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237 The rule also requires that each account for which the adviser relies on the rule be a brokerage account subject to the Exchange Act, and the rules thereunder, and the rules of the self-regulatory organization(s) of which it is a member.

238 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 224.

239 Rule 206(3)-1, supra, note 234.
(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) the disclosure document and each confirmation conspicuously disclose that consent may be revoked at any time.240

c. Cross-Trades. Effecting cross-trades between clients (with a third-party broker-dealer) is not specifically addressed by the Act or SEC rules, but implicates the anti-fraud provisions of the Act.241 All cross-trades involve potential conflicts of interest because the adviser could favor one client over another.242

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.”243

d. Aggregation of Client Orders. In directing orders for the purchase or sale of securities, an adviser may aggregate those orders on behalf of two or more of its accounts, so long as the aggregation is done for the purpose of achieving best execution, and no client is systematically advantaged or disadvantaged by the aggregation.244

Advisers that aggregate orders of securities face conflicts when they allocate the orders to client accounts since, for example, not all securities may have been

240 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).

241 See Renberg Capital Mgmt., Inc., supra note 199. 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).

242 “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).


244 Pretzel & Stouffer, SEC Staff No-Action Letter (Dec. 1, 1995).
acquired at the same price. Advisers should have procedures in place that are designed to ensure that the trades are allocated in such a manner that all clients are treated fairly and equitably, or at least fully disclosed.\textsuperscript{245} For example, advisers can allocate orders based on a \textit{pro rata}, rotational, or random basis.

\textit{Failure to Aggregate.} Advisers are not \textit{required} to aggregate trades. But if failure to aggregate would disadvantage clients, the adviser may be required to explain the consequences of not aggregating.\textsuperscript{246}

e. \textit{Allocation of Client Trades.} Allocation of trades for the benefit of favored clients or personal accounts is a breach of the Adviser’s fiduciary obligations to its client.\textsuperscript{247} 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.\textsuperscript{248}

(1) \textit{Cherry Picking.} This practice occurs most often when an adviser trades through an omnibus brokerage account and delays allocation of the trades until it can determine the “winners” and “losers” and then allocates the winners to favored accounts or proprietary (house) accounts.\textsuperscript{249}

(2) \textit{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 (\textit{e.g.}, \textit{pro rata}) among clients that are legally and


\textsuperscript{246} \textit{Pretzel \& Stouffer, supra note 244.}


\textsuperscript{248} \textit{Release 2204, infra note 358 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).}

\textsuperscript{249} \textit{See SEC v. Slocum, Gordon & Co., 334 F. Supp2d 144, (D. R.I. 2004) (“Cherry picking... is a practice by which an investment adviser purchases a security, waits to evaluate its performance, and then allocates it to himself or his firm rather than clients if it “pops,” or goes up quickly within a short period of time.”). The SEC enforcement actions involving cherry picking often also allege that the adviser made false and misleading statements to clients regarding it allocation practices. See TPG Advisors, Advisers Act Rel. No. 4372 (Apr. 19, 2016).}
financially in a position to buy them or in accordance with disclosure made to clients.\footnote{250}

**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.\footnote{251}

**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.\footnote{252} 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.\footnote{253}

f. **Trade Errors.** The SEC staff has interpreted an adviser’s fiduciary duties to require it to bear losses that are incurred when the adviser makes an error while placing a trade for a client.\footnote{254} Similarly, an adviser will not be entitled to keep any gains arising from errors or use the gains to offset losses the adviser caused.

Advisers are not liable for every error in judgment they make when advising clients, but rather for client losses that result from a negligent breach of their fiduciary duties, here the duty of care. Misreading of trade directions by a trading desk will typically be viewed by the SEC as involving negligence, but the issues become murkier when the error involves misjudgments or simply poor advice.\footnote{255}

Many advisers establish trade error policies that define a trade error and establish

\footnote{250} 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).

\footnote{251} SMC Capital, Inc., SEC Staff No-Action Letter (Sept. 5, 1995).

\footnote{252} 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).

\footnote{253} See complaint in SEC v. Charles J. Dushek, Case No. 13-cv-3669.

\footnote{254} 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”).

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

2. Advertising

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

a. Specific Restrictions

(1) Testimonials. An advertisement may not use or refer to testimonials, which the SEC staff views as including any “statement of a client’s experience with, or endorsement of, an adviser.” 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.” 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.

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

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

257 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.”).

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

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

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

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

262 *Stalker Advisory Services, SEC Staff No-Action Letter (Jan. 18, 1994).* See also *Patricia Owen-Michel, Advisers Act Rel., No. 1584 (Sept. 27, 1996)* (settled administrative proceeding alleging that adviser distributed reprint of newspaper article quoting a client’s testimonial). If the reprint contains false or misleading information, its distribution by the adviser would be prohibited by the general anti-fraud provision of the rule.
investment adviser, but the SEC staff has permitted their use if certain conditions are met that suggest their compilation and presentation are unbiased.\(^{263}\)

**Client Lists.** The SEC staff does not view either a complete or partial list of clients lists as being testimonials, as long as there is no accompanying client commentary.\(^{264}\)

**Social Media.** The SEC staff has generally stated that public commentary (include those of clients) on an independent web site (e.g., the adviser’s Facebook page) would not raise issues when that adviser has no ability to affect the commentary and the web site publishes all comments unedited.\(^{265}\)

(2) **Past Specific Recommendations.** An advertisement may not refer to past specific recommendations made by the adviser, unless the advertisement sets out a list of all recommendations made by the adviser during the preceding year.\(^{266}\) The primary concern underlying the prohibition is that an adviser could “cherry pick” its profitable recommendations and omit the unprofitable ones.\(^{267}\)

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.\(^{268}\)

**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


\(^{264}\) Denver Investment Advisors, Inc., SEC Staff No-Action Letter (July 30, 1993) (full list); Cambiar Investors, Inc., supra note 260 (partial list).

\(^{265}\) 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.

\(^{266}\) Rule 206(4)-1(a)(2). In addition, the rule requires the advertisement to include (i) the name of each recommendation, (ii) the date and nature of each recommendation, (iii) the market price at the time of the recommendation, (iv) the price of the security when the recommendation was acted upon, (v) the market price at the most recent practicable date, and (vi) a disclaimer regarding the profitability of recommendations in the future. For a recent SEC enforcement action alleging a violation of this provision, see Navigator Money Mgmt., Inc., Advisers Act Rel. No. 3767 (Jan. 30, 2014).


\(^{268}\) Investment Counsel Ass’n. of America, SEC Staff No-Action Letter (Mar. 1, 2004).
recommendations would not be an advertisement, and thus not subject to the prohibition.\(^{269}\)

**Objective Non-Performance-Based Criteria.** An adviser may, for example, use criteria, such as largest positions held, largest positions sold during the period without disclosing all of the securities recommended during the period.\(^{270}\)

**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.\(^{271}\)

(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,\(^{272}\) and

(4) **Free Stuff.** An advertisement cannot refer to any report, analysis, or service as free, unless it really is.\(^{273}\)

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.\(^{274}\) Common SEC enforcement actions against advisers for false and misleading advertisements include overstating performance of client accounts (discussed below), inflating number of clients or amount of assets under management,\(^{275}\) and exaggerating qualifications or achievements of principals.\(^{276}\)

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269 Id.
271 The TCIW Group, Inc. SEC Staff No-Action Letter (Nov. 7, 2008).
272 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).
274 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).
c. **Performance Advertising**

The SEC staff considers an advertisement containing performance information misleading if it implies, or if a reader would infer from it, something about an adviser’s competence or possible future investment results that would be unwarranted if the reader knew all of the facts.\(^{277}\) SEC rules do not require advisers to calculate or present the performance of client accounts in any particular way.\(^{278}\) Performance data in advertisements is evaluated based on whether it is false or misleading. The adequacy of disclosure accompanying performance data thus, is critical. Some basic rules have been established:

**Actual Performance of Accounts**

1. **Net of Expenses.** Performance must be net of expenses, including advisory fees, brokerage and any other fee the client would have paid or actually paid.\(^{279}\) However, advisers may present performance results reflecting both gross and net of fees, if presented with equal prominence.\(^{280}\)

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.\(^{281}\)

3. **Market Conditions.** Advertisements should disclose the effect of any material market conditions on a prospective client’s understanding of the performance portrayed, e.g., an advertisement stating the client accounts appreciated by 25%...

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\(^{278}\) If the adviser’s performance claims relies on data or information provided by third parties, the SEC has asserted that the adviser must have a reasonable basis for knowing that such information is accurate. See *Cantella & Co.*, Advisers Act Rel. No. 4338 (Feb. 23, 2016) (adviser advertised performance of investment strategy relying on inflated performance of other adviser’s investment signals).

\(^{279}\) *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., *Shield Mgmt. Co.*, Advisers Act Rel. No. 1872 (May 31, 2000).

\(^{280}\) *Ass’n for Investment Mgmt. Research*, SEC Staff No-Action Letter (Dec. 18, 1996). In addition, the SEC staff has accepted use of a “model fee” deduction equal to the highest fee charged to any account during the performance period. *J.P. Morgan Investment Mgmt., Inc.*, SEC Staff No-Action Letter (May 7, 1996). The basis for the letter is that advertisement of lower performance than actually attained is not misleading.

during the time period would be misleading if it did not also disclose that markets generally appreciated by 40% during the same period.\textsuperscript{282}

(4) \textit{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).\textsuperscript{283}

(5) \textit{GIPS Standards.} The Global Investment Performance Standards are voluntary standards and principals published by the CFA Institute.\textsuperscript{284} False claims of compliance with GIPS standards violate the advertising rule regardless of whether the performance data is otherwise accurate.\textsuperscript{285}

\textbf{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.\textsuperscript{286}

\textbf{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. The SEC staff has not expressed the view that back-tested performance is per-se misleading, but neither has it provided any guidance that could shape how advisers might develop and advertise back-tested performance. Instead, the SEC has brought a number of enforcement actions against advisers, ranging from

\textsuperscript{282} \textit{Clover Capital Mgmt.,} supra note 279.

\textsuperscript{283} \textit{Nevis Capital Mgmt., LLC,} Advisers Act Rel. No. 2214 (Feb. 9, 2004); \textit{Van Kampen Investment Advisory Corp,} Advisers Act Rel. No. 1819 (Sept. 8, 1999); \textit{The Dreyfus Corp.,} Advisers Act Rel. No. 1870 (May 10, 2000).

\textsuperscript{284} See Global Investment Performance Standards Handbook (3rd Ed. 2010).


failure to disclose performance was actually back-tested performance\textsuperscript{287} to failure to disclose the limitations inherent in or aspects of back-tested performance.\textsuperscript{288}

\textit{Raymond J. Lucia Company, Ltd. v. SEC}. A recent federal appeals court upheld an SEC opinion that an adviser has violated Section 206 when, among other things, it failed to apply its own strategy and assumptions when back-testing performance, was unable to replicated the back-tested reports, and could not document support for its results.\textsuperscript{289} The opinion 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. \textit{Portability of Performance}

Advisers, often new advisers without a track record, sometimes wish to market as their own, the performance of accounts managed by (i) a predecessor adviser or (ii) individuals managing accounts 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

5. The advertisement includes all relevant disclosures, including that performance results were from accounts managed by another entity.\textsuperscript{290}


\textsuperscript{289} \textit{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 where the administrative law judge found that a live slideshow presentation was not an “advertisement,” a conclusion with which the SEC disagreed. \textit{Raymond J. Lucia Companies, Inc.}, Advisers Act Rel. No. 4190 (Sept. 3, 2015).

\textsuperscript{290} \textit{Horizon Asset Mgmt. LLC}, SEC Staff No-Action Letter (Sept. 13, 1996).
An adviser that uses its predecessor’s performance must have access to records substantiating the performance (discussed below).291

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.”292 The practical effect of the rule is to preclude an adviser from advertising performance data it cannot substantiate.293

(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.294

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

(3) Third Party Records. The rule anticipates that the adviser’s own records would be used to substantiate performance, but the SEC has acknowledged that the retention of third party records could also satisfy the rule.295

f. Definition of Advertisement

While no communications to clients may be misleading, the specific restrictions discussed above apply only to “advertisements” by advisers. The SEC defines advertisements generally as communications (in writing or electronic form) to more than one person that offer advisory services.296 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.297 Whether a communications

291 Great Lakes Advisors, Inc., SEC Staff No-Action Letter (Apr. 3, 1992) at n.3.
292 Rule 204-2(a)(16).
293 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 assertions (or its expert’s) of actual performance. Id. at n.20
295 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).
296 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. . . .”)
297 Spear & Staff, 42 SEC. 549 (1965) (SEC Opinion).
constitutes an advertisement depends on all facts and circumstances, and has been very broadly applied.

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

*Reports to Clients.* Generally, an advertisement includes both a communication offering advisory services to new clients and one designed to maintain existing clients. 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.

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

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

*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. The SEC staff has not yet addressed private funds, but it may be presumed that the Act’s advertising rule applies to their solicitation material, an issue that has more significance with the SEC’s implementation of the JOBS Act provisions permitting general solicitation.

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298 *Investment Counsel Ass’n. of America*, SEC Staff Letter (Mar. 1, 2004).
300 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).
303 Id.
304 See Section III.B.6.a(2) of this outline. See also, *Comment Letter of the Managed Funds Association* (Mar. 22, 2013) (“[S]olicitation and advertising materials used by all private fund managers are subject to numerous anti-fraud provisions in the federal securities laws, including Section 206 of the Advisers Act, Rule 206(4)-1 and Rule 206(4)-8 under the Advisers Act . . .”) (emphasis added). Private fund sales material is often used to solicit separate account clients of the sponsor of the private fund and thus in many cases the extension of the staff Munder letter to private funds may be of limited use.
**Custody of Client Assets**

A registered adviser with custody of client funds or securities ("client assets") is required by rule 206(4)-2 to take a number of steps designed to safeguard those client assets. These requirements were most recently amended in December 2009.

**g. 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).

**h. 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. An adviser may not comingle its clients’ funds or securities with its own.

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305 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).

306 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.


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

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

i. _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.

j. _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. 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.

k. _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. If the accountant finds a “material
discrepancy” during the examination, it must report the discrepancy to the SEC within one business day.\footnote{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).}

**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.\footnote{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.}

**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.\footnote{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.}

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

   (1) **Audit Approach.** If the pool’s financial statements are audited by an independent public accountant that is registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (“PCAOB”),\footnote{The audited financial statements must be prepared according to, or reconciled to, U.S. GAAP.} and the audited statements are distributed to the pool’s investors: \footnote{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 306 at n. 45.}

   (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.320

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

(A) Must obtain a surprise examination for the pooled investment vehicle; 321

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

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

*Non-U.S. Advisers to Pooled Investment Vehicles.* An adviser whose principal office and place of business is located outside the United States is not subject to the custody rule with respect to the fund regardless of whether its investors are U.S. persons if (i) the fund is also organized in a place outside the United States,322 (ii) the adviser is an exempt reporting adviser, or (ii) the adviser is a foreign private adviser.323

m. **Adviser or “Related Person” as Custodian.**324 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;325 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.\(^{326}\)

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.\(^{327}\)

3. Use of Solicitors

An adviser registered under the Act is generally is 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.

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.\(^{328}\)

This is one of several “bad boy” provisions in the federal securities laws that most frequently is implicated in connection with the settlement of an 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.\(^{329}\)

\(^{326}\) Rule 206(4)-2(a)(6).

\(^{327}\) Exchange Act Rel. No. 34-70072 (July 29, 2013) at 120.

\(^{328}\) See supra note 163 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).
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.330

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.331

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.332

4. **Pay to Play (Political Contributions)**

On July 1, 2010, the SEC adopted rule 206(4)-5 to address so-called “pay to play” practices in which investment advisers make campaign contributions to elected officials of state or municipal governments in order to influence the award of contracts to manage public pension plan assets and other government investment accounts.333 The rule applies to SEC-registered investment advisers, certain exempt reporting advisers, and foreign private advisers, who provide investment advisory services, or are seeking to provide investment advisory services, to state and municipal government entities.334

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

329 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.


332 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.4 of this outline regarding solicitation of government clients.


334 Rule 206(4)-5(a). The rule is modelled on Rules G-37 and 38 of the Municipal Securities Rulemaking Board (MSRB).
(1) **Two-Year Time Out.** An investment adviser may not receive compensation for providing advice to a government entity, either directly or through a “covered investment pool,” for two years after a contribution by the adviser or by any of its “covered associates” to an official of that government entity who can influence the award of advisory business.\(^{335}\)

Covered Associate. Covered associates are the adviser’s executive officers, employees who solicit clients (and their supervisors up the chain of command), and any political action committees they control.\(^{336}\)

(a) **New Covered Associates.** The time out applies to political contributions made by a person within (i) two years of becoming a covered associate if the covered associate solicits clients upon becoming a covered person, or (ii) six months if he or she doesn’t.\(^{337}\) The adviser hiring the covered person (or promoting an employee to be a covered person) will be subject to the time out until the two-year (or six month) period has run with respect to that person’s contribution.

The look-back provision provides regardless of whether the adviser is aware of the covered person’s contributions so it is incumbent that an adviser requires full disclosure of candidates’ relevant political contributions as an adviser would regarding other business activities that might present conflicts.\(^{338}\)

(b) **Departing Covered Associates.** The time-out continues to run even if the covered associates making the political contribution leaves the firm.\(^{339}\)

**Government Officials.** Is a person who, at the time of the contribution, is either an incumbent, candidate, or successful candidate for elective state or municipal office if the office is directly or indirectly responsible for or can influence the outcome of, the hiring of an investment adviser by the government entity.\(^{340}\) Thus, if a governor of a state can appoint at least some of the members of a state pension fund’s board, the governor is a government official, contributions to whose campaign will trigger the two-year time out.

\(^{335}\) 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.3 of this outline regarding the cash solicitation rule that applies to all SEC-registered advisers.

\(^{336}\) Rule 206(4)-5(f)(2).

\(^{337}\) Rule 206(4)-5(b)(2).

\(^{338}\) Pay to Play Release *supra* note 333 at n.217.

\(^{339}\) Pay to Play Release *supra* note 333 at n. 206.

\(^{340}\) Rule 206(4)-5(f)(6). The time-out is triggered by contribution to a candidate for federal office only if the candidate is, at the time of the contribution, serving as an “government official” of a state or municipality.
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.\(^{341}\)

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

Exemptive Authority. The SEC can exempt advisers from the two-year time out if, among other things, the adviser had adopted and implemented policies and procedures reasonably designed to prevent violations of the rule, the adviser did not have actual knowledge of the contribution, and the adviser made reasonable efforts to obtain return of the contribution.\(^{342}\)

(2) Third Party Solicitor Ban. Neither an investment adviser nor any of its covered associates may provide or agree to provide, directly or indirectly, payment to any third party to solicit government clients for the adviser unless such person is a “regulated person.”\(^{343}\)

Regulated Person. “Regulated persons” are:

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

(b) Registered broker-dealers; and

(c) Municipal advisers.\(^{344}\)

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\(^{341}\) TL Ventures Inc., Advisers Act Rel. No. 3859, supra note 149 (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 covered investment pools (in this case, private equity funds) from which the adviser continued to receive compensation attributable to the investments of the government entities).

\(^{342}\) Rule 206(4)-5(e). The SEC has issued several exemptive orders pursuant to this provision. As suggested by the SEC release adopting rule 206(4)-5, the advisers who obtained these exemptive orders, upon learning of the violation, placed compensation earned from the government client subsequent to the date of the contribution in an escrow account for release upon issuance of the order. See, e.g., Davidson Kempner Capital Mgmt. LLC, Advisers Act Rel. No. 3693 (Oct. 17, 2013) (notice) and 3715 (Nov. 13, 2013) (order) and; Ares Real Estate Mgmt. Holding, LLC, Advisers Act Rel. No. 3957 (Oct. 22, 2014) (notice), and 3969 (Nov. 18, 2014) (order).

\(^{343}\) 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.

\(^{344}\) Rule 206(4)-5 limits broker-dealers and municipal advisers to those subject to a pay to play rule adopted by FINRA or the Municipal Securities Rulemaking Board (“MSRB”) that the SEC has found by order to provide STROOCK & STROOCK & LAVAN LLP
This provision covers payments to traditional solicitors for advisers as well as “placement agents” hired by private funds to find investors, typically broker-dealers. 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, the MSRB and FINRA are similar, and based on the template of MSRB rule G-37, first adopted by the MSRB in 1994.

(3) Bundling Ban. Rule 206(4)-5 prohibits an adviser and its covered associates from “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.

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

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

c. Covered Investment Pools. Rule 206(4)-5 includes a provision that applies each of the prohibitions of the rule to an adviser that manages assets of a government entity through a “covered investment pool,” which is defined generally to include a (i) registered investment company, (ii) private fund (e.g., hedge funds and private equity funds), or (iii) bank sponsored collective investment trust.

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

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

345 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).


348 Rule 204-2(a)(18).
5. **Proxy Voting**

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

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

(1) **Voting Client Securities.** The scope of an adviser’s authority to vote securities is typically provided in the advisory contract. Where an adviser does assume responsibility to vote proxies, the SEC has stated that an adviser’s fiduciary obligation requires it to monitor corporate action and vote client securities.\(^{349}\)

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

(2) **Resolving Conflicts of Interest.** In the absence of client disclosure and consent (which is often impracticable to obtain), the SEC stated that an adviser with a material conflict of interest “must take other steps designed to ensure, and must be able to demonstrate that those steps resulted in, a decision to vote the proxies that was based on the clients’ best interest and was not the product of the conflict.”\(^{350}\) 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.\(^{351}\) 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


\(^{350}\) *Id.*

\(^{351}\) *Staff Legal Bulletin 20 (June 30, 2014).*
adequate policies and procedures in place that address any conflicts it may have.352

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.353

6. Duty to Supervise

An adviser has a continuing responsibility to supervise all persons acting on its behalf.354 The SEC may sanction the adviser or any of its management personnel 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.”355

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.356 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

352 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).

353 See also Section VI.A.5 of this outline.

354 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 245 (adviser failed reasonably to supervise employee and did not have policies and procedures designed to detect and prevent employees from engaging in improper personal trading); In re Van Kampen American Capital Asset Mgmt., Inc., Advisers Act Rel. No. 1525 (Sep. 29, 1995) (adviser failed reasonably to supervise employee and did not have policies and procedures designed to detect and prevent employees from mispricing fund securities). Both registered and unregistered advisers have an obligation to supervise persons acting on their behalf. Wilfred Meckel and Robert A. Littell, Advisers Act Rel. No. 2203 (Dec. 15, 2003). See also Western Asset Mgmt. Co. and Legg Mason Fund Adviser, Inc., Advisers Act Rel. No. 1980 (Sept. 28, 2001) (duty to supervise a sub-adviser); TBA Financial Corporation, SEC Staff No-Action Letter (Nov. 7, 1983) (duty to supervise employees who are also “registered representatives”).

355 Section 203(e)(6).

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. 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.

b. **What are the Obligations of a Supervisor?** Management personnel have an obligation to oversee employees (which are not limited to so-called “statutory employees”) of the adviser in a manner reasonably designed to ensure compliance with the securities laws. This requires supervisors to take reasonable steps to determine whether an employee is engaging in unlawful conduct and, if they are, to prevent further violations. 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. For example, supervisors have been held liable for not acting effectively when they have merely relied on “unverified representations of employees.”

**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

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

359 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).*

360 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 358.


362 *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).
supervisory duties and had no reasonable cause to believe that the procedures were not being complied with.\textsuperscript{363}

7. \textit{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.\textsuperscript{364}

a. \textit{Chief Compliance Officer}. Each adviser must designate a chief compliance officer.\textsuperscript{365}

The CCO must be knowledgeable about the Act and have the authority to develop and enforce appropriate compliance policies and procedures for the adviser.\textsuperscript{366}

\textit{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,\textsuperscript{367} or may be a third party (i.e., one not employed by the adviser) specifically engaged to be the adviser’s CCO.\textsuperscript{368}

Regardless, the SEC will hold the adviser the same standards in assessing compliance with the rule.

\textit{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.\textsuperscript{369} 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

\begin{itemize}
\item Section 203(e)(6). See \textit{Dawson-Samberg Capital Mgmt., Inc.}, \textit{supra} note 214 (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 \textit{Cambridge Investment Research Advisors, Inc.}, \textit{supra} note 361.
\item 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. \textit{Release 2204, supra} note 357.
\item Rule 206(4)-7(c). The name of the CCO must be reported on Form ADV (Item 1.J.).
\item See \textit{IMC Asset Mgmt., Inc.}, Advisers Act Rel. No. 3537 (Jan. 29, 2013). The obligation of having a knowledgeable CCO with sufficient authority is not specified in rule 206(4)-7, but rather discussed in the SEC’s adopting release. The lack of experience and competence of its CCO were identified as aggravating factors in the SEC’s finding that IMC failed to meet its compliance obligations under the rule. See also \textit{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.
\item \textit{Release 2204, supra} note 357 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. \textit{Goelzer Investment Mgmt. Inc.}, Advisers Act Rel. No. 3638 (July 31, 2013).
\item 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. \textit{National Exam Program Risk Alert, Vol. V Issue I (Nov. 9, 2015)}.
\item See, e.g., \textit{Eric David Wanger and Wanger Investment Mgmt., Inc.}, Advisers Act Rel. No. 3427 (July 2, 2012); \textit{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).}
\end{itemize}
covered up a violation, knew about the violations and did not act; failed to cooperate with the SEC 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.

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

b. Policies and Procedures. Each adviser must also adopt and implement written policies and procedures reasonably designed to prevent the adviser or its personnel from violating the Act. 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.

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

371 *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. Hombogen, Advisers Act Rel. No. 3321 (Nov. 28, 2011)* (CCO, among other things, directed supervised persons to backdate acknowledgements of receipt of adviser’s code of ethics).

372 See, e.g., *Equitas Capital Advisors, LLC et al, Advisers Act Rel. No. 3704 (Oct. 23, 2013)* (CCO, among other things, failed to conduct compliance reviews, establish adequate compliance procedures, and failed to correct weaknesses in examination program identified by SEC examiners notwithstanding representations to SEC staff); *Buckingham Research Group, Inc., et al, Advisers Act Rel. No 3109 (Nov. 17, 2010)* (CCO failed to discharge his responsibilities adequately by failing to establish policies reasonably designed to prevent misuse of material non-public information, implement compliance policies, conduct an annual review, and cure deficiencies in an examination); *OMNI Investment Advisers Inc. and Gary R. Beynon, Advisers Act Rel. No. 3323 (Nov. 28, 2011)* (CCO was living in Brazil); *Ronald S. Rollins, Advisers Act Rel. No. 3635 (July 29, 2013)* (CCO, among other things, failed to implement policy against holding custody of client assets).

373 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 202.

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

375 Rule 206(4)-7(a).
(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. See “Forensic Measures for Funds and Advisers,” Office of Compliance Inspections and Examinations, CCO Outreach National Seminar (Nov. 14, 2007).

(3) Correct promptly any violations that have occurred.

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.

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

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;

   
   377 See Welhouse & Associate, Inc., supra note 247 (settled administrative action against an adviser for allocating profitable options trades to principal’s personal account in which the SEC staff rebutted the principal’s defense by statistical analysis, concluding that there was “an infinitesimal likelihood” of achieving the profit like those of the principal’s from a chance combination of trades).

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;


379 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 371; Feld & Company, Inc., Advisers Act Rel. No. 3325 (Nov. 28, 2011).
(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;
(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.\textsuperscript{380}

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.\textsuperscript{381}

c. Annual Review. The adviser must review the adequacy and effectiveness of its policies no less frequently than annually.\textsuperscript{382} 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, \textit{e.g.}, the adviser offers a new type of advisory program, manages assets for a new type of client, or acquires

\textsuperscript{380} Release 2204, supra note 357.

\textsuperscript{381} See, \textit{e.g.}, Envision Capital \textit{Mgmt. Lt.} supra note 374; \textit{Comprehensive Capital Mgmt., Inc.}, supra note 305 (failed to reasonably implement adviser’s policy of not acquiring custody of client assets); \textit{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, \textit{Modern Portfolio Mgmt.}, supra note 286.

\textsuperscript{382} Rule 206(4)–7(b).
a new affiliation (a broker-dealer),\footnote{383} or (iii) changes in applicable laws or regulations.\footnote{384} 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.\footnote{385} 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.

**Results of Reviews.** The SEC examination staff expects advisers to address compliance issues uncovered in the annual review.

**Annual Report.** There is no requirement, but some advisers (or their CCO) create an annual report similar to one required to be provided by the CCO of a registered investment company to its board of directors setting forth any (i) material changes to the compliance report during the year, and (ii) any “material compliance matters” that occurred.\footnote{386}

**Recordkeeping.** While the recordkeeping rule requires only that the adviser maintain any records it creates in the course of conducting an annual review, the SEC examination staff typically looks for such records as evidence that an annual review has been conducted.\footnote{387}

8. **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.\footnote{388} The adviser’s code of ethics must (or should, as discussed) cover several following matters set out below.

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

**Minimum Standards.** The SEC has not stated what this minimum standard should be, but in adopting the rule stated that a “good code of ethics should effectively convey to employees the value the advisory firm places on ethical conduct and

\footnote{383} Felt & Co., Inc., supra note 379 (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”).

\footnote{384} Release 2204, supra note 357 at Section II.B.1.

\footnote{385} The SEC has held CCOs responsible for conducting the annual review personally responsible for failing to do so in accordance with the advisers policies and procedures. See e.g., Equitas Capital Advisors, LLC, supra note 372.

\footnote{386} Rule 38a-1(a)(4)(iii).

\footnote{387} Rule 204-2(a)(17)(ii).

\footnote{388} See Consulting Services Group, LLC, and Joe D. Meals, supra note 371 (adviser failed to timely adopt and accurately document ethics code).
should challenge employees to live up not only to the letter of the law, but also to the ideals of the organization.”

b. Compliance with Federal Securities Laws. The code must require supervised persons to comply with federal securities laws.

c. Personal Securities Transactions. The code must require each of an adviser’s “access persons” to:

1. Initial and Annual Holdings Reports. Report his securities holdings (and those of his immediate family members) at the time that he becomes an access person and at least once annually thereafter, and

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.

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; and (iii) that would duplicate information in account statements or confirmations.

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

Commercially-developed software programs permit advisers to download trading data directly from the relevant broker and compare employee and client trading activity to permit compliance staff evaluate trading for conflicts and compliance with the adviser’s personal trading policies. Some advisers require access persons to conduct all personal securities transactions in accounts with broker-dealers that will link to these types of programs.

Access Persons. Access persons are personnel of the adviser (including clerical employees, officers, directors and partners) (i) who are involved in making recommendations to clients or (ii) who have access to the recommendations before

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389 Investment Adviser Codes of Ethics, Advisers Act Rel. No. 2256 (July 2, 2004).
390 Rule 204A-1(b) (1) (holdings reports), and (2) (transaction reports).
391 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 in 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).
392 Rule 204A-1(b)(2)(ii). The exceptions are not available for holdings reports.
393 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).
they are made public. 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.

(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. Such 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 neither involved in making recommendations to clients and does not have access to the recommendations before the client does.

Although SEC rules do not require the adviser to document determinations that directors, officer or partners are not access persons, appropriate documentation of the basis of the determination would seem to be necessary to sustain the adviser's burdens under the rule.

(2) Immediate Family Members. An access person is presumed to have beneficial ownership of securities holdings of members of his immediate family residing in his household, which therefore must be reported.

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. 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

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394 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.

395 An adviser cannot, however, create a related person to avoid obligations under the Advisers Act, including the code of ethics rule. See Section 208(d) of the Act. Accordingly, the personnel of a related person that shares personnel, facilities or is otherwise operationally integrated with the adviser may be considered to be access persons of the adviser. Where an adviser’s code contains a broader definition of access person than provided for in Rule 204A, the SEC may assert that the failure to enforce the broader definition will violate the adviser’s code.

396 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).

397 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 access persons 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).

398 Investment Adviser Codes of Ethics, Advisers Act Rel. No. 2256 (July 2, 2004) (adopting rule 204A-1) at Section II.B.2.
of all personnel. “This approach, while not required, offers certainty as to whether reports are required from a given individual.”

Reportable Securities. Access persons must report holdings of all reportable securities, i.e., securities, other than: (i) direct obligations in of the U.S. government; (ii) certain bank instruments, commercial paper and agreements; (iii) shares of money market funds; (iv) shares in open-end investment companies (mutual funds and ETFs) that are not advised by either the adviser or an entity in a control relationship with the adviser); or (v) shares of a (U.S.) unit investment trust that invests exclusively in an unaffiliated mutual fund.

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. The SEC has stated that an adviser, in addition to “comparing 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.”

d. Pre-approval of Certain Securities Transactions. The code must require the CCO or other designated persons to pre-approve investments by the access persons in (i) IPOs and (ii) limited (private) offerings, which would include most investments in hedge funds or other private funds.

e. Gifts and Entertainment. An adviser’s code of ethics is not required by rule 204A-1 to include a policy on receipt of gifts and entertainment by its personnel. All advisers, however, have an obligation to supervise their employees “with a view to preventing violations” of law. A properly implemented gifts and entertainment

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399 Id. at n.27.
400 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).
401 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).
403 Section 203(e)(6) discussed, supra Section VI.B.6 of this outline.

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policy helps prevent employees from being improperly influenced in their decision making by receipt of gifts and entertainment, and thus protects the interests of the adviser and its clients. 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 recipient’s employer. 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.” 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.

**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. These include employees who are in a position to influence the selection of broker-dealers to effect transactions for the fund, including portfolio managers. The adviser’s policies and procedures (or its code

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404 The acceptance by advisory personnel of excessive gifts and policies has been cited by the SEC as causing a violation of the adviser’s duty to seek best execution [Fidelity Mgmt. & Research Co., Advisers Act Rel. No. 2713 (Mar. 5, 2008) (adviser “allowed certain employees’ receipt of travel, entertainment and gifts and certain employee’s romantic relationships to enter into the selection of brokers. .’’)), and failing to adequately implement policies and procedures to prevent the misuse of non-public information. Institutional Shareholder Services, Advisers Act Rel. No. 3611 (May 23, 2013) (proxy adviser failed to take sufficient steps to implement gifts and entertainment policy that resulted in employees trading information about proxy votes for gratuities).


406 See FINRA Interpretive Letter (June 10, 1999), avail. at, http://www.finra.org/industry/interpretive-letters/june-24-1999-1200am. Gratuities must be valued at cost, and “may not be discounted on the theory that they would not otherwise be used.”

407 See Guggenheim Partners Inv. Mgmt., supra note 256.

408 Section 17(e)(1) makes it unlawful for any “affiliated person” of a registered investment company to accept from any source any compensation (other than a regular salary or wage) for the purchase or sale of property to or for the registered investment company. Generally, an associated person of an adviser to the investment company would be an “affiliated person” under the Investment Company Act. Section 2(a)(3) of the Investment Company Act. Compensation includes anything the associated person believes of value at the time he receives it. “The precise value of the gratuity in the marketplace is of little importance.” U.S. v. Milken, 759 F. Supp. 109, 120 (S.D.N.Y, 1990).

409 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).
of ethics) should identify these persons and disallow their receipt of any gifts and entertainment from broker-dealers.410

**ERISA Clients.** Section 406(b)(3) of ERISA makes it unlawful for a plan fiduciary to “receive any consideration for his own personal account from any party dealing with such a plan in connection with a transaction involving the assets of the plan.” While there is no de minimis, the DOL, as an enforcement matter, treats gifts and entertainment as “not substantial” if the annual aggregate value to any single person is less than $250.411

**f. Outside Business Activities.** Similarly, while not required by the rule, many advisers include in their code of ethics provisions include provisions regarding the 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,412 and (iv) the ongoing supervision of such activities.413

**g. Reporting Violations.** The code must require all supervised persons to promptly report any violations of the code to the adviser’s CCO or other designated person. The obligation applies to matters required to be a part of the code of ethics as well as those that are not, e.g., gifts and entertainment policies.

**h. Distribution and Acknowledgment.** The code must require the adviser to provide each supervised person with a copy of the code, and any amendments, and to obtain written acknowledgment from each supervised person of his receipt of a copy of the code.

**i. Recordkeeping.** Finally, the code of ethics must require the adviser to keep copies of the code, records of violations of the code and of any actions taken against violators of the code, and copies of each supervised person’s acknowledgement of receipt of a copy of the code.

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410 Id.


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

413 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 256 (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).
9. **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.\(^{414}\) 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 enforce these provisions against an adviser that defrauds the investors, but not the fund.\(^{415}\)

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.\(^{416}\)

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.\(^{417}\) 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.\(^{418}\) In adopting the rule, the SEC explained that rule 206(4)-8 would, however, permit the SEC to enforce an adviser’s fiduciary duty created by other law if the adviser fails to fulfill that duty by negligently or deliberately failing to make the required disclosure.

d. **Pooled Investment Vehicles.** Pooled investment vehicles include hedge funds, private equity funds, venture capital funds, and other types of privately offered pools that invest in securities, as well as investment companies that are registered with the SEC under the Investment Company Act.\(^{419}\)


\(^{415}\) *Goldstein v. SEC*, supra note 135.


\(^{417}\) See *Western Asset Mgmt., Advisers Act Rel. No. 3762* (Jan. 27, 2014).


\(^{419}\) 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
10. 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, including the misuse of material, non-public information about the adviser’s securities recommendations and client securities holdings and transactions. The provision applies to all advisers, including state-registered and unregistered advisers.

Insider Trading. Illegal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information (MNPI) about the security. Insider trading violations may also include “tipping” such information, securities trading by the person “tipped,” and securities trading by those who misappropriate such information. An adviser’s insider trading may violate the Advisers Act if its trading breaches a duty to a client or disadvantages a client, but even when an adviser’s clients benefit from the trading, insider trading will violate rule 10b-5 under the Exchange Act. Insider trading by advisers to hedge funds have been a significant focus of the SEC, as well as criminal authorities.

Information Barriers. When personnel of an advisory firm come into possession of MNPI (even unintentionally) about an issuer or security, such information will be imputed to the advisory firm, making it unlawful for the adviser to trade the securities or to advise clients to buy or sell the securities. The presumption is subject to an affirmative defense that (i) the individual making the investment decision (or providing the advice) is not aware of the MNPI, and (ii) the adviser had established and enforced a set of controls designed to ensure that individuals in the firm making investment decisions (or providing investment advice) are not doing so on the basis of MNPI. These often include:

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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.


421 See also Investment Adviser Code of Ethics, Advisers Act Rel. No. 2256 (July 2, 2004) (“We … remind advisers that they must maintain and enforce policies and procedures to prevent the misuse of material, non-public information, which we believe includes misuse of material, non-public information about the adviser’s securities recommendations, and client securities holdings and transaction”).


423 Rule 10b-5-1(c)(2) under the Exchange Act.
a. Information barriers designed to “wall off” groups of employees (or individual employees) with MNPI, allowing those employees on the “other side of the wall” to advise clients or trade securities freely;  

b. Maintenance of restricted lists or blackout periods during which all employees (or only those employees with access to MNPI) are prohibited from trading a security once the adviser has obtained MNPI;  

c. Enforcing trading restrictions and barriers by, among other things, monitoring trading of employees, requiring pre-clearance of trades, and surveillance of electronic communications among employees; and  

d. Educating employees about insider trading and their obligations under the firm’s policies and procedures governing MNPI.  

The design of the controls will turn on the size and structure of the adviser as well as the nature of the MNPI its employees is likely to receive. Information barriers are likely to work better for larger firms while firm-wide trading restrictions might be necessary for smaller firms. Insider trading policies will often be a part of an adviser’s code of ethics.

11. 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. 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

424 The information barrier procedures often require legal or compliance personnel to “chaperone” meetings of groups of employees who are otherwise on separate sides of the firm’s firewall to assure information is not improperly conveyed. Failure to properly maintain an information barrier may result in a violation of Section 204A even in the absence of insider trading. Janney Montgomery Scott, LLC, Exchange Act Rel. No. 64855 (July 11, 2011).


426 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 420 (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).

427 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.
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.428

(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.429 Accordingly, many advisers include additional information in their brochures.

(2) Exceptions to Delivery Obligation. Advisers are not required to deliver a brochure (i) to investment company clients, or (ii) to clients for whom they provide only impersonal services for less than $500.430

(3) Sub-advisers. As a general matter, the SEC treats a sub-adviser as having the same obligations to a client under the Act as an adviser. The SEC staff has expressed the view that, under certain circumstances, the brochure delivery obligations of a sub-adviser that provides investment advice through an unaffiliated adviser that has discretionary authority to select and allocate client assets to the sub-adviser can be satisfied by delivery of the sub-adviser’s brochure to the adviser.431

(4) Private Funds. The brochure must be delivered to private funds, even if it may mean delivering the brochure to the general partner of the fund (typically an affiliate of the adviser), since the fund could be deemed to be the “client” under the Goldstein decision.432 The practical effect of this provision is to require that hedge fund brochures be available on the SEC’s web site.433

While the brochure is not required to be delivered to investors in private funds, it may be advisable to provide them with a copy should a dispute later arise regarding whether an investor was provided all material information about the fund.

(5) Electronic Delivery. Advisers may deliver brochures electronically with client consent.434

428 Rule 204-3(b)(1)&(2).
429 Instruction 3 to Part 2 of Form ADV.
430 Rule 204-3(c).
431 Goldman Sachs & Co., SEC Staff No-Action Letter (June 20, 2013).
432 Goldstein v. SEC, supra note 135.
433 The SEC has stated that publication of an adviser’s brochure discussing advisory services provided to a private fund would not jeopardize the ability of a fund to rely on the private offering exemption or the safe harbor provided in section 506 (now 506(b)) unless the information included in the brochure went beyond that which is required by Part 2 of Form ADV to include matters such as subscription instructions, performance information, and financial statements. Advisers Act Rel. No. 3060, supra note 168.
434 Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information, Advisers Act Rel. No. 1562 (May 9, 1996) (publishing Commission interpretive guidance with respect to use of electronic media to fulfill investment advisers’ disclosure delivery obligations).
(6) **Interim Updates.** Brochures must be updated (and filed with the SEC) between annual amendments promptly whenever any information in the brochure becomes materially inaccurate. An adviser’s obligations under the anti-fraud provisions of the act would require it to provide the updated information to clients.

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.

(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.

**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).

(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.

(3) **Electronic Delivery.** Advisers may deliver brochure supplements electronically with client consent.

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435 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.

436 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.

437 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). See Instruction 5 to Part 2 of Form ADV.

438 *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 168.

439 Instruction 6 to Part 2 of Form ADV.

440 Rule 204-3(c)(2).
12. Systemic Risk Reporting on Form PF

Each registered investment advisers with at least $150 million in “private fund assets under management” must submit periodic reports on Form PF. 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.

a. Determining Private Fund Assets under Management

Private Fund Assets. For purposes of Form PF, private fund assets (or, “regulatory assets under management”) must include assets attributable to investors, whether U.S. or non-U.S. investors, and any uncalled capital commitments. Private fund assets must be calculated on a gross basis. Advisers cannot subtract any outstanding indebtedness or other accrued but unpaid liabilities (including accrued fees or redemptions not yet paid out). Accordingly, borrowings to provide leverage will not reduce the amount of private fund assets.

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.

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. They file annually within 120 days of the end of their fiscal year.

Section 1 requires, for each private fund, limited information about the size, leverage, investor types, investor concentration, liquidity and fund performance.
This section also requires information regarding strategy, counterparty exposures, and use of trading and clearing mechanisms for each private fund that is a hedge fund.

_Larger Private Funds Advisers._ Three types of “large private fund advisers” that meet certain thresholds for assets under management based on investment strategy type are required to complete additional sections of Form PF.

(1) **Large Hedge Fund Advisers.** Advisers managing at least $1.5 billion in hedge fund assets must file quarterly within 60 days of their quarter end and, in addition to Section 1, must complete Section 2 of Form PF. For purpose of Form PF, a hedge fund is generally any private fund that has the ability to pay a performance fee to its adviser, borrow in excess of a certain amount, or sell assets short. A commodity pool must be treated as a hedge fund.

Section 2a requires information about aggregate hedge fund assets the adviser manages, such as the value of investments in different types of assets, the duration of fixed income holdings, the value of turnover for certain asset classes and the geographical breakdown of investments. Section 2b requires, for each hedge fund that has net assets of at least $500 million, more granular information about the fund’s exposures, leverage, risk profile, and liquidity.

(2) **Large Private Equity Fund Advisers.** Advisers managing at least $2 billion in private equity fund assets must file annually within 120 days of the end of their fiscal year (same as smaller advisers) and, in addition to Section 1, must complete section 4 of Form PF. A private equity fund is a private fund that is not a hedge fund, liquidity fund or a real estate fund or a venture capital fund (as those terms are defined in Form PF) and which does not provide redemption rights to its investors.

Section 4 of Form PF requires information about the extent of leverage incurred by funds’ portfolio companies, use of bridge financing, funds’ investments in financial institutions and geographical and industry breakdowns of funds’ investments in portfolio companies.

(3) **Large Liquidity Fund Advisers.** Advisers managing at least $1 billion in combined unregistered and registered money market fund assets must file quarterly within 15 days of their quarter end and, in addition to Section 1, must complete Section 3 of Form PF.

Section 3 of Form PG requires information about each liquidity fund’s portfolio, certain information relevant to the risk profile of the fund and the extent to which the fund has a policy of complying with all or some aspects of rule 2a-7 under the Investment Company Act.

c. **Non-U.S. Advisers.** A registered adviser with a principal office and place of business outside the U.S. may omit reporting of any private fund that, during the

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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.\textsuperscript{446}

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.\textsuperscript{447} 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.\textsuperscript{448}

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.\textsuperscript{449} 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.\textsuperscript{450}

\textsuperscript{446} General Instruction 1 (last paragraph) to Form PF.

\textsuperscript{447} Regulation S-P applies to all investment advisers that are registered with the SEC, regardless of whether their clients are U.S. persons or not U.S. persons, and regardless of whether they conduct their activities through U.S. or non-U.S. offices. Rule 248.1(b). While provisions of Regulation S-AM and S-ID (discussed below) do not address applicability to non-U.S. advisers, it can be presumed that the SEC will apply them to the same extent.

\textsuperscript{448} 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”).

\textsuperscript{449} 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.

\textsuperscript{450} 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 357 (“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. Dunnire v. Morgan Stanley DW, Inc., 475 F.3d 956, 960 (8th. Cir. 2007).
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, and the downloading of customers data by a departing employee to use to solicit clients to move to a new firm, and sharing customer information with a third party in connection with opening unauthorized brokerage accounts. Most recently the SEC brought an action alleging that the adviser’s controls on employee access to personal financial information were flawed and failed to prevent unauthorized access that ultimately led to public disclosure. Although the adviser discovered the data breach, the SEC asserted that the adviser failed to audit its user controls or monitor for suspicious activities.

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.

Cybersecurity. The SEC has brought enforcement actions against advisers for failing to take adequate precautions to prevent unauthorized access to electronic client records. Examination of advisers’ cybersecurity compliance and controls is currently a priority for the SEC staff, 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. 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;


455 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 451.


(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.\(^{458}\)

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.\(^{459}\)

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.\(^{460}\) 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.\(^{461}\)

(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.\(^{462}\) The initial notice must be provided no later than when the client enters into an advisory contract.\(^{463}\) Notices must be clear and conspicuous, i.e., reasonably

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\(^{458}\) "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 455.

\(^{459}\) *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.

\(^{460}\) Rule 248.10. See *Maximilian 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.

\(^{461}\) 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).

\(^{462}\) Rules 248.4(a).

\(^{463}\) Rule 248.4(a), (c)(3)(iii).
understandable and designed to call attention to the nature and significance of the notice. 464

Annual Notice. As long as the advisory relationship continues, the adviser must provide individual clients an annual notice of its privacy policies and opportunity to opt out unless (i) its policies regarding disclosure of non-public personal information has not changed since the last notice sent clients, and (ii) the adviser does not disclose nonpublic personal information of clients other than as permitted without the notice or consent of clients (see below). 465

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. 466

(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. 467 A client’s decision to block information sharing is effective until it is revoked in writing. 468 A client’s decision to consent to disclosure may be revoked at any time. 469

“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. 470 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. 471

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464 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.

465 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 120, to circumscribe the circumstances under which advisers must provide each client an annual privacy notice.


467 Rule 248.10.

468 Rule 248.7(g).

469 Rule 248.7(f).

470 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 466.

471 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.472

Exceptions. An adviser can share personally identifiable financial information without obtaining an opt out from a client in three circumstances:

(A) the information is provided to an affiliate, but the affiliate may disclose the information only to the extent the adviser could under its own policies;473

(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;474 or

This provision permits an adviser to share client information, for example to open a custodial account for a customer and direct the execution of trades to a broker-dealer without obtaining client consent.

(C) the adviser shares the information with a non-affiliate that performs services, including marketing, for the adviser, but the adviser must have entered into a contract with the service provider that prohibits it from using the information except for the purpose for which it is received.475

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.476 The SEC proposed, but has never adopted, an

472 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.

473 Rule 248.11(b)(1).

474 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.

475 Rule 248.13.

exemption under which a departing employee could take limited client records to the employee’s new firm.\textsuperscript{477}

c. **Proper Disposal of Client Information**

A registered adviser must adopt written procedures reasonably designed to protect client records and information, and to dispose of such records properly.\textsuperscript{478} The records covered by this provision include only records that identify individuals.

d. **Affiliated Marketing Rules (Regulation S-AM)**

Regulation S-AM (the “Affiliated Marketing Rule”) allows a client, in certain limited situations, to block affiliates of an adviser from soliciting the client, if the solicitation is derived from certain private information that the adviser has shared with the affiliate.\textsuperscript{479} Unlike Regulation S-P, Regulation S-AM does not restrict the ability of the adviser to share information; instead, it limits the ability of adviser’s affiliate to use “eligibility information” received from the adviser to make a “marketing solicitation” to the client.\textsuperscript{480}

(3) **Scope.** The affiliated marketing rule applies to all registered investment advisers and their “affiliates,” which are persons that are related by common ownership or common control.\textsuperscript{481} These are the same affiliates that Regulation S-P permits advisers to share non-public personal financial information with without client consent.

(4) **Marketing Solicitation.** A marketing solicitation is marketing initiated by the affiliate based on “Eligibility Information” that is designed to encourage the client to purchase the affiliate’s products or services.\textsuperscript{482} It excludes general advertisements.

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\textsuperscript{477} *Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Personal Information, Advisers Act Rel. No. 2712* (Mar. 4, 2008).


\textsuperscript{479} 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.

\textsuperscript{480} Unlike Regulation S-P, there is a private right of action under the *Fair Credit Reporting Act*, for violation of Regulation S-AM. See Sections 616 and 617 of the FCRA. Accordingly, an adviser could be liable to a client if its affiliate uses eligibility information to make a solicitation if the adviser failed to comply with the regulations.

\textsuperscript{481} 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.

\textsuperscript{482} Rule 248.120(o).
(5) **Eligibility Information.** Eligibility Information includes information about a client’s credit standing, character, reputation, personal characteristics and mode of living, as well as transaction or experience information, such as information about his or her account history and information from his or her account application. While the definition is designed primarily for banking institutions, it covers the account information an adviser will typically have, including information from its client it acquired for determining “suitability” of investment advice.

(6) **Disclosure and Opt Out.** An affiliate that receives information may not use that information to make a marketing solicitation to the adviser’s clients unless (i) the potential marketing use of the information has been disclosed to the client in writing, (ii) the client has been provided reasonable opportunity to opt out of receiving the solicitation, and (iii) the client has not opted out.

**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.

**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.

2. **Identity Theft Red Flags (Regulation S-ID)**

Regulation S-ID require certain registered investment advisers to prepare a program designed to prevent identity theft (“Red Flags Rules”).

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483 Rule 248.120(j); Section 603(d) of the FCRA.
484 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.
485 Rules 248.121(a), 122(b) and 122(c).
486 Rule 248.121(c).
487 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 Flag 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).
a. **Scope of Rule.** The Red Flags Rules apply only to registered advisers that are either “financial institutions” or “creditors,” and only as to “covered accounts.”

(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. “Consumers” are defined as individuals, and thus an adviser without individual clients is not a “financial institution.” 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.

(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.

b. **Elements of an Identity Theft Program.** The Red Flags Rules require each adviser with covered accounts to institute a written identity theft program with four elements:

(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.”

(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.

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488 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).

489 Rule 248.201(b)(3).

490 Rule 248.201(b)(7) (defining “financial institution” by reference to Section 603(t) of the FCRA).

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

492 Rule 248.201(b)(5) (defining “creditor” by reference to Section 615(e)(4) of the FCRA).

493 Rule 248.201(b)(3).

494 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.

495 Rule 248.201(b)(10).
3. **Beneficial Ownership Reporting on Schedules 13D and 13G**

*Schedule 13D.* Persons, including advisers, that acquire “beneficial ownership” of 5% or more of shares of a voting class of security registered under Section 12 of the Exchange Act (generally securities publicly traded on a U.S. securities exchanges) must file Schedule 13D with the SEC (unless they are eligible to file Schedule 13G) within 10 days of the transaction that caused the person to hold more than 5%.\(^{496}\) The requirement is designed to notify the company and markets that an investor has accumulated a substantial amount of voting securities and the intentions of the investor. Schedules 13D and G must be filed electronically, via the SEC’s Electronic Data Gathering, Analysis and Retrieval system (“EDGAR”) (rather than the IARD system).\(^{497}\)

**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.\(^{498}\) 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.\(^{499}\) 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 would not.\(^{500}\)

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\(^{496}\) 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.


\(^{498}\) Rule 13d-3.


\(^{500}\) 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.
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.\footnote{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. \textit{Amendments to Beneficial Ownership Reporting Requirements}, Exchange Act Rel. No. 39538 (Jan. 12, 1998). The SEC explained that when an adviser relies on information barriers to avoid attributing ownership, the various business units should maintain and enforce policies and procedures reasonably designed to prevent the flow of information to the other business units, and should obtain an annual independent assessment of their operation. See section VI.B.10.a. of this outline.}

c. Groups. Persons acting in concert for purpose of acquiring, holding, disposing, or voting securities are treated as a single beneficial owner, and the resulting group is required to file a Schedule 13D even if each member of the group owns less than 5%.\footnote{Rule 13d-5(b)(1). See \textit{Roth v. Jennings}, 489 F.3d 499 (2d Cir. 2007) (discussing requirements for formation of a group under section 13(d)). See also \textit{Staff Compliance and Disclosure Interpretations, Question 105.6}. Each member of the group would not, however, have a separate filing obligation.} No formal agreement to act is necessary; a group may be inferred by conduct.\footnote{\textit{Wellman v. Dickinson}, 862 F.2d 355 (2nd Cir. 1982).}

\textit{As a consequence of the beneficial ownership rules, multiple persons may be required to file Schedule 13Gs reporting ownership of the same securities. For example, a hedge fund, its general partner, its adviser and a control person of the adviser may all be required to report the same position. As discussed below, in many cases a single Schedule 13G may be filed for all.}

\textit{Schedule 13G.} SEC-registered advisers are “Qualified Institutional Investors” under SEC rules and may, in lieu of Schedule 13D, submit reports on Schedule 13G.\footnote{Rule 13d-1(b)(1). Advisers filing Form 13G must file an annual amendment within 45 days after the end of each calendar year if there are any changes in the information reported in the previous filing (subject to certain exceptions). Rule 13(d)-2(b). In addition, advisers must amend Schedule 13D promptly upon acquiring beneficial ownership of 10% of a class of equity securities, and must thereafter promptly amend the Schedule 13G upon increasing or decreasing its beneficial ownership by more than 5%. Rule 13(d)-2(d)} Schedule 13G requires substantially less information, and is generally not required to be filed until 45 days after the end of the calendar year in which the adviser becomes a 5% beneficial owner.\footnote{Rule 13d-2(b). If, however, the ownership interest exceeds 10% on the last day of any month (other than December), it must make its initial filing within 10 days after the end of the month.} Only holdings that exceed the 5% threshold as of the end of the calendar year must be reported. A separate filing is made with respect to each reportable position in a class of equity securities.

a. Eligibility. An adviser must have (i) acquired the securities in the ordinary course of its business, and (ii) not with the purpose or effect of changing or affecting...
control of the company. Once eligibility is lost, the adviser must begin filing on Schedule 13D.

b. Joint Filings. A single Schedule 13G can be used to report on behalf of multiple persons as long as each reporting person is a Qualified Institutional Investor. Schedule 13G will often be filed by a parent holding company on behalf of its control persons, investment adviser subsidiaries, and clients of the adviser (e.g., investment companies) that have reporting obligations because they hold 5% positions.

c. Private Funds. Private funds are not Qualified Institutional Investors. Accordingly many advisers to private funds file Schedule 13G as “passive investors,” an approach available for investors that meet the eligibility criteria discussed above in paragraph (a), but are not among the institutions listed in the rule. This approach is available only to investors that have beneficial ownership of less than 20%, and requires investors to file within 10 days of acquiring 5% beneficial ownership. An adviser filing as a passive owner may file jointly with the private funds they advise.

d. Non-U.S. Advisers. Advisers that are not U.S. persons are subject to the filing requirements.

4. Institutional Investor Reporting on Form 13F

An SEC-registered investment adviser that has investment discretion over at least $100 million in “section 13(f) securities” must file Form 13F listing those positions. The filing must be made quarterly with the SEC through the SEC’s EDGAR system. This requirement was designed “to create a central depository of historical and current data

506 Rule 13d-1(b). See Perry Corp., Exchange Act Rel. No. 60351 (July 21, 2009) (shares are not held in the “ordinary course” when an adviser is acquiring ownership of securities for the purpose of influencing the direction or management of the issuer or influencing the outcome of a transaction; thus the adviser is not eligible to file Form 13G).


508 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).

509 Rule 13d-1(c).


about the investment activities of institutional investment managers” to assist investors and regulators.  

**Control Persons.** A persons controlling an adviser having discretionary authority over section 13(f) securities is deemed to have discretionary authority over such securities. As a result, a person controlling multiple advisers may have an obligation to file Form 13F because it and the advisers it controls collectively have discretionary authority over $100 million of section 13(f) securities even if some or all of the advisers it controls do not. Only one of the advisers must file Form 13F, and can report aggregate holdings for all the advisers having a filing obligation under section 13(f).

**Section 13(f) Securities.** These primarily include equity securities traded on U.S. exchanges (e.g., NYSE, NASDAQ), shares of closed-end investment companies and ETFs. 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.

**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 persons, or (ii) reveal the adviser’s manager’s program of acquisition or disposition of a security the disclosure of which would cause substantial harm to the strategy. 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.

**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.

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513 Rule 13f-1(b).
514 “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. See [http://www.sec.gov/divisions/investment/13flists.htm](http://www.sec.gov/divisions/investment/13flists.htm).
515 The Division of Investment Management has published a [FAQ regarding Form 13F (“13F FAQs”)](http://www.sec.gov/divisions/investment/13flists.htm).
516 Section 13(f)(4) of the Exchange Act.
517 See [Letter from the Division of Investment Management to Section 13(f) Confidential Treatment Filers (June 17, 1988)](http://www.sec.gov/divisions/investment/13flists.htm) (explaining circumstances under which confidential treatment will be granted).
518 See also 13F FAQs at FAQ #4.
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.\(^{519}\) These requirements are designed to assist the SEC in both identifying, and obtaining trading information on, market participants that conduct a substantial amount of trading activity.\(^{520}\)

**Large Trader.** An adviser is a “large trader” if it exercises investment discretion over one or more accounts through which transactions in “national market system securities” are effected through one or more registered broker-dealers in amounts that, in the aggregate, amount to either: (i) 2 million shares or shares with a fair market value of $20 million during a calendar day; or (ii) 20 million shares or shares with a fair market value of $200 million during a calendar month.\(^{521}\)

**National Market System Securities.** These securities include options and equity securities listed on the NYSE, NYSE Amex and Nasdaq, as well as equity securities listed on other U.S. national exchanges.\(^{522}\) The scope of securities that fall under this definition is narrower than the scope of securities that trigger Form 13F filing.\(^{523}\)

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.\(^{524}\) 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.\(^{525}\)

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520 Id.

521 See id.

522 See Regulation NMS, rule 600(b)(46), (47) and (82).

523 See supra note 514 and accompanying text.

524 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.

525 See *LTR Release*, supra, note 519. 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.
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.526

Large traders were required to begin complying with the rule’s requirements on December 1, 2011.527

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.”528 A dealer is any person who is in the business of buying and selling securities for his own account, including through a broker.529 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;530 (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.531

526 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 its representatives may request an exemption from the SEC pursuant to section 36 of the Exchange Act and subsection (g) of rule 13h-1. Id.

527 The rule also requires registered broker-dealers to monitor accounts for the purpose of identifying “unidentified large traders,” capture certain information relating to all transactions on behalf of large traders and unidentified large traders that are effected directly or indirectly by or through it, and make such information available to the SEC through the already-established trade-reporting infrastructure, commonly referred to as the “electronic blue sheets.” Id.

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

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

530 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.

531 InTouch Global, LLC, SEC Staff No-Action Letter (Nov. 14, 1995); First Atlantic Advisory Corp., SEC Staff No-Action Letter (Feb. 20, 1974).
b. **Private Fund Distribution Activities.** Interests in private funds are considered to be securities, and promotional and sales activities on behalf of private funds by advisory personnel may require registration. Rule 3a4–1 under the Exchange Act provides a “safe harbor” from broker-dealer registration for an adviser that markets interests in a fund it manages. However, the conditions of the rule are narrow, prohibit the payment of transaction-based compensation to employees, and limit the frequency of an offering. There is significant uncertainty about the circumstances under which an adviser not using the services of a broker-dealer to distribute shares of a private fund making a continuous offering must register as a broker-dealer.

c. **Private Equity Fund Deal Activities.** Advisers to private equity funds may be required to register as broker-dealers when they participate in and receive transaction fees in connection with the acquisition or disposition of portfolio companies. The SEC has recently brought an enforcement action against an adviser for failure to register as a broker-dealer involved in such a transaction without the participation of a broker-dealer.

D. **Contractual Requirements**

While the Advisers Act deems an adviser to be a fiduciary with respect to its client, the scope of its obligation to a client is determined in the first place by the terms of the advisory contract it enters into with its client. The Act does not require advisory contracts to be written, and the existence of a contract and the interpretation of its terms are generally matters of state law. 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.

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532 Rule 3a4–1 provides an exemption for an associated person of an issuer of securities, which in the case of a private fund may include a natural person who is a partner, officer, director or employee of the fund or the corporate general partner of the issue.


535 [Blackstreet Capital Mgmt. LLC, Advisers Act Rel. No. 4411 (June 1, 2016)](https://www.sec.gov/divisions/investment/orders/2016/20160601-4411.pdf) (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 534.](https://www.sec.gov/news/speech/2013-0406.html)

536 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.
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.\footnote{537}

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, \textit{i.e.}, a fee based on a share of the capital gains or appreciation of a client’s funds.\footnote{538} Congress included this provision in the Act because of its concern that a performance fee would encourage undue speculation with clients’ investments.\footnote{539}

a. Assets Under Management. The commonly charged fee based on an amount of assets under management is specifically excepted.\footnote{540}

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.\footnote{541} 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.”\footnote{542}

\footnote{537}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. \textit{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. Kimnang & Co., Inc., SEC Staff No-Action Letter (Nov. 30, 1973).}

\footnote{538}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.” \textit{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.

\footnote{539}See H.R. Rep. No 2639, 76th Cong., 2d Sess. 29 (1940).

\footnote{540}Section 205(b)(1).

\footnote{541}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. \textit{Advisers Act Rel. No. 315 (Apr. 6, 1972).}

\footnote{542}But see \textit{Royce Value Trust, SEC Staff No-Action Letter (Dec. 22, 1986)}, \textit{(the SEC staff stated it would not object if an advisory agreement contained a performance fee that decreased at a greater rate than it increased and provided for no compensation if the net asset value per share declined). In 2006, the SEC has instituted several settled enforcement actions against advisers that entered into advisory contracts with investment companies that charge...}
c. **Non-U.S. Clients.** The Act also excepts contracts with persons who are not residents of the United States.\(^{543}\) 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;\(^{544}\)

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,\(^{545}\) or is a “qualified purchaser”;\(^{546}\) or

3. natural person who is an officer, director, trustee, or general partner (or a person serving in a similar capacity) of the adviser, or an employee who participates in investment decisions of the adviser and has done so for at least 12 months.\(^{547}\)

e. **Qualified Purchaser Funds.** The Act also excepts contracts with certain funds not registered under the Investment Company Act of 1940 because they are offered only to certain wealthy or sophisticated investors.\(^{548}\) 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

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\(^{543}\) Section 205(b)(5).

\(^{544}\) Rule 205-3(d)(1)(i).

\(^{545}\) Rule 205-3(d)(1)(ii)(A). The SEC recently increased the amount from $2 million to $2.1 million of assets under management. *Advisers Act Rel. No. 4421 (June 14, 2016)* (Order Approving Adjustment for Inflation). Section 205(e) of the Act requires the SEC, every five years, to adjust for inflation the amount of both the net worth and assets tests under management test. In 2016, only the net worth test was adjusted.

\(^{546}\) 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.

\(^{547}\) Rule 205-3(d)(1)(iii).

\(^{548}\) Section 205(b)(4).
could otherwise enter into a performance fee contract under the rule. 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.

Non-U.S. Funds. The SEC staff has stated that if the fund is organized under the laws other than the U.S., only the equity owners who are U.S. residents must be qualified clients.

2. Overbilling of Advisory Fees.

By entering into an advisory contract, clients consent to the deduction of fees specified therein from their accounts. Withdrawal of amounts greater than that which the client has authorized will be viewed by the SEC as conversion of client assets or disclosure of false information and a violation of the anti-fraud provisions of the Act, i.e., not merely a breach of contract.

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

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549 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).

550 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.3 of this outline (discussing joint registration).

551 See Lazard Frères Asset Mgmt., SEC Staff No-Action Letter (Feb. 12, 1996).

552 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).

553 Marco Investment Mgmt. LLC, Advisers Act Rel. No. 4348 (Mar. 2, 2016); Equitas Capital Advisers, supra note 371; Guggenheim Partners Inv. Mgmt., supra note 256; Envision Capital Mgmt., supra note 374.


2. \textit{Assignments of Advisory Contracts}

Advisory contracts must contain a provision prohibiting their assignment without consent of the client.\textsuperscript{556} An assignment generally includes any direct or indirect transfer of an advisory contract by an adviser or any transfer of a controlling block of an adviser’s outstanding voting securities.\textsuperscript{557}

\textit{Safe Harbor.} The SEC has adopted a rule providing a safe harbor for a transaction that does not result in a change of \textit{actual} control or management of the adviser (e.g., a corporate reorganization) would not be deemed to be an assignment for these purposes.\textsuperscript{558}

\textit{Consent.} 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 an actual consent, or may be inferred through the use of a negative consent, if clients are given some amount of notice, e.g., 60 days.\textsuperscript{559}

\textit{Notification of Partnership Changes.} If the adviser is organized as a partnership, each of its advisory contracts must provide that the adviser will notify the client of a change in its membership.\textsuperscript{560}

\textsuperscript{556} 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). \textit{American Century Companies, Inc.}, SEC Staff No-Action Letter (Dec. 23, 1997). Assignment without consent, however, could be construed to be a violation of an adviser’s fiduciary responsibilities in violation of section 206 of the Act. Thus, it is not advisable, in practice, to draw the distinction the staff has drawn.

\textsuperscript{557} Section 202(a)(1). The Act does not include a definition of “controlling block of an adviser’s voting securities,” but “control” is defined in section 202(a)(12) 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.” Unlike the Investment Company Act (see section 2(a)(9)), there is no presumption of control in the Advisers Act.

\textsuperscript{558} 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. \textit{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.

\textsuperscript{559} Instruction to Item 5 of Form ADV-W; \textit{Jennison Associates Capital Corp, SEC Staff No-Action Letter (Dec. 2, 1985)} (60 days).

\textsuperscript{560} 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. \textit{Ayco Company, L.P. (Dec. 14, 1995)}. 

\textbf{STROOCK \& STROOCK \& LAVAN LLP}
3. **Hedge Clauses**

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

**Culpability Provisions.** Historically, the SEC staff took the position that the prohibition would, for example, preclude an adviser from purporting to limit its culpability to acts involving gross negligence or willful malfeasances, even if the hedge clause explicitly provides that rights under federal or state law cannot be relinquished. 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.” The current approach of the staff thus permits culpability clauses based upon regular standards for modifying fiduciary duties when the obligation of full disclosure and consent is satisfied.

Culpability clauses do not, however operate to restrict the SEC’s ability to enforce violations of Section 206(2) of the Act, which has been interpreted to include negligent conduct.

**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.

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561 Section 215(a).


563 Auchincloss & Laurence Inc., SEC Staff No-Action Letter (Feb. 8, 1974).


566 SEC. v. Steadman, supra note 186.

567 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 overruled in a decision more sympathetic to arbitration clauses. See Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220 (1987).
Dodd Frank Act. Section 921(b) of the Dodd-Frank Act added a new section 205(f) of the Advisers Act, authorizing the SEC to prohibit, or impose conditions or limitations on the use of advisory contracts that contain arbitration provisions if it finds that the prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors. 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. 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), unless the adviser is to receive a pre-determined amount upon termination for services already performed, and the client is provided adequate disclosure.

5. Rescissions Rights

Advisory contracts entered into in violation of the Advisers Act are void. A client may sue for rescission of such contract, and obtain restitution of any fees, commissions or other compensation paid to the adviser pursuant to the contract. Restitution does not include compensation for any investment losses as a result of a

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568 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.

569 See, e.g., National Deferred Compensation, SEC Staff No-Action Letter (Aug. 31, 1987) (“an adviser may not fulfill its fiduciary obligations if it imposes a fee structure penalizing a client for deciding to terminate the adviser’s service or if it imposes an additional fee on a client for choosing to change his investment”); Robert D. Brown Investment Counsel, Inc., SEC Staff No-Action Letter (July 19, 1984) (contract for investment supervisory services containing a provision restricting a client’s ability to terminate the contract or forcing the client to forfeit a portion of prepaid fees in the event of termination may violate Section 206). An advisory contracts with a registered investment company must be terminable at any time. Section 15(a)(3) of the Investment Company Act. See Orinda Asset Mgmt. LLC., Advisers Act Rel. No. 4513 (Aug. 25, 2016).

570 National Regulatory Services, SEC Staff No-Action Letter (Dec. 2, 1992). The staff does not see this view altered by the decision Transamerica v. Lewis, supra note 74, that clients do not have a private right of action under section 206 of the Act, because they continue to have rights to sue for equitable damages under section 215 of the Act.


572 Section 215(b).

573 Transamerica Mortgage, supra note 74. This is the only private right of action under the Act recognized by the courts. In order to sue under Section 2015(b), a claimant must be a party to the contract. Zurich Capital Markets Inc. v. Coghlanese, 332 F. Supp. 2d 1087, 1114 (N.D. Ill. 2004).

fraud or other misconduct by the adviser, including a violation of section 206 of the Act by the adviser.\textsuperscript{575}

E. Recordkeeping Requirements

The SEC generally requires a registered adviser to maintain two types of books and records: (i) typical accounting and other records that any business would normally keep; and (ii) certain additional records the SEC believes necessary in light of the adviser’s fiduciary duties.\textsuperscript{576} The requirement to keep records does not turn on the medium in which a document is created or maintained.\textsuperscript{577} Thus, electronic documents, including emails, must be maintained if they meet the required record described below.

1. Typical Records
   a. All checkbooks, bank statements, and reconciliations.
   b. All written agreements entered into by the adviser with any client or otherwise relating to the business of the adviser, e.g., rental and service agreements, mortgages, employment contracts, advisory contracts. All invoices or statements relating to the adviser’s business.
   c. 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. Copies of each securities transaction and holdings report made by an access person under the adviser’s code of ethics.
   b. Documents supporting an adviser’s decision to approve an access person’s personal securities transactions.
   c. A list of all persons who currently are “access persons” and who have been access persons within the last five years.
   d. A 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.
   e. A cross reference of securities held by client and by issuer.

\textsuperscript{575} 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).

\textsuperscript{576} Rule 204-2.

\textsuperscript{577} Rule 204-2(g) (permitting records to be maintained in electronic format, subject to procedures designed to maintain their integrity).
f. All written communications received and copies of all written communications sent by the adviser relating to:

(1) any recommendation made or proposed to be made, and any advice given or proposed to be given;

(2) any receipt, disbursement, or delivery of funds or securities; or

(3) the placing or executing of any order to purchase or sell any security.578

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.579

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. Copies of any power of attorney.

j. A copy of each brochure and brochure supplement prepared in compliance with the brochure rule and any document prepared in compliance with the requirements of Form ADV.

k. Clients’ acknowledgement of receipt of a solicitation agreement.

l. Documents substantiating any performance advertised.580

m. Certain additional records if the adviser has custody or possession of clients’ cash or securities.581

578 Rule 204-2(a)(7). If recommendations made as to specific securities in a communication that does not state the reasons for the recommendation, a separate memorandum explaining the reasons must be created and maintained kept. Rule 204-2(a)(11).


580 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 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.

581 Rule 204-2(a)(17)(iii) and (b).
n. Copies of the code of ethics and amendments thereto.

o. 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. The SEC examination staff have taken the position that advisers are therefore required to keep a deficiency log of all violations of the Federal securities laws.

p. Copies of each supervised person’s written acknowledgment of receipt of a copy of the code of ethics.

q. Copies of the adviser’s compliance policies and procedures, and copies of any records document the adviser’s annual review of its compliance policies.

r. Certain additional records regarding political contributions and advisory services to any government entity.

3. Time, Place and Manner of Retention

a. General. All books and records required to be kept by the rule must be maintained and preserved in any easily accessible place for a period of no less than five years. The first two years, the records must be kept in the offices of the adviser.

b. Third Party Recordkeepers. The SEC staff has stated that 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. The SEC has held third party recordkeepers responsible under the Act for causing the adviser to maintain required records.

c. Electronic Records. Records required to be kept may be maintained or stored electronically using various media, provided that the adviser establishes and maintains procedures:

(1) to preserve the records and safeguard them from loss, alteration or destruction;

(2) that limit access to authorized personnel; and

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582 Rule 204A-1(a)(2).
583 Rule 204-2(a)(18) and (h).
584 Rule 204-2(e). The first two years, the records must be kept in the offices of the adviser.
585 First Call, infra note 583; 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).
(3) that reasonably assure that any reproduction of paper records onto electronic media is accurate.\footnote{Rule 204-2(g)(3). Records may be kept electronically regardless of how they were originally created.}

Electronic records must be arranged and indexed in a way that permits easy location, access, and retrieval of each record; provided to the SEC staff promptly in the medium and format in which it is stored (or, if requested, printed out); and (to prevent their loss) a duplicate copy of the record must be stored (in electronic format) at a separate location.\footnote{Rule 204-1(g)(2).}

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.\footnote{First Call Corporation, SEC Staff No-Action Letter (Sept. 6, 1995).}

4. \textit{Applicability to Non-U.S. Advisers}

\begin{enumerate}
\item \textbf{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.\footnote{Rule 204-2(j).} Because of the burdens associated with maintaining two sets of records most advisers choose the second option.

\item \textbf{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.\footnote{See Advisers Act Rel. No. 3222, supra note 108 at n.515 (“[W]e do not apply most of the substantive provisions of the Advisers Act to the non-U.S. clients of a non-U.S. adviser registered with the Commission.” In the case of a private fund, the fund would be treated as the client. The SEC staff has provided guidance in a series of no-action letters regarding the recordkeeping obligations of registered advisers that are located offshore. Under this guidance, the registered adviser must, in order to rely on the letters, comply with the Act’s recordkeeping rules, other than (i) rules 204-2(a)(3) and (7) with respect to transactions involving offshore clients that do not relate to advisory services performed by the registered adviser on behalf of United States clients or related securities transactions; and (ii) rules 204-2(a)(8), (9), (10), (11), (14), (15) and (16) and 204-2(b) with respect to transactions involving, or representations or disclosures made to, offshore clients. See, e.g., Royal Bank of Canada, SEC Staff No-Action Letter (June 3, 1998).}
\end{enumerate}
c. *Foreign Private Advisers.* Exempt reporting advisers, including foreign private advisers, are not subject to any of the recordkeeping requirements under the Advisers Act.\(^{592}\)

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.\(^{593}\)

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

**F. Administrative Oversight**

The staff of the of the SEC’s Office of Compliance, Inspections and Examinations located in the SEC’s 11 regional offices and the Washington headquarters conducts compliance examinations of advisers registered with the SEC.\(^{594}\) 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.\(^{595}\)

The SEC staff annually publishes a list of current examination priorities.\(^{596}\)

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

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\(^{592}\) The SEC has not implemented its statutory authority to adopt such rules. *Release 3221,* supra note 83 at n.164.

\(^{593}\) An exception, set forth in staff letters, is for records provided upon request by a non-U.S. participating affiliate. *See supra* note 153.

\(^{594}\) For more detailed information, see *Examinations by the Securities and Exchange Commission’s Office of Compliance Inspections and Examinations* (Feb. 2012).

\(^{595}\) *Examination Information for Broker-Dealers, Transfer Agents, Clearing Agencies, Investment Advisers and Investment Companies.*

\(^{596}\) OCIE’s *Examination Priorities for 2016* was posted on January 11, 2016.
c. Foreign private advisers.597

The SEC has announced, however, that it will not conduct routine examinations of exempt reporting advisers.598

2. Records Subject to Examination

All records of a registered adviser (and not only those required to be created or maintained pursuant to SEC rule) are subject to examination by SEC staff.599

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.600

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.601

This provision of the Act provides the SEC with examination authority over persons who are not investment advisers. Enacted as part of Dodd-Frank Act (and subsequent to the Madoff scandal), it responds to SEC staff concerns that the SEC could not always determine whether client assets were properly accounted for if held by institutions over which it had no regulatory authority.

c. Attorney-Client Privilege

An adviser may decline to provide SEC examiners with documents subject to the attorney-client privilege. Generally, these are communications made in confidence

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597 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 83 at n. 190.

598 Release 3221, supra note 83, at Section II.B.2.

599 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.

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

601 Section 204(d), as amended by section 929Q(b) of the Dodd-Frank Act.
to an attorney by the adviser for the purpose of seeking legal advice. The SEC staff will request a “privilege log,” a list and a description of documents the adviser is not turning over in reliance on the privilege.

The SEC will not recognize attorney-client privilege as extending to the work of an adviser’s chief compliance officer merely because the chief compliance officer is a lawyer. A chief compliance officer who also serves as a lawyer for the advisers will need to take care to separate the functions in order to preserve the privilege.

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.

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. 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. The SEC will generally resist divulging examination information, asserting, among other things, broad exemptions for proprietary information.

Advisers responding to requests for information from the SEC should consider requesting confidential treatment, which will provide greater assurances that the SEC will be successful in preventing third parties from obtaining examination data. All of the SEC’s enforcement actions are public and will often result in disclosure of information examination material.

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602 See SEC, Division of Enforcement, Enforcement Manual (Oct. 9, 2013).
603 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).
604 Rule 502(a) of the Federal Rules of Evidence, which applies to civil litigation as well as a federal agency proceeding.
605 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).
607 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.
3. **Types of Examinations.**

The staff is currently conducting four types of examinations:

a. **Routine Examinations.** The SEC staff conducts on-site exams of SEC-registered advisers based on an assessment of compliance risk associated with the adviser. If the SEC staff has concerns about an adviser’s internal controls, or if the adviser engages in activities the staff considers presents higher risk to clients (such as taking custody of client assets) exams will be more frequent. 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) 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.

d. **Presence Examinations.** Beginning in 2012 the staff conduct focused examinations of certain investment advisers to private funds that were required to register with the SEC in response to the Dodd-Frank Act. Although the formal program is completed, it is understood that the staff continues to conduct these examinations.

4. **Examinations of Non-U.S. Advisers**

An adviser with its principal offices and business outside the United States that is registered with the SEC is subject to examination by SEC staff. The SEC staff examines non-U.S. based advisers registered with the SEC, albeit less frequently than domestic advisers.

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608 See *Equitas Capital Advisors*, supra note 372 (adviser examined by SEC staff in 2005, 2008 and 2011; SEC ultimately brought enforcement action against adviser and CCO for multiple compliance failures).


610 The Dod-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.

611 See *Letter to Newly Registered Advisers from Drew Bowden, Deputy Director, Office of Compliance Inspections and Examinations* (Oct. 9, 2012).

612 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.
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.613

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.614

c. **Reciprocal Examinations.** In some cases, the SEC staff may request that a local national regulator provide it with information about a firm doing business outside the United States, which may result in the local regulator conducting an examination of the adviser and sharing the results with the SEC. Where an adviser is doing business in multiple countries the SEC may coordinate with multiple national regulators for the purpose of developing an overall assessment of the adviser’s practices.

The SEC has entered into memoranda of understanding with the European Union, the United Kingdom, Hong Kong and many other national regulators in which the regulators agree to permit on-site visits, share information, and provide other types of reciprocal assistance to each other with respect to advisers.615

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.616

   **Promptly Provide.** The SEC has stated that the “promptly” standard imposes no specific time limit, but it expects that a fund or adviser could delay furnishing electronically stored records for more than 24 hours only in unusual circumstances. It expects, however, that in most cases advisers will be able to (and thus must)

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613 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.”).

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


616 Wells Fargo Advisers, supra note 420 (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).
provide records “immediately or within a few hours of request.” 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.

b. **Truthful and Accurate Records and Statements**

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

> On occasion the staff of an adviser will alter or create false records to cover up a deficiency or violation of the law. Such cover-ups are viewed by the SEC staff as worse than the underlying violation and could turn a deficiency letter into an enforcement referral.

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.

6. **Focus of Examinations**

During routine examinations, examiners look particularly for evidence of the following:

a. safekeeping of client assets;
The SEC staff will seek to independently verify client account balances by contacting custodians, clients and other persons. OCIE has developed a standard form, which it will provide to such persons. 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 focus of recent SEC staff examinations has been on the effectiveness of advisers’ cybersecurity compliance and controls.

7. Results of Examination

Generally, there are three possible results from an examination.

a. The SEC staff finds no problems and sends the adviser a letter stating that the inspection is finished (a rare event!).

b. The SEC staff sends a “deficiency letter” informing the adviser of any violations or possible violations found and requests the adviser to promptly take any necessary corrective steps and notify the SEC staff of the corrective actions taken. The deficiency letter will require the adviser to respond in writing, addressing the deficiencies identified.

Failure to take corrective actions in response to a deficiency letter is cited frequently as a contributing factor in the SEC’s decision to bring an enforcement action. That being said,

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623 See OCIE Routine Account Information Confirmation.

sometimes a deficiency identified by staff will not be based on a correct application of the law or a misunderstanding of facts, and some “deficiencies” amount to suggestions rather than statements of legal obligations. Advisers responding to these letters are well-advised to consult with counsel.

The Dodd-Frank Act amended the Exchange Act to require the SEC to provide such a letter within 180 days after the later of (i) the date the SEC staff completes the on-site portion of the examination, or (ii) receives all records requested from the adviser.

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, 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) referral to criminal authorities for prosecution.

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.

Self-Regulatory Organization. Section 914 of the Dodd-Frank Act required the SEC to conduct a study of approaches to improve the frequency of examination of investment advisers. In January 2011, the SEC submitted a staff study that asserted that the SEC’s examination program requires a source of funding that is adequate to permit the SEC to meet the new challenges it faces, and sufficiently stable to prevent adviser examination resources from periodically being outstripped by growth in the number of registered investment advisers. To accomplish this, the staff recommended that Congress consider


626 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.

627 In a number of enforcement cases, the SEC identifies the failure of the adviser to address deficiencies identified during multiple examination. See, e.g., Du Pasquier & Co., Inc., Advisers Act Rel. No. 4004 (Jan. 21, 2015) (recurring violations identified in multiple examinations); Consultiva Internacional, Inc., Advisers Act Rel. No. 3441 (Aug. 3, 2012) (same).

628 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 pleaded 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.

629 See Equitas Capital Advisor, LLC, supra note 372 (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).
the following three approaches to strengthen the SEC’s investment adviser examination program:

1. Authorize the SEC to impose user fees on SEC-registered investment advisers to fund their examinations by OCIE;

2. Authorize one or more SROs to examine, subject to SEC oversight, all SEC-registered investment advisers; or

3. Authorize FINRA to examine dual registrants (i.e., firms registered with the SEC as both advisers and broker-dealers) for compliance with the Advisers Act.630

Competing legislation was introduced in 2012 to authorize the SEC to designate an SRO for investment advisers,631 and to authorize the SEC to fund adviser examinations through user fees.632 Neither was enacted.

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630 Study on Enhancing Investment Adviser Examinations.

STROOCK & STROOCK & LAVAN LLP
### Appendix A

**Applicability of Provisions and Rules**

|                             | Registered Advisers | Exempt Reporting Advisers | Unregistered Advisers
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<tbody>
<tr>
<td><strong>Fiduciary Obligations</strong></td>
<td>Yes</td>
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<tr>
<td><strong>Principal Trade Restrictions</strong></td>
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<td><strong>Agency Cross Transactions</strong></td>
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<td><strong>Cash Solicitation Rule</strong></td>
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<td><strong>Proxy Voting Rule</strong></td>
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<td><strong>Duty to Supervise</strong></td>
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<td><strong>Compliance Rule</strong></td>
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<td><strong>Code of Ethics Rule</strong></td>
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<td><strong>Pay to Play Rule</strong></td>
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<td><strong>Fraud Against Investors in Pooled Investment Vehicles</strong></td>
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<td><strong>Insider Trading Policies and Procedures</strong></td>
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<td><strong>Beneficial Reporting on Schedules 13D and G</strong></td>
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<td>Yes</td>
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<tr>
<td><strong>Contractual Requirements (including performance fee restrictions)</strong></td>
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1. State laws may impose similar obligations on advisers registered with a state.
2. Except state-registered advisers. See supra Section VI.B.4.
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.