A SURVEY OF REGULATIONS APPLICABLE TO INVESTMENT ADVISERS

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1. Introduction 27
2. A Bit of History 28
3. The Golden Rule 28
4. The Advisers Act's Structure 29
   A. *Sections and Rules* 29
   B. *Proposing and Adopting Releases for SEC Rules* 29
   C. *SEC Staff Letters, FAQ Responses, and Administrative Proceedings* 30
5. An Overview of Selected Regulations 33
   A. *The Advisers Act* 33
   B. *The Securities Act of 1933* 36
   C. *The Securities Exchange Act of 1934* 37
   D. *The Investment Company Act of 1940* 38
   E. *The Employee Retirement Income Security Act of 1974* 38
   F. *Regulation S-P* 38
6. Parting Thoughts 39

1. Introduction

When I joined the Securities and Exchange Commission in 2003 they asked me for a three-year commitment. I was told that it took at least a year for a new examiner to learn enough to become useful in the field, and the SEC wanted to lock in a return on its investment. After spending more than five years focused on the regulation of investment advisers I am still learning new things, so a single article cannot possibly cover everything that a practitioner needs to know.

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Instead, this article is meant to be a useful introduction. Because many complicated issues have been greatly simplified, investment advisers dealing with potential regulatory issues should consult with experienced professionals and should not rely solely on this overview.

2. A Bit of History

Following the excessive speculation of the 1920s and the suffering of the Great Depression, Congress passed several laws in an effort to curb financial fraud and other illegal and unethical activities. The Securities Act of 1933 (governing the issuance of stocks, bonds, and other types of securities), the Securities Exchange Act of 1934 (creating the SEC and also governing broker-dealers and trading activities), the Investment Company Act of 1940 (governing mutual funds and other pooled investment vehicles), and the Investment Advisers Act of 1940 ("Advisers Act") (governing investment advisers) were all passed with the stock market crash of 1929 looming large in the rear-view mirror. Of these four statutes, investment advisers are most affected by the Advisers Act. However, this article will also touch on other regulations as they relate to investment advisers. Notably, the term "investment adviser," when used in a regulatory context, relates to companies that provide investment advice, rather than the individuals who work for those companies.

3. The Golden Rule

Any analysis of the regulations that apply to investment advisers should be prefaced with a mention of the Supreme Court's 1963 decision in the case of *SEC v. Capital Gains Research Bureau, Inc.*[1] The Court stated in its opinion that investment advisers owe a fiduciary duty to their clients.[2] Pursuant to this duty, an investment adviser must act with prudence and diligence, place the interests of clients ahead of its own interests, and disclose any conflict of interest between itself and its clients. An investment adviser's fiduciary duty has profound implications for the interpretation and application of specific regulations described in this overview.

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1. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).
2. *Id.* at 194.

4. The Advisers Act's Structure

A. *Sections and Rules*

The Advisers Act is divided into *sections* that relate to particular topics, many of which are relatively broad.[3] For example, Section 204A requires investment advisers to maintain policies and procedures that have been designed to prevent insider trading.[4] This section does not prescribe any specific policies or procedures; it simply states that they should be "reasonably designed."[5]

Congress included language in some sections of the Advisers Act that gives the SEC the authority to establish associated *rules* consistent with Congress' intentions. The SEC can use this authority to adopt specific rules that supplement the general guidelines contained in the Advisers Act's sections. To continue the example noted above, in 2004 the SEC adopted Rule 204A-1 requiring all registered investment advisers to adopt codes of ethics containing five particular provisions that, among other things, are designed to prevent and detect insider trading by employees.[6]

Notably, an investment adviser could be in compliance with technical rules adopted by the SEC, but still violate a section of the Advisers Act enacted by Congress. For example, depending on an investment adviser's exposure to inside information, a code of ethics could contain all five of the provisions required by Rule 204A-1, but still not be "reasonably designed" to prevent insider trading as required by Section 204A. A good compliance program should be designed to comply with both the letter and the spirit of all applicable regulations.

B. *Proposing and Adopting Releases for SEC Rules*

The 1946 Administrative Procedure Act requires federal agencies to follow standardized rulemaking procedures.[7] When the SEC is considering enactment of a new rule it will generally issue a *Proposing Release* describing the rule and the problems it is designed to ad-

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3. *See* Investment Advisers Act of 1940 §§ 201-221, 15 U.S.C. §§ 80b(1-21) (2006).

4. Advisers Act § 204A, 15 U.S.C. § 80b(4a).

5. *Id.*

6. SEC Investment Adviser Code of Ethics, 17 C.F.R. § 275.204A-1 (2009).

7. Administrative Procedure Act (APA) of 1946, 5 U.S.C. §§ 551-559, 701-706, 1305, 3105, 3344, 5362, 7521 (2006).

dress.[8] After a rule has been proposed, the public can submit comments supporting or opposing the rule. This comment period is an opportunity for industry participants to share their opinions as to whether the proposed rule should be adjusted to avoid unintended consequences or loopholes. The SEC will consider any comments and then vote on whether to adopt the new rule, either as proposed or with amendments.

When a new rule is adopted the SEC issues an *Adopting Release* that describes the rule, the problems it is designed to address, any comments that were received after the rule's proposal, and any changes implemented in response to those comments.[9] The Proposing and Adopting Releases are important sources of information for investment advisers because they explain a rule's intended functioning. For example, Rule 204A-1 does not explicitly require an investment adviser to train its employees about the code of ethics, but the associated Adopting Release gives an indication of the SEC's expectations, stating:

> Although we [the SEC] do not believe it is necessary to require employee education as an element of codes of ethics, we expect most advisory firms will ensure that their employees have received adequate training on the principles and procedures of their codes.[10]

Investment advisers often refer to Proposing and Adopting Releases when there is a question about the implementation of an SEC rule.

C. *SEC Staff Letters, FAQ Responses, and Administrative Proceedings*

Some of the rules adopted by the SEC can be difficult to interpret because they are broadly written. For instance, Rule 206(4)-1(a)(5) under the Advisers Act prohibits any advertisement that "contains any untrue statement of a material fact, or which is otherwise false or mis-

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8. *See* APA Rulemaking, 5 U.S.C. § 553.

9. *See id.*

10. SEC Investment Adviser Codes of Ethics, 69 Fed. Reg. 41,696, 41,700 (July 9, 2004); Advisers Act Release No. 2,256, Company Act Release No. 26,492 (Aug. 31, 2004), *available at* http://www.sec.gov/rules/final/ia-2256.htm.

leading."[11] In certain instances it may be unclear whether an advertisement is misleading and therefore prohibited by the rule. For example, if a portfolio manager terminates his employment with Investment Adviser X and joins Investment Adviser Y, can he or she advertise the performance achieved at Investment Adviser X when seeking new clients for Investment Adviser Y? Continuing this example, does the analysis change if the portfolio manager was part of a team at Investment Adviser X, but will be the sole decision maker at Investment Adviser Y? What if the records that are necessary to demonstrate the relevant performance are retained by Investment Adviser X and are not available to Investment Adviser Y?

When the correct interpretation of an Advisers Act section or rule is in question, an investment adviser can write to the SEC's Division of Investment Management for guidance. The adviser typically describes the course of action it would like to pursue and explains why this course of action is believed to be within the spirit of the law. The Division of Investment Management will consider the question and, depending on its analysis, may respond with a public letter. In some cases the Division of Investment Management will decide, based on the relevant facts and circumstances, that it would not recommend an enforcement action by the SEC's Division of Enforcement if the investment adviser follows the proposed course of action. These public letters, which are often called "no-action letters" or "interpretive letters," can then be considered by other investment advisers that are grappling with similar questions. For example, letters issued to *Great Lakes Advisors*[12] in 1992 and *Horizon Asset Management, LLC*[13] in 1996 provide specific guidance about the preceding example involving a portfolio manager advertising his or her track record from Investment Adviser X after joining Investment Adviser Y.

While some rules adopted by the SEC are difficult to interpret because they are broadly written, others present challenges because they are particularly complicated. For example, Rule 206(4)-2 under the

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11. SEC Advertisements by Investment Advisers, 17 C.F.R. § 275.206(4)(1)(a)(5) (2009).

12. Great Lakes Advisors, SEC No-Action Letter, 1992 WL 105179 (Apr. 3, 1992).

13. Horizon Asset Mgmt., SEC No-Action Letter, 1996 WL 554956 (Sept. 13, 1996).

Advisers Act governs the safekeeping (or "custody") of client assets.[14] Assets are often held by banks or broker-dealers, but this is not always the case and different types of assets may be held in different ways. The rule also includes several exceptions, as well as one exception to an exception! Needless to say, its interpretation can be challenging depending on the relevant facts and circumstances. Shortly after Rule 206(4)-2 was adopted, the SEC's Division of Investment Management published 11 pages of responses to certain frequently asked questions.[15] Like no-action and interpretive letters, FAQ responses do not carry the same weight as the Advisers Act or the associated rules but they are informative nonetheless.

It has been said that any fool can learn from his or her own mistakes, but if you are really smart you will learn from other people's mistakes. This principle can be applied to the regulation of investment advisers, as the SEC is required by federal statute to publish summaries of its administrative proceedings (also known as "enforcement actions"). These proceedings serve to put the community of investment advisers on notice about the kinds of activities that the SEC finds unacceptable. As an example, § 206 of the Advisers Act prohibits practices that are fraudulent or deceptive to an investment adviser's clients and prospects.[16] This important prohibition is broadly written and broadly interpreted, so it is sometimes difficult to determine whether particular practices would be considered violations. Does § 206 prohibit, for example, an investment adviser from trading its clients' accounts through a broker-dealer that has referred clients to the investment adviser? What if the investment adviser could obtain better trade execution from a different broker-dealer, but chooses to use the inferior broker-dealer in order to preserve the referral arrangement? In 1988 the SEC settled an administrative proceeding against Mark Bailey & Co. for failing to give clients sufficient disclosure about this type of referral arrangement.[17] Investment advisers that are contemplating a referral arrangement with a broker-dealer can

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14. SEC Custody of Funds or Securities of Clients by Investment Advisers, 17 C.F.R. § 275.206(4)(2) (2009).

15. SEC Staff Responses to Questions About Amended Custody Rule, http://www.sec.gov/divisions/investment/custody_faq.htm (last visited Nov. 30, 2009).

16. Advisers Act § 206, 15 U.S.C. § 80b(6).

17. Mark Bailey & Co., Advisers Act Release No. 1105, 1988 WL 901756 (Feb. 24, 1988).

now use the terms of the settlement discussed in *Bailey* to better understand the interpretation of Section 206. It is important to note that administrative proceedings are often highly dependent upon the relevant facts and circumstances, and that the respondents in these proceedings generally do not admit or deny the SEC's findings as part of the settlements.

SEC staff letters, FAQ responses, and administrative proceedings can provide important context when interpreting the Advisers Act and associated rules. A good place to find relevant no-action letters is: http://www.sec.gov/divisions/investment/im-noaction.shtml. However, at the time of publication this website only included letters issued after the mid-1990s. Obtaining other types of interpretive guidance, or older staff letters, often requires experience and at least a little bit of digging.

5. An Overview of Selected Regulations

As noted previously, investment advisers tend to be most concerned about compliance with the Advisers Act and its associated rules, but the Securities Act, the Securities Exchange Act, and the Investment Company Act can also have important implications for investment advisers. This section will highlight some of the specific regulations that are often applicable to investment advisers.

A. *The Advisers Act*

Section 202 presents definitions that are used throughout the Advisers Act. Notably, "person" can mean a natural person or a company, and "security" is broadly defined to include many different types of investment vehicles.[18] Section 202 also defines the term "investment adviser." [19] Determinations as to whether an entity is an investment adviser can be challenging depending on the relevant facts and circumstances.

Sections 203 and 203A describe the types of investment advisers that must register with the SEC, and also divide responsibility for regulating investment advisers between the federal government and the states.[20] An investment adviser with $30 million or more in assets

18. Advisers Act § 202(a)(16-18), 15 U.S.C. § 80b(2)(a)(16-18).
19. *Id.* § 202(a)(11).
20. *Id.* §§ 203-203A.

under management may need to register with the SEC, while a smaller adviser may instead need to register with the state where it maintains its principal office. Paragraph (b)(3) of § 203 states that an adviser with 14 or fewer clients need not register with the SEC so long as it does not: (i) hold itself out publicly as an investment adviser; or (ii) manage a registered investment company (such as a mutual fund).[21] Paragraph (b)(3) is often referred to as the "Private Adviser Exemption," and, at the time of this writing, is available to investment advisers with any amount of assets under management.[22]

Section 204 gives the SEC authority to require investment advisers to maintain certain records and make certain filings, and also gives the SEC examination authority over all of an investment adviser's records.[23] Rule 204-2 lists a large number of records that a registered investment adviser must create and maintain.[24] Rule 204-3 requires registered investment advisers to provide all clients with certain important disclosures at the inception of the relationship, and also to offer the disclosures at least annually thereafter.[25]

Section 204A requires an investment adviser to adopt and implement policies and procedures that have been reasonably designed to prevent insider trading.[26] Rule 204A-1 requires a registered investment adviser to adopt and implement a written code of ethics with five specific provisions that, among other things, call for employees to disclose their personal securities transactions.[27]

Section 205 governs contracts between investment advisers and their clients.[28]

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21. *Id.* § 203(b)(3).

22. *See* Phillip Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006) (United States Court of Appeals found that when an investment adviser manages a privately offered pooled investment vehicle (or "hedge fund"), only the fund counts as a client of the adviser; investors in that fund are not clients). This decision limited the SEC's ability to regulate hedge fund managers, and also distinguished between the duties owed to a hedge fund and those owed to investors in the fund. Recent hedge fund frauds may prompt Congress to amend the Private Adviser Exemption or otherwise expand the SEC's authority over hedge fund managers.

23. Advisers Act § 204, 15 U.S.C. § 80b(4).

24. SEC Books and Records to be Maintained by Investment Advisers, 17 C.F.R. § 275.204-2 (2009).

25. SEC Written Disclosure Statements, 17 C.F.R. § 275.204-3 (2009).

26. Advisers Act § 204A, 15 U.S.C. § 80b(4a).

27. 17 C.F.R. § 275.204A-1.

28. Advisers Act § 205.

Section 206 prohibits an investment adviser from engaging in activities that are fraudulent or deceptive to any client or prospect.[29] Paragraph (1) makes it unlawful to "employ any device, scheme, or artifice to defraud," while paragraph (2) makes it unlawful to "to engage in any transaction, practice, or course of business which operates as a fraud or deceit."[30] In other words, scienter is a component of paragraph (1), but it need not be present for a violation of paragraph (2) to occur.

Paragraphs (1) and (2) of § 206 implicitly impose certain obligations on investment advisers that are not explicitly described in any other section or rule of the Advisers Act. For example, investment advisers must value securities in client accounts fairly, and in a manner that is consistent with disclosures to clients. There is no particular rule governing the appropriate way(s) to value securities, but the SEC will not hesitate to take enforcement action against investment advisers that artificially inflate the value of clients' portfolios or otherwise act in ways that deviate from their disclosures.

Paragraph (3) of § 206 imposes disclosure and consent obligations on any investment adviser (whether or not it is registered with the SEC) seeking to engage in principal trades and agency cross trades, which are two particular types of transactions that Congress found to pose particular compliance risks.[31] Paragraph (4) gives the SEC authority to prescribe additional anti-fraud rules as necessary.[32] There are currently seven such rules in effect, all of which are described below.

Rule 206(4)-1 prohibits certain types of advertisements that the SEC has defined to be false or misleading.[33]

Rule 206(4)-2 governs the protection of client assets from loss or misappropriation.[34]

Rule 206(4)-3 requires prospective clients to receive certain disclosures when they are referred by an entity that has been paid to make the referral (often called a "solicitor").[35]

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29. *Id.* § 206.
30. *Id.* § 206(1-2).
31. *Id.* § 206(3).
32. *Id.* § 206(4).
33. SEC Advertisements by Investment Advisers, 17 C.F.R. § 275.206(4)(1) (2009).
34. SEC Custody of Funds or Securities of Clients by Investment Advisers, 17 C.F.R. § 275.206(4)(2) (2009).

Rule 206(4)-4 imposes an affirmative disclosure obligation for registered investment advisers that experience financial distress or a material legal or disciplinary event.[36]

Rule 206(4)-6 requires the adoption of written policies and procedures and the provision of certain disclosures about the voting of proxies associated with securities held in client accounts.[37]

Rule 206(4)-7 is referred to as the Compliance Program Rule and requires the: (i) adoption of reasonably designed written compliance policies and procedures; (ii) performance of a comprehensive review of the investment adviser's compliance program at least annually; and (iii) the appointment of a chief compliance officer who is responsible for administering the compliance program.[38]

Rule 206(4)-8 prohibits fraudulent, deceptive, and manipulative practices involving investors in privately offered pooled investment vehicles.[39]

Section 208(d) prohibits any person from doing anything indirectly if it would be unlawful to do that same thing directly. In other words, an investment adviser cannot evade the Advisers Act through the creation of sham legal entities or transactions.[40]

Sections 209, 213, 214, and 217 describe the SEC's authority to take enforcement action in connection with violations of the Advisers Act.[41]

B. *The Securities Act of 1933*

Although the Securities Act of 1933 ("Securities Act")[42] imposes many obligations on issuers of securities, it has limited applicability to most investment advisers.

Notably, interests in private funds (or "hedge funds") are securities that could require registration under the Securities Act. However,

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35. SEC Cash Payments for Client Solicitations, 17 C.F.R. § 275.206(4)(3) (2009).

36. SEC Financial and Disciplinary Information that Investment Advisers Must Disclose to Clients, 17 C.F.R. § 275.206(4)(4) (2009).

37. SEC Proxy Voting, 17 C.F.R. § 275.206(4)(6) (2009).

38. SEC Compliance Procedures and Practices, 17 C.F.R. § 275.206(4)(7) (2009).

39. SEC Pooled Investment Vehicles, 17 C.F.R. § 275.206(4)(8) (2009).

40. Advisers Act § 208(d).

41. *See* Advisers Act §§ 209, 213, 214, 217.

42. *See* Securities Act of 1933 §§ 1-28, 15 U.S.C. §§ 77a-77aa (2006).

§ 4(2) of the Securities Act exempts "transactions by an issuer not involving any public offering."[43] Section 4(2) can be difficult to interpret, so many private funds rely on Rule 506 of Regulation D, which includes more specific guidance and provides a safe harbor for compliance with Section 4(2).[44] Interests sold outside of the U.S. may also be exempt from the Securities Act's registration requirements pursuant to Regulation S.[45]

C. *The Securities Exchange Act of 1934*

The Securities Exchange Act of 1934 ("Securities Exchange Act") primarily relates to securities transactions placed by broker-dealers.[46] However, certain provisions of this act have direct implications for investment advisers. Insider trading cases, including cases against investment advisers and their employees, are often prosecuted under § 10(b) of the Exchange Act[47] and Rule 10b-5[48] thereunder. Investors who hold significant interests in a public company's stock (generally more than 5%) may need to make public filings about their positions pursuant to § 13(d) of the Exchange Act. Also, in a 1986 Securities Exchange Act interpretive release,[49] the SEC described an investment adviser's duty to seek best execution when trading clients' accounts, as well as permissible and prohibited uses of soft dollars.[50] Finally, in response to the market events of 2008, the SEC instituted several interim short selling restrictions and reporting requirements. More permanent short selling restrictions or reporting requirements may be forthcoming pursuant to the SEC's rulemaking authority under the Exchange Act.

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43. Securities Act § 4(2), 15 U.S.C. § 77d(2) (2006).

44. SEC Exemption for Limited Offers and Sales Without Regard to Dollar Amount of Offering, 17 C.F.R. § 230.506 (2009).

45. *See* 17 C.F.R. §§ 230.901-04 (2009).

46. *See* Securities Exchange Act of 1934 §§ 1-38, 15 U.S.C. §§ 78a-78nn (2006).

47. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2006).

48. SEC Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2009).

49. Scope of Section 28(e), Exchange Act Release No. 34-23,170, 51 Fed. Reg. 16,004-01, 1986 WL 95666 (Apr. 30, 1986).

50. Section 28(e) of the Exchange Act permits an investment adviser, under certain limited circumstances, to enter into "soft dollar" arrangements whereby portions of clients' commission payments are used to purchase investment-related research.

D. *The Investment Company Act of 1940*

The Investment Company Act of 1940 ("Investment Company Act") regulates publicly offered investment pools, which today are generally referred to as "mutual funds."[51] Section 3 of the Investment Company Act provides two important exemptions from the definition of an "investment company:" § 3(c)(1) exempts private funds with no more than 100 owners and § 3(c)(7) exempts private funds that are only offered to wealthy "qualified purchasers" (as defined in § 2 of the act).[52] Hedge funds generally rely on these exemptions to avoid the Investment Company Act's significant regulatory requirements.

E. *The Employee Retirement Income Security Act of 1974*

The Employee Retirement Income Security Act of 1974, commonly known as ERISA, is administered by the Department of Labor. This act imposes special restrictions on the treatment of pension and retirement plan assets.[53] Private funds can generally avoid the compliance obligations set forth in ERISA by accepting a de minimus number of investors that are subject to ERISA.

F. *Regulation S-P*

In 2000 the SEC adopted Regulation S-P, which is designed to prevent investment advisers, broker-dealers, and investment companies from inappropriately disclosing consumers' nonpublic personal information.[54] Entities subject to Regulation S-P must adopt and implement policies and procedures that are reasonably designed to protect this information and must also make periodic disclosures to consumers about the ways in which their nonpublic information may be used.[55]

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51. Investment Company Act of 1940 §§ 1-65, 15 U.S.C. §§ 80a(1-64) (2006).
52. Investment Company Act §§ 3(c)(1), 3(c)(7).
53. *See* Employee Retirement Income Security Act of 1974, 29 U.S.C. 1001 et seq., (2006).
54. SEC Regulation S-P, 17 C.F.R. pt. 248 (2009).
55. *Id.*

6. Parting Thoughts

In 2003 the SEC adopted the Compliance Program Rule,[56] which made explicit the SEC's expectation that registered investment advisers maintain robust compliance programs.[57] Each registered investment adviser must have an informed and empowered Chief Compliance Officer and must adopt, implement, and periodically review policies and procedures that are appropriate relative to its operations and compliance risks.[58] A good compliance program administered by an effective Chief Compliance Officer will help to protect the investment adviser, its clients, and the broader capital markets. If you have an interest in the regulation of investment advisers then there is still a lot to learn. An excellent place to start is the Compliance Program Rule's adopting release.[59]

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56. SEC Compliance Procedures and Practices, 17 C.F.R. § 275.206(4)-7 (2009).
57. *Id.*
58. *Id.*
59. SEC Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 74,714 (Dec. 24, 2003); Advisers Act Release No. 2,204, Company Act Release No. 26,299 (Feb. 5, 2004), *available at* http://www.sec.gov/rules/final/ia-2204.htm.