Introduction to the Investment Advisers Act of 1940

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Topics that we will cover

• Who is an Adviser
• SEC Oversight
• Overview of Regulatory Structure
• The Advisory Business
• Registration Under the Advisers Act
• Disclosure Requirements
• Conduct Standards
• Compliance
• Applicability of State Securities Law
Who is an Adviser?

Background
Section 202 (a) (11) of the Investment Advisers Act defines an investment adviser as:
any person who, for compensation, engages in the business of advising others, either
directly or through publications or writings, as to the value of securities or as to the
advisability of investing in, purchasing, or selling securities or who, for compensation and as
part of a regular business, issues or promulgates analyses or reports concerning
securities.

The definition consists of three critical elements as follows:
- entity must be engaged “in the business” of providing advice to others.
- the advice must be with respect to securities
- the advice must be provided in return “for compensation”

Exclusions:
The definition excludes certain persons and entities from the Advisers Act coverage. The
exclusions include:
- Banks and Bank Holding Companies
- Lawyers, Accountants, Engineers & Teachers
- Broker-Dealers
- Publishers & Authors
Broker-Dealer Exception

- Not all broker-dealer advisory activities are subject to the Advisers Act; Section 202(a)(11)(C) of the Advisers Act provides an exception for broker-dealers from the definition of investment adviser.
- In order to rely upon the 202 (a)(11)(C) Broker-Dealer Exception:
  - The advice must be solely incidental to the firm’s brokerage activities
  - The broker-dealer may not receive “special compensation” for the investment advice

- The exception recognizes that broker-dealers “commonly give a certain amount of advice to their customers in the course of their regular business and that it would be inappropriate to bring them within the scope of the [Advisers Act] merely because of this aspect of their business. Advisers Act Release 2 (October 28, 1940).

- Registered representatives may rely on this exclusion (if the registered representative is acting within the scope of employment with the brokerage firm, with the knowledge and consent of the firm, and fully subject to its control).

- Section 202 (a)(11)(C) has not evolved to keep pace with the evolution of broker-dealer advisory services. The SEC adopted rule 202 (a)(11)-1 in April 2005 with a view to updating the scope of the exception with respect to:
  - Fee-based brokerage accounts
  - Financial planning services
  - Discretionary brokerage accounts

- Rule 202 (a)(11)-1 aftermath; where we are today
Exclusion for Publishers/Authors

- Publishers of a bona fide newspaper, news magazine or business or financial publication of general and regular circulation are excluded.

- In 1985, the scope of the exclusion was given greater certainty by the United States Supreme Court in Lowe v. SEC.
  - Impersonal Advice as opposed to tailored.
  - Disinterested as opposed to promotional material disseminated by a “tout”.
  - Publication must be of regular and general circulation.
  - Current treatment of newsletters.
SEC Oversight – Division of Investment Management

- Handles investment adviser registrations
- Proposes and issues rules and forms
- Issues no-action letters
- Evaluates and issues orders of exemption
- Develops policy to assist Commission
- Coordinates with other offices/divisions
- Staff interacts with other regulators
Office of Compliance Inspection and Enforcement; Enforcement Division

• OCIE implements statutory authority to examine and review advisers.
• Enforcement through Asset Management Unit actively follows up on tips, leads and referrals from inside and outside the SEC to bring cases against advisers and associated individuals/entities.
FINRA/SRO

- There is no Adviser SRO
- FINRA Regulates Broker-Dealers- and in that regard reviews certain aspect of broker-dealers advisers activity.
- FINRA has positioned itself (somewhat) as an Adviser SRO.
Research in the Advisers Act

- Reflects Regulatory Structure
- Advisers Act – Section versus U.S.C
  - Section 206 (Prohibited Transactions)/15 U.S.C. 80b-6
- Private Rights of Action are Limited
- Conduct Shaped by Fiduciary Duty
  - Enforcement Actions Very Important as Source of Law
- SEC Rules (Proposed and Final Rulemaking Releases)
- SEC No-Action letters
- SEC Exemptive Orders (Less Frequent than ICA)
- Interpretative Releases
- IM Staff Updates/ Guidance
Research in Advisers Act

- **FINRA**
  - NASD Notice to Members
  - FINRA Regulatory Notice
- **Trade Groups**
  - Investment Advisers Association (“IAA”)
  - Investment Company Institute (“ICI”)
  - National Society of Compliance Professionals (NSCP)
- **Secondary sources**
  - Treatises
- **Publications**
  - The Investment Lawyer
  - Compliance Reporter
Sources for Following Developments

• Sec.gov
  ▪ Concept releases
  ▪ Proposed rules
  ▪ No-Action Letters; Staff Guidance (Under Division of Investment Management Tab)
  ▪ Speeches by commissioners and Head of Division of Investment Management; OCIE

• Many news services available online
  ▪ BNA Securities Regulation and Law Report
Overview of Regulatory Structure

The Statute
Sec. 203. Registration of Investment Advisers.
Sec. 203A. State and Federal Responsibilities.
Sec. 204. Annual and Other Reports.
Sec 204A. Prevention of Misuse of Nonpublic Information.
Sec. 205. Investment Advisory Contracts.
Sec. 206. Prohibited Transactions by Registered Investment Advisers.
Sec. 206A. Exemptions.
Sec. 222. State Regulation of Investment Advisers.
Rulebook
202(a)(1)-1 Certain transactions and deemed assignments.
202 (a)(11)(g) -Family offices
202(a)(30) Foreign private advisers
203-1 Application for investment adviser registration
203-2 Withdrawal from investment adviser registration
203-3 Hardship exemptions
203(1)-1 Venture capital fund defined
203a-1 Eligibility for SEC registration; Switching to or from SEC registration
203a-3 Definitions
203a-5 Transition rules
204-1 Amendments to Form ADV
204-2 Books and records to be maintained by investment advisers
204-3 Delivery of brochures and brochure supplements
204-4 Reporting by exempt reporting advisers
204(b)-1 Reporting by investment advisers to private funds
204a-1 Investment advisers codes of ethics
205-1 Definition of “investment performance” of an Investment company and “investment record” of an appropriate index of securities prices.
Rulebook -- Continued

205-2 Definition of “specified period” over which the asset value of the company or find under management is averaged.
205-3 Exemption from the compensation prohibition of section 205(a)(1) for investment advisers
206(3)-1 Exemptions of investment advisers registered as broker-dealers in connection with the provision of certain investment advisory services.

206(3)-3t Temporary rule for principal trades with certain advisory clients.
206(3)-2 Agency cross transactions for advisory clients

206(4)-1 Advertisements by investment advisers
206(4)-2 Custody of funds or securities of clients by investment advisers
206(4)-3 Cash payments for client solicitations
206(4)-4 [Reserved]
206(4)-5 Political contributions by certain investment advisers
206(4)-6 Proxy voting
206(4)-7 Compliance procedures and practices
206(4)-8 Pooled investment vehicles

222-1 Definitions
222-2 Definition of “client” for purposes of the national de minimis standard.
Overview of Regulatory Structure (cont’d)

- Other Regulatory Frameworks Come Into Play
  - The State Law Framework
  - The Investment Company Act of 1940
  - ERISA
  - CFTC
  - OCC
  - FINRA
The Advisory Business

• Advisers come in various shapes and sizes - individuals and entities can be advisers

• Various Business Structures
  ▪ Stand-Alone Advisers
  ▪ Subsidiary of Larger Organization

• Distinguish By:
  ▪ Client Base (Retail; Institutional; Private Funds)
  ▪ Activity (Financial Planning; Portfolio Management)
    ▪ Discretionary versus Non-Discretionary
  ▪ Registration Type (SEC v. State)
Broker-Dealer Dual Registrants

Many firms are dually registered with the SEC as investment advisers and as broker-dealers, and are subject to two different, and sometimes overlapping regulatory schemes. The application of these laws to a dually registered firm depends on whether the firm is acting as a broker-dealer or as an investment adviser with respect to a particular client, product or transaction.

- Whether adviser or broker-dealer rules apply? A Broker-dealer can distinguish broker-dealer clients from advisory clients.

- Type of compensation involved is key in distinguishing if broker-dealer or investment adviser rules will apply.
Registration Under the Investment Advisers Act

• Registration under the Advisers Act is effected by filing the Form ADV with the SEC and paying a fee.

• A distinction needs to be made between the adviser itself and individuals with the adviser.
  ▪ Registration is required of the adviser itself
  ▪ Individuals associated with the adviser (which includes employees and those otherwise associated) are not separately registered as advisers.
  ▪ These individuals are typically “investment advisory representatives” or “associated persons of the adviser.” (States refer to as “IARs” – on the BD side of states refer to these individuals as “Agents”).
Registration Under the Investment Advisers Act (cont’d)

• The Form ADV consists of two parts.
• Part 1 is principally for use by regulators.
• Part 2A (The “Brochure”) serves as the basis for the disclosure document the adviser must provide to each of its advisory clients.
• Part 2B (The “Brochure Supplement”) is provided to clients with respect to certain advisory personnel.
Conduct Standards/Restrictions on Activities

• An adviser’s conduct is shaped first and foremost by the fiduciary duty it owes clients.

• Section 206 of the Advisers Act contains the anti-fraud provisions of the Advisers Act. That section provides that it is unlawful for an adviser directly or indirectly to:
  - employ any device, scheme, or artifice to defraud any client or prospective client (Section 206 (1));
  - engage in any transaction, practice, or course of business that operates as a fraud or deceit upon any client or prospective client (Section 206(2)); and
  - engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative (Section 206(4)).
In *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, the Supreme Court noted that in applying the antifraud provision, an adviser is to be held to a fiduciary standard. This fiduciary standard will guide an adviser throughout its course of conduct.

- Among the most important requirements of Sections 206(1) and (2) is making full and adequate disclosure to clients regarding matters that may have an impact on the adviser’s independence and judgment.
Conduct Standards/Restrictions on Activities (cont’d)

- The Advisers Act restricts certain specific activities that may be grouped into the following categories:
  - Attracting Clients;
  - Components of the Advisory Relationship;
    - The Advisory Contract
    - Compensation
    - Suitability
    - Custody
    - Proxy Voting
  - Brokerage Transactions and Trading Practices.
  - Interactions with Municipalities: Pay to Play Practices
Attracting Clients

• **Advertising**
  
  Rule 206 (4)-1 is the primary rule covering advertising under the Advisers Act. The Rule includes four specific categories of misleading advertising and one catchall provision.
Attracting Clients (cont’d)

The most significant of the four specific categories are:

- No Testimonials
- Past Specific Recommendations (can not refer to successful securities recommendations without referring to unsuccessful recommendations)
- The catch-all category prohibits the use of any advertisement that “contain any untrue statement of a material fact, or which is otherwise false or misleading.”
- One particular kind of advertising - performance advertising - has been the source of many interpretative questions under the catch-all category.
  - Clover Capital Line of No-Action Letters
Attracting Clients (cont’d)

• Referral Fees

Many advisers rely on parties providing referrals – commonly known as “solicitors” – as sources of new business. Adviser cash payments to solicitors are governed by Rule 206 (4)-3

- Written agreement between solicitor and adviser is required
- Disclosure statement must be provided to the client and a signed acknowledgement received from the client when the solicitor is not affiliated with the adviser.
- Different treatment for affiliated versus unaffiliated third party solicitors.
The Adviser-Client Relationship

• **Advisory Agreements**
  - Every advisory agreement with a client must provide, in substance, that the adviser may not assign the agreement without the client’s consent.
• **Compensation**

Generally, advisers are given wide latitude in structuring advisory fees, except for performance fees.

- The prohibition against the deduction of performance fees is contained in Section 205 (a) (1) of the Advisers Act.

- Exceptions to the performance-fee prohibition
  - Asset-based fees
  - Fulcrum fees (popular arrangement with mutual funds. Allows adviser to adjust its base fee up or down depending on performance of the fund compared to an index)
  - Wealthy client (Rule 205-3)
  - Qualified Purchaser Fund
  - Foreign Clients
The Adviser- Client Relationship (cont’d)

• **Suitability**

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.
The Adviser- Client Relationship (cont’d)

• **Custody**
  - The Advisers Act imposes various requirements when an adviser maintains custody of client assets.
  - A registered adviser that holds, directly or indirectly, client funds or securities or has authority to obtain possession of clients’ funds or securities, is deemed to have “custody” of those funds or securities. Rule 206(4)-2 establishes standards that apply when an adviser has or is deemed to have custody.
    - Qualified custodian
    - Delivery of account statements
    - Surprise Audit; Internal Control Report (if custody by adviser or affiliate).
    - Special rules for pooled investment vehicles
• Proxy Voting
  - Rule 206 (4)-6 provides that Proxy voting policies and procedures must be adopted that are reasonably designed to ensure that the adviser votes proxies relating to clients’ securities in the best interest of clients.
Brokerage and Trading Practices

• **Duty of Best Execution**

As a fiduciary, an adviser is required to carry out its selection of brokers subject to the standard of “best execution.”

The advisory contract typically specifies whether the adviser or the client will be responsible for selecting the broker to execute orders on behalf of the client.
• **Soft Dollars**

  - As fiduciaries, advisers should negotiate with broker-dealers for lower commissions for its clients. In practice, brokers are reluctant to lower their usual commissions to clients, instead providing rebates that are paid in kind (by “soft” dollars) rather than in cash. An advisers’ receipt of soft dollars could constitute a breach of the adviser’s fiduciary duty.

  - The limits of Section 28 (e) have been addressed in various SEC releases and letters.

  - Section 28 (e) of the Securities Exchange Act of 1934 provides that advisers fall within the safe harbor when they pay more than the lowest available brokerage commissions if they receive research and benefits from the brokers.

  - Safe harbor: research, brokerage, and “mixed-use”
Trading

Section §206 (3) of the Advisers Act restricts advisers from acting in ways in which the advisers’ interest conflicts with clients’ interests. This includes principal transactions and agency cross transactions.

In a **principal transaction** the adviser engages in transactions in which it buys securities for the adviser’s own inventory from a client or sells securities from the adviser’s own inventory to the client.

**Agency cross-transactions** involve the adviser operating on behalf of its advisory clients and those of the party on the other side of the brokerage transaction.
The Investment Advisers Act regulates principal transactions and agency-cross transactions by requiring that an adviser disclose the conflict and receive the consent of the client before effecting the transaction. (Section 206 (3) of the Advisers Act)

- Rule 206(3) -2 provides for safe harbor for agency cross transactions. Allows for blanket consent
- Temporary Rule 206(3)-3t
Interaction with Municipalities: Pay to Play Practices

On June 30, 2010, the SEC adopted Rule 206(4)-5 (the – “Rule”) under the Investment Advisers Act. The Rule is designed to curtail “pay to play” practices by investment advisers.

There are three key aspects of the Rule:

(i) Two-Year Compensation “Time Out” – a two-year “time out” from receiving compensation for providing advisory services to certain government entities after certain political contributions are made;

(ii) Solicitor Ban – a prohibition from paying third parties for soliciting government clients; and

(iii) Restriction on Coordinating Contributions – a prohibition on coordinating or soliciting contributions and payments.
Compliance and Recordkeeping

• **Recordkeeping Obligations**

  Rule 204-2 under the Advisers Act requires that a broad range of books and records be maintained. The types of books and records required to be maintained include:

  - the registered adviser’s accounting records;
  - the registered adviser’s corporate records;
  - records relating to the compliance policies and procedures;
  - records relating to clients, including transactions information, portfolio records and contracts;
Compliance (cont’d)

- Records relating to advertising and performance presentations;
- Records relating to client’s assets that are, or are deemed to be, in the custody of the adviser; Records relating to personal securities transactions by principals and employees of the adviser;
- Books and records must generally be maintained and preserved in an easily accessible place for five years from the end of the fiscal year during which the last entry was made on such record, and the first two years in an appropriate office of the adviser.
Compliance (cont’d)

- Books and records relating to the advertisements or performance information used in marketing materials must be maintained for a period of not less than five years from the end of the fiscal year during which the adviser last published or disseminated the materials.

- Articles of incorporation, charters, minute books, and stock certificate books of the adviser and of any predecessor, must be maintained in the principal office of the adviser and preserved until at least three years after termination of the enterprise.
Compliance (cont’d)

• **Compliance Program: Rule 206 (4)-7**
  - A registered adviser must adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act by the registered adviser or any of its supervised persons.
  - These policies and procedures must be reviewed annually by the registered adviser to determine their adequacy and effectiveness.
  - Registered advisers are required to designate a chief compliance officer that has a position of sufficient seniority and authority within the organization to administer the compliance policies and procedures.
Compliance (cont’d)

• **Insider Trading and Code of Ethics**

Under Section 204A of the Advisers Act, an adviser must establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material, non-public information by the adviser or any person associated by the adviser.

Each registered adviser must adopt a code of ethics that:

- Sets out a standard of business conduct for the adviser and its supervised persons;
- Prevents access to material nonpublic information of the adviser’s securities recommendations and client services, unless needed by personnel of the adviser for their duties; and
- Requires periodic reporting and review of the personal trading reports from “access persons” of the adviser and the implementation of personal trading procedures.
Compliance (cont’d)

• **Privacy**  
  Under Regulation S-P, a registered adviser must adopt policies and procedures that address administrative, technical, and physical safeguards for the privacy protection of private customer records and information.

• **Business Continuity Planning**  
  The SEC has taken the position that a registered adviser’s fiduciary obligations to its clients include the obligation to take steps to protect the clients’ interests from being placed at risk as a result of significant business disruptions.
Applicability of State Securities Law

• Prior to 1997 investment advisers were regulated directly by both the U.S. Securities and Exchange Commission and the securities commissions in each state in which the adviser transacted business.

• The National Securities Markets Improvement Act (NSMIA) established a new regulatory framework requiring advisers to determine its status as an SEC registered adviser or alternatively, as a state registered adviser.
Applicability of State Securities Law (cont’d)

- Very generally, large investment advisers (e.g., advisers with at least $100 million of “assets under management” and advisers to an investment company registered under the Investment Company Act of 1940) are registered with the SEC, smaller advisers are registered with the states.

- States retain some jurisdiction over SEC registered advisers. Most notably, each state continues to have the authority to require the licensing, registration, or qualification of an “investment adviser representative” of the SEC-registered adviser who has a “place of business” in the state.