

An Overview of the Advisers Act and the SEC's Regulation of Investment Advisers

PLI Fundamentals of Investment Adviser Regulation 2023

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An Overview of the Advisers Act and the SEC's Regulation of Investment Advisers

**Poll: 1. The SEC Division that is closest to Advisers
Act rulemaking is:**

An Overview of the Advisers Act and the SEC's Regulation of Investment Advisers

Today's Discussion

- Fundamental Concepts
- Registration of Investment Advisers & Exemptions
- Federal vs. State Regulation
- Substantive Regulation under the Advisers Act
- Administration of and Examinations under the Advisers Act
- Recent Developments and Items to Watch

An Overview of the Advisers Act and the SEC's Regulation of Investment Advisers

Fundamental Concepts

An Overview of the Advisers Act and the SEC's Regulation of Investment Advisers

Fundamental Concepts

Who is an “investment adviser”?

— Section 202(a)(11) of the Advisers Act – an investment adviser is any person who:

- for **compensation**
- **engages in the business** of
- **advising others as to** the value of securities or as to the advisability of investing in, purchasing, or selling **securities**;

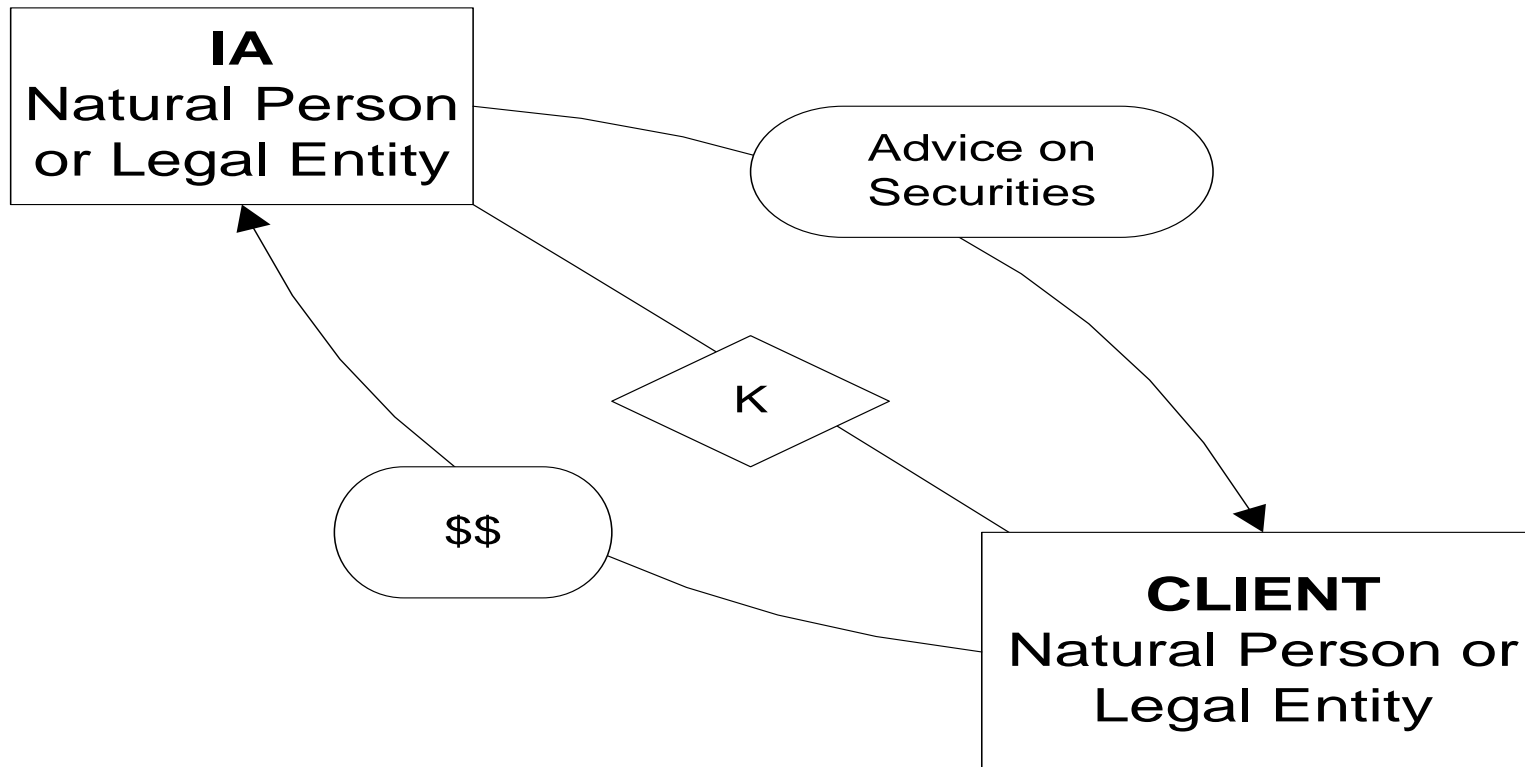
OR

- who, for **compensation**, as part of a **regular business**, issues or **promulgates analyses or reports concerning securities**.

An Overview of the Advisers Act and the SEC's Regulation of Investment Advisers

Fundamental Concepts

Who is an “investment adviser”?



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Fundamental Concepts

Who is not an “investment adviser”?

— Section 202(a)(11) excludes the following:

- A bank, unless it serves or acts as an investment adviser to a registered investment company;
- Any lawyer, accountant, engineer, or teacher whose performance of such services is “**solely incidental**” to the practice of his profession;
- Any broker or dealer whose performance of such services is “**solely incidental**” to the conduct of his business as a broker or dealer and who receives **no special compensation** for such services;
- The publisher of any *bona fide* newspaper, news magazine or business or financial publication of general and regular circulation;

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Fundamental Concepts

Who is not an “investment adviser”? (cont'd)

— Section 202(a)(11) excludes the following:

- Any person whose advice, analyses, or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities exempted pursuant to Section 3(a)(12) of the Securities Exchange Act of 1934;
- Any nationally recognized statistical rating organization, unless such organization issues recommendations as to purchasing, selling, or holding securities or in managing assets on behalf of others; and
- Any “family office,” as defined at Rule 202(a)(11)(G)-1 under the Advisers Act

An Overview of the Advisers Act and the SEC's Regulation of Investment Advisers

Fundamental Concepts

What is the Advisers Act?

- The Advisers Act is, in general, a disclosure statute
- Pursuant to the Advisers Act, an investment adviser owes a fiduciary duty to each client
- Through its substantive provisions and the rules adopted under it, the Advisers Act imposes significant requirements and prohibitions on investment advisers
 - Examples:
 - Custody
 - Advertising
 - Proxies
 - Code of Ethics
 - Political contributions (“pay-to-play”)
 - Best execution and other trading-related issues
- Advisers Act also contains enforcement mechanisms

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Registration of Investment Advisers & Exemptions

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Registration of Investment Advisers & Exemptions

Registration Requirements

- Section 203(a) of the Advisers Act creates a general obligation for investment advisers to be registered with the Securities and Exchange Commission (SEC)
- To apply for registration, investment advisers file Form ADV electronically through the Investment Adviser Registration Depository (IARD)
 - Form ADV Part 1 – “check the box” format
 - Form ADV Part 2 – narrative disclosure through a brochure and brochure supplement
 - Form ADV Part 3 – relationship summary or “Form CRS”
- Form ADV is subject to certain annual and interim updating requirements

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Registration of Investment Advisers & Exemptions

Exemptions from Registration

- State-only investment adviser
 - An investment adviser (other than a private fund adviser) *all* of whose clients are residents of the state within which such investment adviser maintains its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on a national securities exchange
- Insurance company investment adviser
 - Any investment adviser whose only clients are insurance companies
- Foreign private adviser
 - Less than \$25 million in regulatory assets under management (RAUM) from U.S. clients and private fund investors, fewer than 15 U.S. clients and private fund investors and no place of business in the U.S.

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Registration of Investment Advisers & Exemptions

Exemptions from Registration

- Charitable investment adviser
 - Any investment adviser that is a charitable organization or a trustee, director, officer, employee, or volunteer of the charitable organization acting within the scope of such person's employment whose advice is provided only to a limited number of entities (e.g., charitable organizations and trusts)
- Church plan investment adviser
 - A "church plan" described in Section 414(e) of the IRC or any trustee, director, officer, or employee of or volunteer for any such plan or person, if investment advice is provided *exclusively* to any plan, person, entity, account, or fund excluded from the definition of an investment company because it is a church plan
- Commodity trading investment adviser
 - An investment adviser that is registered with the Commodities Futures Trading Commission (CFTC) as a commodities trading advisor (CTA) whose business does not consist primarily of acting as an investment adviser and that does not act as an investment adviser to a registered investment company (RIC) or business development company (BDC)

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Registration of Investment Advisers & Exemptions

Exemptions from Registration

- Advisers to small business investment companies and rural business investment companies that are not BDCs
- Exempt reporting advisers
 - Investment advisers solely to venture capital funds
 - Investment advisers solely to private funds with less than \$150 million in regulatory assets under management (RAUM) in the U.S.
 - Unlike other exempt entities, such advisers must file an abbreviated version of Form ADV Part 1A with the SEC in order to rely on this exemption (the other exemptions are self-effectuating)
 - Subject to the anti-fraud provisions of the Advisers Act

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Registration of Investment Advisers & Exemptions

Extraterritorial Reach of the Advisers Act

- A non-U.S. adviser – i.e., an adviser without a principal office or place of business in the U.S. – may still be subject to regulation under the Advisers Act
 - A non-U.S. adviser with aggregate assets under management of \$25 million or more attributable to clients in the U.S. and investors in the U.S. in private funds advised by the investment adviser is generally required to register with the SEC
 - A registered non-U.S. adviser is generally required to comply with the Advisers Act and the rules thereunder with respect to any U.S. clients it may have
 - The SEC has acknowledged that most of the substantive provisions of the Advisers Act do not apply with respect to the non-U.S. clients of a registered non-U.S. adviser
 - Non-U.S. advisers may be eligible for certain exemptions, such as the private fund adviser exemption, the venture capital fund adviser exemption, and the foreign private adviser exemption

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Federal vs. State Regulation

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Federal vs. State Regulation

Division of Responsibilities between the SEC and the States

- Investment advisers are regulated by the SEC or the States
- NSMIA (National Securities Markets Improvement Act – 1996)
 - Created a two-tiered regulatory scheme
 - Divides regulation of “large” advisers and “small” advisers
 - However, for SEC-registered investment advisers, states may require “notice filings” and collect filing fees and require “investment adviser representatives” to register with the state
 - States also retain enforcement authority against any adviser for violations of state anti-fraud laws

An Overview of the Advisers Act and the SEC's Regulation of Investment Advisers

Federal vs. State Regulation

Division of Responsibilities between the SEC and the States

- Section 203A of the Advisers Act – an investment adviser that is regulated as an investment adviser in the state in which it maintains its principal office and place of business is not permitted to register with the SEC, unless the investment adviser:
 - Has RAUM of at least \$100 million, **OR** RAUM between \$25 million and \$100 million and is not subject to regulation at the state level;
 - Is an adviser or sub-adviser to a RIC; or
 - Is eligible for some other exemption from the prohibition against registration with the SEC
 - Foreign adviser with principal office and place of business outside the U.S.
 - Investment adviser to a BDC and with at least \$25 million of RAUM
 - Pension consultant with respect to assets of plans having an aggregate value of at least \$200,000,000
 - Related adviser that controls, is controlled by, or is under common control with an SEC-registered adviser
 - An investment adviser that expects to be eligible for registration within 120 days
 - Multi-state adviser that is required to register in 15 or more states
 - Internet adviser that provides advice to all of its clients exclusively through an interactive website

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Federal vs. State Regulation

State Regulation of SEC-Registered Investment Advisers

- In general, no law of any state that requires the registration, licensing, or qualification as an investment adviser or supervised person of an investment adviser, applies to any person:
 - that is registered with the SEC as an investment adviser, or that is a supervised person of such person; or
 - that is not registered under Section 203 because that person is excluded from the definition of an investment adviser under Section 202(a)(11).
 - “Supervised Person” means any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other persons who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser
- ***Except . . .***

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Federal vs. State Regulation

State Regulation of SEC-Registered Investment Advisers

- A state may, however:
 - license, register, or otherwise qualify an “investment adviser representative” who has a “place of business” located within that state (as such terms are defined under Rule 203A-3 under the Advisers Act); and
 - investigate and bring enforcement actions against an investment adviser or persons associated with an investment adviser representative in cases of fraud
 - For SEC-registered investment advisers, an “investment adviser representative” means a supervised a person of the investment adviser:
 - who has more than five clients who are natural persons; and
 - more than ten percent of whose clients are natural persons (other than “excepted persons”)
 - However, a supervised person is not an IAR if the supervised person:
 - does not on a regular basis solicit, meet with, or otherwise communicate with clients; or
 - provides only impersonal investment advice

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Substantive Regulation under the Advisers Act

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Substantive Regulation under the Advisers Act

Fiduciary Duty

- An investment adviser owes a fiduciary duty to each client
 - *SEC v. Capital Gains Research Bureau, Inc.* 375 U.S. 180 (1963); *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979)
- An investment adviser's fiduciary duty is broad and applies to the entire adviser-client relationship, although the adviser and its client may shape and scope the relationship by agreement, provided there is full and fair disclosure and informed consent
- Obligations imposed on investment advisers as fiduciaries -
 - Duty of Care – requires an investment adviser to provide investment advice in the best interest of its client, based on the client's objectives; seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades; and provide advice and monitoring over the course of the relationship
 - Duty of Loyalty – must eliminate or make full and fair disclosure of all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which is not disinterested such that a client can provide informed consent to the conflict
- Combination of care and loyalty obligations requires the investment adviser to act in the best interest of its client at all times, and not subordinate its client's interest to its own or place its own interests ahead of the interests of its client

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Substantive Regulation under the Advisers Act

Anti-Fraud Provisions

- Under Section 206 of the Advisers Act, it is generally unlawful for an investment adviser (registered or not) to:
 - Employ any device, scheme, or artifice to defraud any client or prospective client (scienter is required);
 - Engage in any transaction, practice, or course of business which operates as fraud or deceit upon any client or prospective client (no scienter is required);
 - Violate the principal trade or agency cross provisions; or
 - Engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative

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Substantive Regulation under the Advisers Act

Specific Requirements and Rules

- Disclosure Delivery – Rules 204-3 and 204-5
 - Generally require delivery of brochures, brochure supplements and relationship summaries to clients
- Compliance Program – Rule 206(4)-7
 - Requires adoption of a compliance program, including adoption of written policies and procedures, annual compliance review, and designation of a chief compliance officer
- Code of Ethics – Rule 204A-1
 - Requires establishment, maintenance and enforcement of a written Code of Ethics containing certain specified elements
- Marketing – Rule 206(4)-1
 - Investment adviser advertising is subject to a set of general prohibitions, and must comply with certain requirements in connection with compensated testimonials and endorsements, third-party ratings and performance presentations

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Substantive Regulation under the Advisers Act

Specific Requirements and Rules

- Investment advisory contracts – Section 205(a)
 - In general, the contract may not contain terms providing for performance-based compensation to the investment adviser (subject to certain exemptions), and assignment of the contract without the client's consent
- Books and Records – Rule 204-2
 - Must make and keep certain true, accurate and current books and records relating to the adviser's advisory business
- Principal Trades – Section 206(3)
 - Cannot act as principal for own account and knowingly sell any security to or purchase any security from a client without disclosing to the client, in writing before the compensation of each such transaction, the capacity in which the adviser is acting and obtaining the consent of the client to such transaction
- Agency Cross Transactions – Rule 206(3)-2
 - Subject to certain conditions, can engage in an agency cross transaction (where the adviser or an affiliate of the adviser acts as broker for both the advisory client and another person on the other side of the transaction)

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Substantive Regulation under the Advisers Act

Specific Requirements and Rules

- Custody – Rule 206(4)-2
 - Prohibition against having “custody” of client funds or securities, unless a qualified custodian holds such funds or securities in a certain manner, notification is sent to a client upon adviser opening a custodian account on the client’s behalf, and there is a reasonable basis to believe the qualified custodian sends the client quarterly account statements. Certain forms of custody also give rise to independent verification and internal control report requirements.
- Proxy Voting – Rule 206(4)-6
 - Written policies and procedures relating to the voting of client securities, and disclosure to clients on proxy voting and policies and procedures
- Supervision – Section 203(e)(6)
 - If the SEC finds that an investment adviser has “failed reasonably to supervise” another person subject to its supervision “with a view to preventing violations” of the federal securities or commodities laws, the SEC may take enforcement action against the investment adviser
- Political Contributions (“Pay-to-Play Rule”) – Rule 206(4)-5
 - Designed to curtail the corrupting influence of “pay-to-play” practices by investment advisers to public pension plans and similar government investment accounts
- Form PF – reporting requirement for certain private fund advisers

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Administration of and Examinations under the Advisers Act

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Administration of and Examinations under the Advisers Act

Administration of the Advisers Act

- The SEC's Division of Investment Management is the operating division primarily responsible for administering the Advisers Act
- The Division's Chief Counsel office is responsible for interpretations of legal and policy issues arising under the Advisers Act
- The Division of Examinations, which is a separate division of the SEC, is responsible for examining investment advisers

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Administration of and Examinations under the Advisers Act

Administration of the Advisers Act

- Records of investment advisers are subject to examination by the SEC staff pursuant to Section 204(a) of the Advisers Act
- Pursuant to Section 204(b) of the Advisers Act, most examinations are confidential
- Three types of examinations
 - Routine Examinations - On-site exam of investment advisers based on risk assessments
 - Sweep Examinations - On-site exam for the purpose of evaluating a perceived problem, or to understand current industry practices in a particular area prior to developing a regulatory solution
 - Cause Examinations - On-site exam for which the staff has cause to believe there is a material violation - often based on receipt of a complaint from a client or a competitor, press reports of problems, or anonymous tips

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Recent Developments and Items to Watch

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Recent Developments and Items to Watch

Chair Gensler's ambitious agenda for investment advisers

- Private fund adviser rules
- Form PF updates
- Custody Rule amendments
- Outsourcing rule
- Digital engagement practices
- Cybersecurity risk management and Reg S-P
- ESG



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