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# Do I Have a Bridge for You: Fiduciary Duties and Investment Advice

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## **DO I HAVE A BRIDGE FOR YOU: FIDUCIARY DUTIES AND INVESTMENT ADVICE**

Francis J. Facciolo\*

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## INTRODUCTION

The debate about financial advice in the United States has taken a wrong turn. Instead of focusing on particular practices and the potential that these practices raise for conflicts of interest between advisers and their clients, the debate has focused recently on whether brokers,<sup>1</sup> advisers to municipal and state issuers,<sup>2</sup> and advisers to employee benefit plans regulated by the Employee Retirement Income Security Act (“ERISA”)<sup>3</sup> should be held to a fiduciary duty standard. A fiduciary standard implies, in the words of Justice Cardozo, that “[a] trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.”<sup>4</sup> The thought is that brokers and ERISA advisers will be more attentive to their clients’ needs if such a fiduciary standard applies. Certainly, this is the basis upon which the Department of Labor is currently considering rules that apply fiduciary standards to ERISA advisers.<sup>5</sup>

This Article argues that this reliance on fiduciary duties is misplaced. In part, this is because most fiduciary duties that arise with respect to financial advice can be modified by an agreement between the fiduciary and the beneficiary. To be sure, there are procedural limits to ensure that a beneficiary has both the capacity and the information necessary to enter into a particular arrangement. But fiduciary duties turn out to be just a more punctilious version of contract law, with a few exceptions. This general contractual principle applies to both state fiduciary duties and to

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1. See, e.g., Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 701, 703 (2010) (describing broker and adviser duties as being “fiercely debated”).

2. See MUN. SEC. RULEMAKING BD., MSRB Notice 2011-48, MSRB Files Municipal Adviser Fiduciary Duty Rule and Interpretive Notice, (Aug. 23, 2011), available at <http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2011/2011-48.aspx> (detailing the proposed duties of loyalty and care under MSRB rule G-36).

3. Press Release, U.S. DEP’T OF LABOR, News Release: US Labor Department’s EBSA to Re-Propose Rule on Definition of a Fiduciary, (Sept. 19, 2011), available at <http://www.dol.gov/ebsa/newsroom/2011/11-1382-NAT.html>.

4. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

5. See *Opportunities for Savings: Removing Obstacles for Small Business: Hearing Before the S. Spec. Comm. on Aging*, 112th Cong. 4 (2012) (statement of Phyllis Borzi, Assistant Sec’y, Emp. Benefits Sec. Admin., Dep’t of Labor) (noting that “Our new rule [that revises the definition of ‘fiduciary’] will hold advisers responsible so that small employers can have confidence in the investment advice they receive and won’t be left holding the responsibility for losses that occur when . . . they’ve dutifully followed . . . [imprudent] investment advice . . .”).

federal fiduciary duties that arise under statutes such as the Investment Advisers Act of 1940 (the “IAA”), the Investment Company Act of 1940 (the “ICA”), and ERISA.

Relying on fiduciary duties in connection with financial advice is also misplaced because, even where these duties exist, they are cabined by procedural restrictions that make them, as a practical matter, unavailable to beneficiaries. This is most evident in the IAA. Under this Act, the Supreme Court has held that advisers have a fiduciary duty to their clients, but has restricted the reach of this duty by also holding that clients do not have a private cause of action unless they qualify under section 215.<sup>6</sup> This has left enforcement of fiduciary duties under the IAA to the Securities Exchange Commission (the “SEC”) and state security regulators. Although the Supreme Court has not spoken about this issue in the context of the ICA, lower court case law overwhelmingly supports the conclusion that, except under sections 30(h) and 36(b), no private causes of action exist under the ICA.<sup>7</sup>

In theory, the SEC could be a powerful advocate for fiduciary duties. In practice, though, the SEC is so resource poor that it has done a remarkably poor job in recent years in finding basic fraud among investment advisers, much less in enforcing fiduciary duties.<sup>8</sup> The SEC is so resource constrained that it examines the typical investment adviser once every eleven years.<sup>9</sup> The SEC’s failures led Congress, in section 914 of the Dodd-Frank Act, to direct the SEC to study the structure of investment adviser regulation<sup>10</sup>.

In a political climate where Congress is very unlikely to give the SEC significant additional funding,<sup>11</sup> the debate has become whether a self-

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6. *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 17, 19–20 (1979) (noting the existence of federal fiduciary standards and holding that the only private cause of action is under § 215 to void the investment advisor contract).

7. *See, e.g., Olmsted v. Pruco Life Ins. Co. of N.J.*, 283 F.3d 429, 433 (2d Cir. 2002) (“Congress’s explicit provision of a private right of action to enforce. . . [§36(b) of the ICA] suggests that omission of an explicit private right to enforce other sections was intentional.”).

8. *See infra* notes 272-83 and accompanying text.

9. *See* SEC. & EXCH. COMM’N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS 14, A-4, A-5 (2011), available at <http://www.sec.gov/news/studies/2011/913studyfinal.pdf> (finding that an increase in the number of investment advisers and a decrease in OCIE staff dedicated to examining these advisers has resulted in advisers only being examined every eleven years) [hereinafter 2011 SEC Study on Investment Advisers & Broker-Dealers].

10. Dodd Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 914(a), 124 Stat. 1376 (2010)

11. Mark Schoeff Jr., *SEC Must Get Smart with Exams, Be More Efficient*, INVESTMENTNEWS, (Mar. 13, 2012), <http://www.investmentnews.com/article/20120313/blog07/120319966> (reporting that “as Washington obsesses about the budget deficit . . . the

regulatory organization for registered investment advisers should be created.<sup>12</sup> Such an organization would be self-funding and not subject to the severe resource restraints of the SEC. This Article does not examine this debate or take a position on what constitutes the proper method of resolving the regulatory problems. Rather, the purpose of this Article is to note that there are material problems in relying on the SEC, as currently structured, in enforcing investment advisers' fiduciary duties.

This Article looks at both state law and federal securities laws to see what fiduciary duties mean in the context of financial advice. In particular, it looks closely at New York law and the IAA. It concludes that, with the exception of a few substantive restrictions found in the IAA, which have corollaries in the ICA and ERISA, fiduciary principles do not interfere with the freedom of beneficiaries and fiduciaries in creating contractual arrangements defining the nature of these principles. Certainly this freedom is subject to procedural safeguards that are more stringent than those for normal contracts but, once these procedures are followed, and assuming that the beneficiary is capable of giving informed consent, the advisory contract can have almost any term.<sup>13</sup>

This Article examines only one part of financial advice—advice with respect to securities. Financial advice covers a range of asset classes that are not securities unless the investment in the assets is indirect. Thus, this Article does not discuss investments in such asset classes as real estate, commodities, or collectibles. This Article concludes that the best way to approach these conflicts is not to focus on fiduciary duties and disclosure. Rather, the more successful approach would be to ban certain conflicts of interest. Further, this conclusion would not be materially changed if financial advice about assets other than securities were discussed. But it is important to acknowledge this limitation so as not to expect a broader discussion. In addition, going forward, this Article will use the phrase “investment advice” rather than “financial advice.”

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agency never gets as much money as it says it needs”).

12. Suzanne Barlyn, *COMPLY-FINRA Reignites Efforts to Oversee Investment Advisers*, REUTERS, Nov. 21, 2012, available at <http://www.reuters.com/article/2012/11/21/finra-advisers-comply-idUSL1E8MK60H20121121> (observing that FINRA is advocating a self-regulatory organization for investment advisers, while “[i]nvestment advisers are vehemently opposed....”).

13. See Seth T. Taube, et al., *The Price of Managing Money: The Applicability and Scope of Investment Adviser Regulation*, N.J. LAWYER MAGAZINE, Dec. 2000, at 40 (“There are few substantive restrictions on advisory contracts under the [IAA].”).

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## I. THE DUTIES OF INVESTMENT ADVISERS UNDER STATE LAW

The Restatements (Third) of Agency<sup>14</sup> and Trusts give a great deal of contractual flexibility to fiduciaries and beneficiaries in fashioning their relationships. An agent has particular flexibility. Sections 8.01 to 8.05 of the Restatement (Third) of Agency set out the various default legal restrictions on the agency relationship. The touchstone of an agent's fiduciary duty is the duty of loyalty, meaning that the agent must act for the principal's benefit in all matters connected with the relationship.<sup>15</sup> An agent must not accept material benefits from third parties for actions taken related to the agency, nor may the agent act as or on behalf of an adversary or prepare to compete with the principal.<sup>16</sup> Finally, an agent may not use property or confidential information for any purpose except for the principal's benefit.<sup>17</sup>

Section 8.06 allows an agent to obtain its principal's consent to conduct by the agent that would otherwise be a breach of duty under one of sections 8.01 to 8.05.<sup>18</sup> But, the agent is subject to various procedural restrictions in obtaining an effective consent from its principal. The agent must have "(i) act[ed] in good faith, (ii) disclose[d] all material facts that the agent knows, has reason to know, or should know would reasonably affect the principal's judgment . . . and (iii) otherwise deal[t] fairly with the principal."<sup>19</sup> The consent also may not extend beyond "either a specific act or transaction, or acts or transactions of a specified type that could reasonably be expected to occur in the ordinary course of the agency relationship."<sup>20</sup> Contained within Comment b is the important qualification that:

an agreement that contains general or broad language purporting to release an agent in advance from the agent's general fiduciary obligation to the principal is not likely to be enforceable. This is because a broadly sweeping release of an agent's fiduciary duty may not reflect an adequately informed judgment on the part of

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14. RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) ("Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act.").

15. *Id.* §8.01.

16. *Id.* §§ 8.02–04.

17. *Id.* § 8.05.

18. *See id.* §8.06, reporter's note (a) (explaining that the Restatement (Second) of Agency contained similar provisions allowing most duties owed by an agent to a principal to be qualified by consent of the principal.).

19. *Id.* § 8.06(1)(a).

20. *Id.* § 8.06(1)(b).

the principal; if effective, the release would expose the principal to the risk that the agent will exploit the agent's position in ways not foreseeable by the principal at the time the principal agreed to the release.<sup>21</sup>

The concept contained in Comment b finds its counterpart in the SEC's position on hedge clauses under the IAA, which are discussed in Part V.C.2. of this Article.

Although trust law contemplates a three-party arrangement with a settlor, a trustee, and a beneficiary, unlike the two-party arrangement of an investment adviser and advisee, trust law affords a great deal of latitude to the parties in crafting their relationship. The Restatement (Third) of Trusts contains similar provisions with respect to varying the default duties of trustees, as does the Restatement (Third) of Agency with respect to agents. Although there is language in the Restatement (Third) of Trusts that indicates that a settlor may be limited in the extent to which she can waive fiduciary duties owed by a trustee,<sup>22</sup> there is no such limitation on what a beneficiary may do in consenting to a "breach of trust," excepting procedural limitations on this consent. The beneficiary must have "the capacity to" consent, must be aware of her "rights and of all material facts and implications that the trustee knew or should have known relating to the matter," and must have made the decision free of any "induce[ment] by improper conduct of the trustee."<sup>23</sup> The Restatement (Third) of Trusts contains a specific section covering exculpatory and no-contest clauses in the trust instrument. Section 96 allows such clauses so long as they were not obtained by the trustee "as a result of the trustee's abuse of a fiduciary or confidential relationship" and do not

purport[] to relieve the trustee (a) of liability for a breach of trust committed in bad faith or with indifference to the fiduciary duties of the trustee, the terms or purposes of the trust, or the interests of the beneficiaries, or (b) of accountability for profits derived from

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21. *Id.* § 8.06 cmt. b.

22. *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 50 cmt. c (2003) ("It is contrary to sound policy, and a contradiction in terms, to permit the settlor to relieve a 'trustee' of all accountability."); *id.* § 77 cmt. d (2003) ("[T]rust terms may not altogether dispense with the fundamental requirement that trustees not behave recklessly but act in good faith, with some suitable degree of care, and in a manner consistent with the terms and purposes of the trust and the interests of the beneficiaries."); *id.* § 86 cmt. b (2003) ("A trustee's duties, like trustee powers, may be modified by the terms of the trust, but the duties of trusteeship are subject to certain minimum standards that are fundamental to the trust relationship and normally essential to it."); *id.* § 87 cmt. d (2003) ("It is contrary to sound policy, and a contradiction in terms, to permit the settlor to relieve a *trustee* of all accountability.") (emphasis in original).

23. *Id.* § 97.

a breach of trust.<sup>24</sup>

State case law is in accord with the Restatements. In New York, for example, *Ridgely v. Keene* held that an investment adviser was in a “relation[ship] . . . of confidence and trust” with his clients when “[h]e expected them to act upon his advice in the purchase and sale of stock.”<sup>25</sup> The investment adviser in *Ridgely* published “circular letters” that were sent to approximately 1,000 subscribers.<sup>26</sup> The investment adviser agreed with a group of stockbrokers that he would tout Southern Pacific shares, and, in return, the stockbrokers agreed to make a payment to the adviser.<sup>27</sup> Although the investment adviser’s clients purchased over 100,000 shares, the stockbrokers evidently refused to honor their side of the agreement to pay the investment adviser.<sup>28</sup> The investment adviser sued the stockbrokers and the Appellate Division refused to enforce the contract, holding that it was “illegal and contrary to good morals.”<sup>29</sup>

The investment adviser had represented to its clients that it had no connection to any stockbrokers. The Appellate Division, however, held that, “even had there been no express representations made by him, there would have been an implied obligation on his part not to receive pay from third parties for advising [his clients] in a particular way.”<sup>30</sup> In addition, the court held that the investment adviser’s state of mind was not relevant because “his belief in the soundness of his advice is wholly immaterial.”<sup>31</sup>

The Appellate Division ended with sweeping language that might lead one to expect that New York does not allow the beneficiary of a fiduciary duty to consent to any variation in its terms: “The law takes into account human frailty, and *absolutely* forbids the assumption of conflicting obligations and duties . . . .”<sup>32</sup> This conclusion, however, is belied by later New York case law that makes clear that an informed beneficiary may agree to variations in the default fiduciary rules. For example, in *Cholot v. Strohm*, the Appellate Division held that a broker acting for the sellers of shares who received compensation from the buyer of the shares did not violate section 439 of the Penal Law (now sections 180.00 to 180.05)<sup>33</sup>

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24. *Id.* § 96(1).

25. *Ridgely v. Keene*, 134 A.D. 647, 649 (N.Y. App. Div. 1909).

26. *Id.* at 648.

27. *Id.*

28. *Id.* at 648.

29. *Id.* at 650.

30. *Id.* at 649.

31. *Id.*

32. *Id.* (emphasis added).

33. Commercial bribing in the second degree is “confer[ring], or offer[ing] or agree[ing] to confer any benefit upon any employee, agent or fiduciary without the consent of the latter’s employer or principal, with intent to influence his conduct in relation to his



because he “told . . . the owners of the . . . shares . . . what compensation he was to receive from” the buyer of the shares.<sup>34</sup> In the court’s view, the sellers “knew that [the buyer] was compensating [the broker] for his services.”<sup>35</sup>

There has been debate among legal academics on the extent to which fiduciary law actually functions as contract law or as tort law. On one side stands Professor Tamar Frankel, the most prominent academic in the study of investment companies and investment advisers.<sup>36</sup> She points out, for example, that the duties of disclosure under fiduciary law and contract law

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employer’s or principal’s affairs.” N.Y. PENAL LAW § 180.00 (McKinney 2010). Commercial bribing in the first degree is the same as the second degree, but requires that the benefit to the agent “exceed[] one thousand dollars and cause[] economic harm to the employer or principal in an amount exceeding two hundred fifty dollars.” *Id.* at § 180.03. Commercial bribe receiving in the second degree occurs when a fiduciary “solicits, accepts or agrees to accept any benefit from another person upon an agreement or understanding that such benefit will influence his conduct in relation to his employer’s or principal’s affairs.” *Id.* at § 180.05. Commercial bribe receiving in the first degree is the same as the second degree, but requires that the “value of the benefit solicited, accepted or agreed to be accepted exceeds one thousand dollars and causes economic harm to the employer or principal in an amount exceeding two hundred fifty dollars.” *Id.* at § 180.08.

34. *Cholot v. Strohm*, 256 N.Y.S. 647, 653 (App. Div. 1932).

35. *Id.*; *accord* *United States v. Grace Evangelical Church of S. Providence Ridge*, 132 F.2d 460 (7th Cir. 1942); *Schiff v. Kirby*, 194 N.Y.S.2d 695 (Sup. Ct. 1959) (holding similarly). Although *Grace Evangelical Church of South Providence Ridge* is not a case under New York law, it is particularly interesting as it provides a clear example of why a fiduciary should not be allowed to benefit from payments from a third party even if the beneficiary agrees to this arrangement. The U.S. Department of War had hired a Mr. Herman to acquire land for various projects such as an ordinance factory. 132 F.2d at 461. As part of the option contracts that Mr. Herman presented to landowners, the landowner agreed to pay Mr. Herman a 5% commission on the sales price to the U.S. if the U.S. exercised its purchase option. *Id.* The majority of the court had no problem in rejecting the U.S.’s argument that this contract was against public policy “because it appears therefrom that the agent of the Government was to receive a commission from the vendor.” *Id.* As the majority pointed out, “[i]t is obvious that the Government was fully aware of this provision; that it was fully advised and had apparently approved a system whereby it permitted its agent to procure options providing for payment of his commission by the vendors.” *Id.* The dissenting judge would have upheld the district court in denying enforcement of the option contract on the grounds that it was against public policy. The dissenting judge opined that:

“[s]ound reason and common sense, alike, condemn this contract as violative of sound public policy. Instead of protecting the public (the Government and the taxpayers), it furnished incentive for raids on the Treasury. Herman was financially benefited by higher, not lower, purchase prices. Under the circumstances, the vendor was, of course, willing to pay a commission to the buyer’s representative for both were interested in boosting the price. But who was there to protect the U.S. Government?”

*Id.* at 463 (Evans, J., dissenting).

36. See TAMAR FRANKEL, *FIDUCIARY LAW* (Oxford University Press 2007) (providing a primer on fiduciary law and its development).

are very different.<sup>37</sup>

A fiduciary must provide an entrustor with relevant information, including information about conflicts of interest, even if the entrustor does not ask for it. A fiduciary must account for its actions. Further, it is doubtful whether an entrustor can effectively waive the right to truthful information. A contract party need not offer information unless the other party asks for it or unless it is required by the contract terms or specific law to do so.<sup>38</sup>

On the other side, commentators such as Professor Langbein,<sup>39</sup> Judge Easterbrook, and Professor Fischel<sup>40</sup> have made strong arguments that fiduciary law functions as a set of default rules that are subject to negotiation between the parties. “[V]irtually all trust law is default law—rules that the parties can reject. The rules of trust law apply only when the trust instrument does not supply contrary terms.”<sup>41</sup>

This Article does not take a position on this debate, but makes a more limited point. Fiduciary duties are not inviolable. Rather, they are subject to being negotiated between the fiduciary and the beneficiary. Certainly, the beneficiary receives the benefit of a process that is meant to ensure she has full disclosure upon which to base her decisions. And there may even be certain limits to what the beneficiary can agree to, as pointed out by Professor Frankel.<sup>42</sup> But within these parameters, the relationship between a fiduciary and a beneficiary may be defined by agreement between the two parties.

The fact that fiduciary duties function as defaults does not mean that they are necessarily irrelevant. It might be the case, for example, that the process of getting a beneficiary’s consent to a conflict of interest means that some investment advisers never seek consent from their advisees for certain conflicts. An investment adviser might be afraid that its advisees, if

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37. *Id.* at 235–36.

38. *Id.*

39. John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625 (1995).

40. Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993).

41. Langbein, *supra* note 39, at 650. “Another fundamentally contractarian reinforcement for the conventional duties of loyalty and prudence is the rule that the beneficiary may consent to trustee behavior that would otherwise breach these duties.” *Id.* at 660. For a similar analysis in the context of corporate law, see Henry L. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990).

42. See Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1212 (1995) (noting that there beneficiaries (or entrustors) “may only waive fiduciary duties owed to them if they follow a two-step procedure.”).

asked to consent to a particularly egregious conflict, might leave the investment adviser for another investment adviser that does not seek such consent. This is certainly the theory behind many of the federal securities laws. As expressed in the famous words of Louis Brandeis: “Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”<sup>43</sup> As Brandeis understood the effects of disclosure, “real” disclosure would lead underwriters to stop charging excessive commissions on securities offerings, presuming that potential buyers would go on “strike” against such commissions.<sup>44</sup>

This market-based discipline, however, has been challenged by work in behavioral economics that, in turn, has been applied to disclosure issues by legal academics. A series of cognitive biases have been identified that can influence investors. One leading article in the area of securities regulation has identified the relevant biases as including “the hindsight bias, the (flawed) reliance on heuristics (including the availability heuristic), the presence of overconfidence and overoptimism, the endowment effect (and other framing related biases), and the confirmation bias.”<sup>45</sup> The article goes on to state that “[f]rom a behavioral perspective . . . disclosure risks confusing investors already suffering from bounded rationality, availability, and hindsight.”<sup>46</sup>

Beyond the general concerns with effectiveness of disclosure that have been identified in the literature on cognitive biases and securities regulation, concerns about the effectiveness of disclosure as a remedy for conflicts of interest have been raised by one group of researchers.<sup>47</sup> This

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43. LOUIS D. BRANDEIS, *OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT* 92 (1914).

44. *Id.* at 101–02.

45. Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 *STAN. L. REV.* 1, 7–9 (2003) (footnotes omitted).

46. *Id.* at 60. For a number of reasons, Professors Choi and Pritchard themselves are not proponents of applying behavioral insights to securities regulation. They argue that some cognitive biases offset each other and that the regulators who make up the SEC are subject to their own cognitive biases. *Id.* at 16, 20–36. They also point out that “[d]espite efforts at categorization, no underlying theory behind why we operate under biases has emerged. Instead of a theory, behavioral economics relies on a hodgepodge of evidence showing the effectiveness of human decisionmaking in various circumstances (often in a controlled, laboratory setting).” *Id.* at 10. In the view of Professors Choi and Pritchard, the lack of a theory means that it is impossible to know what regulatory interventions would be effective in dealing with cognitive biases in investors. *Id.* at 11.

47. Professors Daylian Cain (the School of Management, Yale University), George Lowenstein (the Department of Social and Decision Sciences, Carnegie Mellon University), Sunita Shah (the Fuqua School of Business), and Don Moore (Tepper School of Business, Carnegie Mellon University) have cooperated in a shifting group on a series of experiments and papers reporting on these experiments. See Daylian M. Cain et al., *When Sunlight Fails*

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research has produced a provocative body of work arguing that not only may disclosure of conflicts of interest provide no additional protection to beneficiaries, but it may actively encourage both beneficiaries and advisers to ignore the conflicts.<sup>48</sup> In addition, this research has found beneficiaries to be incapable of accurately discounting the advice they receive from conflicted advisers.<sup>49</sup>

This research was based on a series of experiments where the beneficiaries (called “estimators” in the research) were asked to estimate various values of houses for sale, for example, and were advised on appropriate estimates.<sup>50</sup> The researchers created two situations, one in which advisers would benefit from high estimates (“conflicted”), and one in which advisers would not benefit (“non-conflicted”).<sup>51</sup> In addition, some advisers told their estimators that they were giving conflicted advice, while other estimators were not told about the conflict.<sup>52</sup>

This research was based on the assumption that “whether disclosure hurts or helps the advisee depends on the net impact of disclosure on two competing effects: (1) bias in the advisor’s suggestion and (2) discounting by the advisee.”<sup>53</sup> Some advisers were motivated by disclosure of their conflicts of interest “to exaggerate their advice further; however, others are likely to rein in their advice, instead.”<sup>54</sup> The reason that a conflicted adviser would exaggerate is obvious: the adviser benefits from an advisee overestimating. A conflicted adviser would be tempted to exaggerate even more if the conflict is disclosed out of concern that the advisee will discount conflicted advice. But another adviser “might attempt to counteract the increased mistrust that disclosure brings by reigning in advice so that it looks realistic (i.e., so that the advice is not beyond the plausible max).”<sup>55</sup>

The researchers located the tendency of advisers to exaggerate in what they termed “moral licensing.”<sup>56</sup> A series of psychological mechanisms all provide cover for providing conflicted advice. Surprisingly, when there is no disclosure of a conflict, advisers will forego “giv[ing] maximally biased

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*to Disinfect: Understanding the Perverse Effects of Disclosing Conflicts of Interests*, 37 J. CONSUMER RES. 836, 837 (2011) (discussing prior research).

48. *Id.* at 849-50.

49. *Id.* at 850-51.

50. *Id.* at 842.

51. *Id.* at 843.

52. *Id.*

53. *Id.* at 838.

54. *Id.* at 841.

55. *Id.* at 839.

56. *Id.* at 841.

advice,”<sup>57</sup> in part because of the adviser’s “desire to behave as she thinks the receiver expects her to behave.”<sup>58</sup> But disclosure reduces the moral restraint that advisers feel in advising advisees.<sup>59</sup>

The net effect of this academic work on disclosure under the federal securities law, and disclosure of conflicts of interest in particular, is that we should be skeptical of the effectiveness of disclosure as a remedy for conflicts of interest, especially when we are considering financial advice to small investors. This is the lesson that has been drawn, for example, in Australia from its Future of Financial Advice initiative and in the United Kingdom from its Retail Distribution Review initiative.<sup>60</sup> In deciding to restrict certain compensation arrangements that compensate investment advisers for selling certain products, both countries have focused on the conflicts such compensation arrangements can create between the self-interest of the investment advisers and the best interests of their clients.<sup>61</sup> And, in both countries, the regulatory authorities have rejected disclosure as the sole or primary remedy.<sup>62</sup>

In Australia, the Australian Securities & Investments Commission (the “ASIC”) has issued a detailed report on financial literacy among investors, discussing many of the cognitive biases identified by behavioral economics.<sup>63</sup> In the United Kingdom, the Financial Services Authority (the “FSA”), which recently has been split into two separate regulatory authorities, commissioned a report by several academics that discussed behavioral economics in detail.<sup>64</sup>

The Australian report called for more research in the area, especially

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57. *Id.* at 839.

58. Jason Dana, Daylian M. Cain & Robyn M. Dawes, *What You Don't Know Won't Hurt Me: Costly (But Quiet) Exit in Dictator Games*, 100 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 193, 195 (2006).

59. Cain, *supra* note 47, at 840; *see also* Chen-Bo Zhong, Katie A. Liljenguist & Daylian M. Cain, *Moral Self-Regulation: Licensing and Compensation in Psychological Perspectives on Ethical Behavior and Decision-Making*, in PSYCHOLOGICAL PERSPECTIVES ON ETHICAL BEHAVIOR AND DECISION MAKING (David De Cremer ed., 2009) (asserting that advisers are more likely to provide candid advice in the presence of disclosure).

60. *See* Francis J. Facciolo, *The Revolution in Investment Adviser Regulation*, 18 INVESTMENT LAWYER 21 (Oct. 2011) (discussing reforms in Australia and the U.K. with regard to changes in the compensation of investment advisers for their advice by retail clients).

61. *Id.* at 24-25, 27-28.

62. *Id.* at 29.

63. AUSTL. SEC. & INVS. COMM'N (ASIC), REPORT 230, FINANCIAL LITERACY AND BEHAVIOURAL CHANGE 99-101 tbl. A1.17 (2011) (Austl.) [hereinafter ASIC Report 230].

64. DAVID DE MEZA ET AL., FIN. SERVS. AUTH. (FSA), FINANCIAL CAPABILITY: A BEHAVIOURAL ECONOMICS PERSPECTIVE (2008) (U.K.), available at <http://www.fsa.gov.uk/pubs/consumer-research/crpr69.pdf>.

in “‘real’ financial settings.”<sup>65</sup> But, based on the research done through 2010, the report concluded that “[w]hile raising people’s level of financial knowledge forms the basis of many financial literacy initiatives around the world, there is a growing body of research suggesting that knowledge is only one factor when considering how to help people make positive financial decisions.”<sup>66</sup>

The de Meza report prepared for the FSA reaches similar conclusions to the ASIC report:

The indirect evidence from behavioural economics is that low financial capability is more to do with psychology than with knowledge. Institutional design and regulation are probably far more effective than education, though crisis counselling [sic] may be helpful. More research is needed on whether cognitive biases can be overcome in the personal finance domain.<sup>67</sup>

It is long past time for the United States to move beyond either fiduciary duties or disclosure when regulating investment advice to individual investors. Fiduciary duties that can be varied by informed consent are merely a more demanding form of disclosure. If disclosure itself is not an effective means of protecting individual investors, then fiduciary duties will also be ineffective, except in those situations in which the investment adviser does not specify what those duties are in the agreements with its clients. In other words, fiduciary duties would function as default rules, much as the Uniform Commercial Code provides default rules in sales. But a legally savvy investment adviser would make sure to vary these default rules by contract.

## II. THE DUTIES OF INVESTMENT ADVISERS UNDER THE FEDERAL SECURITIES LAWS

In *Capital Gains Research Bureau*, the Supreme Court addressed the duties that investment advisers owe their clients in connection with an allegation of scalping.<sup>68</sup> The investment adviser in *Capital Gains* had published a newsletter that recommended particular stocks to 5,000 subscribers.<sup>69</sup> Prior to recommending the stocks, the investment adviser purchased these stocks and, once its recommendations came out and the price of these stocks increased, the investment adviser sold them at a

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65. ASIC Report 230, *supra* note 63, at 4.

66. *Id.* at 32.

67. DE MEZA ET AL., *supra* note 64, at 4.

68. *S.E.C. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

69. *Id.* at 183.

profit.<sup>70</sup> On the SEC's motion for a preliminary injunction against these practices, the Supreme Court held that this scalping "operate[d] as a [section 206(2)] fraud or deceit upon any client or prospective client."<sup>71</sup> In arriving at this holding, the Court several times made general statements concerning the fiduciary duties owed by investment advisers to their clients, noting that "[t]he Investment Advisers Act of 1940 . . . reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship;'"<sup>72</sup> that "Congress recognized the investment adviser to be . . . a fiduciary;"<sup>73</sup> and that the IAA, "in recognition of the adviser's fiduciary relationship to his clients, requires his advice be disinterested."<sup>74</sup>

As Professor Laby has argued persuasively, these statements in *Capital Gains* do not unambiguously support the conclusion that the Supreme Court held that Congress created a fiduciary duty under the IAA.<sup>75</sup> The Supreme Court may only have been pointing to a pre-existing state law duty rather than construing Congress' intent. Later courts, however, including the Supreme Court itself, have "often cited [*Capital Gains*] for the proposition that the Advisers Act imposed a federal fiduciary duty on advisers."<sup>76</sup> It is now settled law that the IAA creates fiduciary duties for investment advisers.<sup>77</sup>

Once we examine the IAA and provisions of related federal securities acts that apply to investment advisers, two things become clear. First, these acts collectively provide for few substantive restrictions on investment advisers that grow out of these fiduciary duties. Second, even with respect to the limited restrictions on investment advisers under the IAA and ICA, the courts have not been favorably disposed to private causes of action.

In the IAA, the only obvious substantive restrictions are on certain capital appreciation or capital gain performance fees contained in section 205(1), on assignments without the approval of the advisee contained in

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70. *Id.*

71. *Id.* at 181 (internal quotations omitted).

72. *Id.* at 191.

73. *Id.* at 194.

74. *Id.* at 201.

75. Arthur B. Laby, *SEC v. Capital Gains Research Bureau and the Investment Advisers Act of 1940*, 91 B.U. L. REV. 1051 (2011).

76. *Id.* at 1053 (internal citation omitted).

77. *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 16 (1979) ("As we have previously recognized, § 206 establishes 'federal fiduciary standards' to govern the conduct of investment advisers.") (quoting *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 471, n.11 (1977)). As Professor Laby details, the trail of Supreme Court precedent leads from the general statements in *Capital Gains*, which do not identify the source of the fiduciary duty, through footnote eleven in *Santa Fe*, which characterizes the holding in *Capital Gains*, to the confident statement of Congress' intent in *Transamerica*. Laby, *supra* note 75, at 1063–75.

section 205(2), and on principal sales contained in section 206(3).<sup>78</sup> Through the administrative process, the SEC has created other substantive restrictions, including restrictions on the fees that investment advisers may charge,<sup>79</sup> restrictions on certain brokerage transactions,<sup>80</sup> and restrictions on releases by advisees of investment adviser liability for breaches of fiduciary duties.<sup>81</sup>

The ICA contains certain substantive restrictions on the arrangements between investment advisers and registered investment companies. In section 36(b), the ICA also contains the injunction that:

[t]he investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser.<sup>82</sup>

Although there has been a fair amount of litigation involving section 36(b), there is not a single published case in which a plaintiff prevailed on such a claim.<sup>83</sup> The ICA also regulates the contract between an investment adviser and a registered investment company as to form (it must be in writing), methods of approval by shareholders and the board of directors of a registered investment company, assignment by the investment adviser of the contract, and content of the contract (to a certain extent).<sup>84</sup> Finally, the ICA's prohibited transaction provisions in section 17 cover investment advisers if they are affiliates of a registered investment company, which

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78. Investment Advisers Act of 1940 §§ 205(a)(1)–(2), 206(3), 15 U.S.C. §§ 80b-5(a)(1)–(2), 80b-6(3) (2006).

79. See *infra* Part IV.A–C (explaining restrictions on the performance fees).

80. See *infra* Part IV.A–C (clarifying the implications of the IAA on investment advisers acting as brokers).

81. See *infra* Part IV.A–C (describing the ways the IAA and ICA prevent investment advisers from limiting their liability to advisees).

82. Investment Company Act of 1940 § 36(b), 15 U.S.C. § 80a-35(b) (2006).

83. See, e.g., John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 117 (2010) (noting empirical study of 36(b) cases since 2000 shows no plaintiff's verdicts); John P. Freeman et al., *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 OKLA. L. REV. 83, 86 (2008) (claiming that 36(b) has never yielded a plaintiff's verdict); James R. Carroll & David S. Clancy, 'Excessive Fee' Lawsuits, NAT'L L.J., May 26, 2008, at 12 (describing how no plaintiff has won a 36(b) verdict going back to the 1990s). It is possible that plaintiffs have found a means of more successfully pursuing section 36(b) actions by focusing on investment advisers that regularly use sub-advisers. See Francis J. Facciolo, *New Wave of Cases Involving Investment Adviser Fees*, N.Y.L.J., Oct. 4, 2013, at 4, available at <http://www.newyorklawjournal.com/id=1202622006908/New-Wave-of-Cases-Involving-Investment-Adviser-Fees?slreturn=20141003154711>.

84. Investment Company Act of 1940 § 2, 15 U.S.C. § 80a-2 (2006).



they normally will be by operation of the definition of “affiliate” in section 2(3)(E).<sup>85</sup>

The Securities and Exchange Act of 1934, in section 28(e), provides a safe harbor from fiduciary duty claims to investment advisers who comply with its terms. These claims are those that would arise:

solely by reason of [a person, such as an investment adviser] having caused [an] account to pay a member of an exchange, broker, or dealer an amount in excess of the amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction.<sup>86</sup>

Such payments are commonly called “soft dollar” transactions because the person effecting the transaction is using commissions to pay for something other than the execution of a securities transaction, such as research, rather than using “hard dollars” to pay for the something else.<sup>87</sup>

Finally, there are substantive restrictions that are contained in NASD Rules 2830 and 2420, which have been carried forward by FINRA. These restrictions constrain the activities of broker-dealers when acting as sales agents for registered investment companies.<sup>88</sup> Without engaging in the debate about what standards broker-dealers should be held to when dealing with clients, broker-dealers certainly do provide investment advice to many clients. Broker-dealers escape regulation under the IAA if they can meet the “solely incidental” test set forth in section 202(a)(11)(C).<sup>89</sup> But broker-dealer commissions and certain transactions with investment companies are substantively regulated under Rule 2830.<sup>90</sup> The regulation of commissions is indirect, as a broker-dealer cannot sell shares in a registered investment company “if the sales charges described in the prospectus [of the investment company] are *excessive*.”<sup>91</sup> The rule then defines what levels of charges “shall be deemed excessive,” with different rules for investment

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85. *Id.* §§ 2(3)(E), 17 (defining “affiliated person” of an investment company as “any investment adviser thereof or any member of an advisory board thereof”).

86. Securities Exchange Act of 1934 § 28(e)(1), 15 U.S.C. § 78bb(e)(1) (2006).

87. *See generally* D. Bruce Johnsen, *The SEC’s 2006 Soft Dollar Guidance: Law and Economics*, 30 CARDOZO L. REV. 1545, 1553–54 (2009) (discussing typical soft dollar arrangements).

88. FIN. INDUS. REGULATORY AUTH., FINRA MANUAL, NASD RULES §§ 2420, 2830, available at <http://finra.complinet.com> (last visited Sept. 28, 2014).

89. Investment Advisers Act of 1940 § 202(a)(11)(C), 15 U.S.C. § 80b-2(a)(11)(C) (2006) (exempting from the definition of investment adviser any broker or dealer performing advisory services solely incidental to its main function and who receives no special compensation for the advice).

90. FIN. INDUS. REGULATORY AUTH., *supra* note 88, § 2830.

91. FIN. INDUS. REGULATORY AUTH., *supra* note 88, § 2830 (emphasis added).

companies that charge asset-based sale charges and those that do not.<sup>92</sup>

In addition, Rule 2830 also regulates certain transactions between broker-dealers and registered investment companies that might lead a broker-dealer to favor sales of shares in one investment company over shares in another investment company.<sup>93</sup> All of these prohibited transactions involve arrangements whereby an investment company would use its portfolio transactions to reward a broker-dealer for sales of shares in the investment company. The problem is fairly straightforward: a broker-dealer might favor sales of shares in a particular investment company because the investment company directs its portfolio business to the broker-dealer, thus generating commissions for the broker-dealer. The methods of a broker-dealer's favoring a particular investment company are varied.<sup>94</sup>

The basis for Rule 2830 is a broker-dealer's duty of suitability and the conflicts of interest that these sales practices raise.<sup>95</sup> In other words, a broker-dealer should not be influenced in selling shares of an investment company to a client by commissions that the broker-dealer is receiving from the investment company for portfolio transactions. The only concern of the broker-dealer should be whether the shares in the investment company are suitable for the client. Having said this, the conflicts of interest that a broker-dealer faces in these situations are the same as those faced by an investment adviser who receives compensation from a product provider such as an investment company.<sup>96</sup>

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92. *Id.* "An 'asset-based sales charge' is a sales charge that is deducted from the net assets of an investment company and does not include a service fee." *Id.* § 2830(a)(8)(A). In other words, FINRA is describing fees that are allowed under Rule 12b-1 plans. Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26,591, 69 Fed. Reg. 54,728, 54,729 n.19 (Sept. 9, 2004); Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change Relating to the Limitation of Asset-Based Sales Charges as Imposed by Investment Companies, Exchange Act Release 30,897, 57 Fed. Reg. 30,985, 30,986 n.9 (July 13, 1992).

93. See FIN. INDUS. REGULATORY AUTH., *supra* note 88, § 2830(k)(1) (stating "[n]o member shall . . . favor . . . the sale or distribution of shares of any any particular investment company . . . on the basis of brokerage commissions received or expected . . .").

94. See, e.g., John Howat & Linda Reid, *Compensation Practices for Retail Sale of Mutual Funds: The Need for Transparency and Disclosure*, 12 FORDHAM J. CORP. & FIN. L. 685, 687-91 (2007) (describing various methods fund managers use to encourage broker-dealers to favor a fund, such as directed brokerage arrangements, 28(e) soft dollar practices, shelf-space agreements, and differential cash compensation).

95. See *id.*; FIN. INDUS. REGULATORY AUTH., *supra* note 88, § 2111.

96. See James S. Wrona, *The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and a Framework for Enhanced Investor Protection*, 68 BUS. LAW. 1, 46-47 (2012) (noting that investment advisers and broker-dealers are regulated in very similar ways except for conflict disclosure and

In examining the duties of investment advisers under the federal securities laws, this Article focuses on the IAA. In part, this choice is driven by the fact that the IAA is the federal statute that captures the largest group whose business is premised on investment advice. The ICA focuses on one subset of investment advisers, those who advise registered investment companies.<sup>97</sup> FINRA rules focus on broker-dealers as salesmen for securities in investment companies.<sup>98</sup> In this capacity, broker-dealers can certainly render investment advice. But these broker-dealers do not necessarily devote themselves to investment advice. If they do, then they must become dual-registrants, registering under both the Securities Exchange Act of 1934 (“‘34 Act”) and the IAA.<sup>99</sup> It is the IAA that covers all those whose main business is investment advice.<sup>100</sup>

### III. THE DUTIES OF INVESTMENT ADVISERS UNDER THE INVESTMENT ADVISERS ACT

The definition of investment adviser in section 202(a)(11) is quite broad. It works by sweeping in anyone who offers investment advice in any form and then exempting from the definition certain groups, such as “publisher[s] of any bona fide . . . financial publication of general and regular circulation” and “any broker or dealer whose performance of such [advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation” for such advisory services.<sup>101</sup> In addition, certain sections of the IAA apply only to registered investment advisers. Section 203(b) exempts from registration

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proposing that broker-dealers file a “Form ADV-type” of document regarding conflicts of interest so that customers can make more informed decisions about investment advice).

97. See Investment Company Act of 1940 § 2(a)(20), 15 U.S.C. § 80a-2(a)(20) (2006) (defining the term “investment adviser” as an investment adviser to an investment company).

98. See James T. Koebel, *Trust and the Investment Adviser Industry: Congress’ Failure to Realize FINRA’s Potential to Restore Investor Confidence*, 35 SETON HALL LEGIS. J. 61, 64–65 (2010) (describing FINRA’s role in regulating broker-dealers and arguing that there is a gap in oversight for investment advisers).

99. See e.g., Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 395, 403–04 (2010) (detailing the exclusion from IAA registration for broker-dealers who provide advisory services in the context of brokerage and noting that brokers who provide advice separate from conventional brokerage are ineligible for the exclusion and must dual-register).

100. Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b-202(a)(11) (2006) (broadly defining “investment adviser” as any person who advises others on the value of securities).

101. *Id.* § 202(a)(11)(C)–(D). See generally Francis J. Facciolo, *When Should a Broker-Dealer Be Treated as an Investment Adviser?*, N.Y.L.J., Aug. 1, 2011, at 4 (describing recent cases on the solely-incidental issue).

certain types of investment advisers, although this is a smaller group than it formerly was.<sup>102</sup>

As described above in Part III, the Supreme Court has interpreted Section 206 – and specifically subsections (1) and (2) – as creating a fiduciary standard for investment advisers.<sup>103</sup> Subsection (1) provides that it is “unlawful for *any* investment adviser . . . to employ any device, scheme, or artifice to defraud any client or prospective client.”<sup>104</sup> Subsection (2) provides that it is “unlawful for *any* investment adviser . . . to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.”<sup>105</sup> Each of these subsections applies to both registered and unregistered investment advisers.<sup>106</sup>

Beyond these general anti-fraud principles, there is very little in the IAA that substantively regulates the contract between an investment adviser and its clients that can be seen as reinforcing its fiduciary duty to its advisees. Part IV of this Article explores these limited areas. There certainly are additional restrictions under the IAA, and the rules and regulations promulgated by the SEC pursuant to the IAA, on how an investment adviser conducts its business and on how it makes disclosures to its clients.<sup>107</sup> But the contract between an investment adviser and its

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102. 15 U.S.C. § 80b-3(b) (2000), *amended by* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 403, 124 Stat. 1376 (codified at 15 U.S.C. § 80b-3(b)) (making a major change in section 203(b), effective July 21, 2011, requiring registration by many investment advisers who previously had relied on the former exemption contained in section 203(b)(3) for an investment adviser who “had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any [registered] investment company.”); *see, e.g.*, Press Release, Sec. & Exch. Comm’n, More Than 1,500 Private Fund Advisers Registered with the SEC Since Passage of the Financial Reform Law (Oct. 19, 2012), *available at* <http://www.sec.gov/news/press/2012/2012-214.htm> [hereinafter SEC Press Release] (demonstrating that this change made many once exempt investment advisers subject to registration). The Dodd-Frank Wall Street Reform and Consumer Protection Act also requires registration for investment advisers who act as an investment adviser to any private fund regardless of client number or the location of clients only within a single state. 15 U.S.C. § 80b-3(b)(1). Dodd-Frank also requires registration for advisers registered with the Commodity Futures Trading Commission as a commodity trading adviser but who advise a private fund with predominately securities-related advice. *Id.* § 80b-3(b)(6)(B)

103. *See supra* note 77 and accompanying text (recognizing “federal fiduciary standards” for investment advisers).

104. Investment Advisers Act of 1940 § 206(1), 15 U.S.C. §§ 80b-6(1) (2006) (emphasis added).

105. *Id.* § 206(2), 15 U.S.C. §§ 80b-6(2) (2006) (emphasis added).

106. *See id.* § 205(a) (“No investment adviser *registered or required to be registered* with the Commission shall . . .”) (emphasis added).

107. Beyond the areas discussed in this Article, registered investment advisers are subject, for example, to record keeping obligations (Rule 204-2); certain disclosure

clients is remarkably free of restrictions.

### A. Compensation

The SEC has pursued substantive regulation of investment advisers in the IAA in the area of compensation, both as to amount and type. The IAA itself contains restrictions on performance fees,<sup>108</sup> while the regulation of the amount of compensation is solely a child of SEC no-action letters.<sup>109</sup>

#### 1. Excessive Compensation

The SEC has read a restriction on excessive compensation into the IAA through a series of no-action letters in the 1970s. The SEC continues to cite to this restriction in public appearances<sup>110</sup> despite the fact that there has been no further clarification of the SEC's position in the past forty years. One cannot help but wonder about the "precedential" value<sup>111</sup> of forty-year-old no-action letters that have spawned no follow-up jurisprudence other than public statements by SEC staff members and other

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obligations to clients and prospective clients (Rule 204-3), a requirement to adopt a code of ethics (Rule 204A-1); certain client prospective consent and investment adviser disclosures with respect to agency cross transactions (Rule 206(3)-2); restrictions on advertising (Rule 206(4)-1); custody requirements for customer funds and securities (Rule 206(4)-2); restrictions on cash payments for client solicitations (Rule 206(4)-3); restrictions on political contributions by certain investment advisers (Rule 206(4)-5); requirements for proxy voting of client securities (Rule 206(4)-6); and requirements for compliance programs (Rule 206(4)-7). *Id.* §§ 204, 206.

108. *See infra* notes 127-141 and accompanying text.

109. *See infra* notes 110-126 and accompanying text.

110. ROBERT E. PLAZE, SEC. & EXCH. COMM'N, REGULATION OF INVESTMENT ADVISERS BY THE U.S. SECURITIES AND EXCHANGE COMMISSION, 50 n.256 (2013), available at [http://www.sec.gov/about/offices/oia/oia\\_investman/rplaze-042012.pdf](http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf).

111. "Precedential" is in quotes because, theoretically, IAA no-action letters and no-action requests do not bind even the Commission itself with respect to the particular party that has written to the Division of Investment Management. But, as a practical matter, both the SEC and the rest of the investment management bar treat no-action letters as precedent, citing to earlier letters with regularity in later letters. The SEC also cites earlier letters in releases and enforcement actions. No-action letters even get cited in court cases as evidence of SEC policies. Finally, earlier letters are used by the private bar as guidance for advice to clients. *See, e.g.*, Thomas P. Lemke, *The SEC No-Action Letter Process*, 42 BUS. LAW. 1019 (1987) (opining that, while the precedential effect of no-action responses to nonrecipients is less weighty, they may nonetheless be used by anyone engaging in materially similar transactions); Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921, 966-990 (1998) (stating that no-action letters and their interpretations are received with automatic deference by a majority of judges but that a minority of judges will treat no-action letters as merely advisory).

members of the investment management bar.<sup>112</sup>

The earliest of these letters is one from Richard J. Laibinger, Jr., in 1971.<sup>113</sup> It also is quite typical of the later letters. Mr. Laibinger wrote to the SEC, requesting permission to charge the fees that he had listed in his application for registration as an investment advisor.<sup>114</sup> He proposed “to charge advisory fees of \$2,000 minimum for portfolios valued at \$30,000 or less, \$3,000 minimum for portfolios valued between \$30,000 and \$50,000 and \$4,000 minimum for portfolios valued at \$50,000 or more.”<sup>115</sup> For these fees, a client would have received “a maximum of six personal conferences” and “any special reports” about securities produced by Mr. Laibinger.<sup>116</sup>

In the SEC’s view, such fees were “substantially in excess of the prevailing fees charged by other investment advisers offering comparable services.”<sup>117</sup> The SEC expressed skepticism that “any amount of disclosure could adequately apprise potential clients of the excessive nature of the fees.”<sup>118</sup> The SEC went beyond this skepticism about disclosure, noting that such high fees “appear to be so unconscionably high as to violate the applicable anti-fraud provisions of the federal securities laws.”<sup>119</sup>

Later no-action letters rephrase the relationship between the anti-fraud provisions and disclosure as it was explained to Mr. Laibinger, but they do continue to express skepticism that any amount of disclosure would be effective. In addition, the later letters give an actual figure—two percent—as to what comparable asset-based fees are,<sup>120</sup> although the issue has been raised whether the SEC should allow for higher fees if there are additional services being performed other than standard investment advice.<sup>121</sup> In light

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112. Clifford E. Kirsch, *Financial Planning*, in *CORPORATE LAW & PRACTICE* 245, 248–49 (Practising Law Institute 2012) (printing a presentation given July 18, 2012 by Kirsch).

113. Richard J. Laibinger, Jr., SEC No-Action Letter, 1971 WL 7757 (Sept. 11, 1971).

114. *Id.* at \*1

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.*

120. The SEC will recharacterize certain service charges as investment advisory fees if such service charges are part of what is normally included within an advisory fee. *See* Standard & Poor’s Corp., SEC No-Action Letter, 1975 WL 11120, at \*9 (Nov. 23, 1975) (“[m]oreover, in determining whether management compensation is so large as to require special disclosure, consideration must be given to the total cost to the investor, not merely that portion of the management compensation which is labelled [sic] the advisory fee. It is our understanding that investment advisers providing investment supervisory services do not normally impose service charges in addition to the advisory fee.”).

121. Scheinman and Bell, SEC No-Action Letter, 1976 WL 12226, at \*2 (Feb. 1, 1976). The Knowles & Armstrong, Inc. No-Action Letter is cited in Scheinman and Bell for the proposition that “the SEC has, under certain circumstances, permitted an ‘extra charge’ for

of the fact that these letters are forty years old, it is hard to know what to make of these concerns. But these 1970s letters continue to be cited by SEC staff members and private investment management lawyers without any discussion of whether a line should be drawn at two percent or some other percentage.<sup>122</sup>

The later 1970s letters start with the anti-fraud provisions of section 206 of the IAA, stating the SEC's view "that the antifraud [sic] provisions in Section 206 of the Act apply to excessive advisory fees."<sup>123</sup> The later 1970s letters differ in how they treat disclosure. Some letters contemplate that otherwise excessive fees might be adequately disclosed to an advisee, thus immunizing the investment adviser from a fraud action under section 206.<sup>124</sup> Other letters express the SEC's view that no amount of disclosure could be effective. This latter position seems to stem from the SEC's view that no reasonable investor would ever agree to pay more than what the market rate was and, therefore, even if consent was obtained, the disclosure must have been inadequate. As the SEC has stated its view:

However, even if you were to prepare such a disclosure statement, we cannot give you any assurance that, in circumstances where the fee charged was more than 2% of the assets actually under management, we would not take the position that the fee arrangement would violate Section 206 because it is doubtful whether a client in full possession of all the

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the rendition of advice concerning options" and, therefore, a fee of greater than two percent could be justified. *Id.* However, Scheinman does not stand for this proposition, as the SEC took no position since it had been provided with only "limited facts." *Id.* Knowles, however, cannot be read for this conclusion. Knowles & Armstrong, Inc., SEC No-Action Letter, 1974 WL 10959 (Apr. 16, 1974). The no-action applicant in Knowles did propose to charge an option fee in addition to its basic one-percent advisory fee. *Id.* at \*1. But the SEC, in its response granting no-action relief, relied on the fact that these two fees would total less than two percent. *Id.* at \*2

122. See Kirsch, *supra* note 112, at 248-49 ("The SEC Staff has taken the position that advisory fees, in total, that exceed 3.00% per year require additional disclosure essentially informing the client that he or she could likely receive comparable services from another adviser for a lower fee.") (footnote omitted) (citing to 1970s no-action letters); Plaze, *supra* note 110, at 50 n.256 (noting that "The [SEC] staff had indicated that it will consider an advisory fee greater than 2% of the total assets . . . excessive and would violate section 206.").

123. Crystal Sec. Corp., SEC No-Action Letter, 1973 WL 8418, at \*2 (Sept. 10, 1973).

124. The required disclosure has two parts. First, that the fees being charged are "higher than that normally charged in the industry," and second, "that other advisers can provide the same or similar services at lower rates." Philip R. Bulliard, SEC No-Action Letter, 1974 WL 10973, at \*3 (July 5, 1974). Procedurally, the SEC has recommended that disclosure should be in writing and that "[i]t would be advisable for [the adviser] to receive from each such advisory client a written acknowledgment of his receipt and understanding of the matters disclosed therein." Fin. Counseling Corp., SEC No-Action Letter, 1974 WL 7071, at \*2 (Dec. 7, 1974).

facts would consent to such a fee arrangement.”<sup>125</sup>

The principles of the excessive fee no-action letters have been applied by the SEC to several other industry practices, such as directed brokerage programs in which advisees do not receive the full benefit of the compensation paid by brokers for the business directed to them. These programs raise similar consent issues in the SEC’s view:

“Unless the *full* benefits of the adviser’s reduction in expenses are passed through to his clients, we cannot envision at this time any situation in which implementation of this course of business would not result in a breach of fiduciary duty to clients or that a client in full possession of all the facts would knowingly consent to such arrangement.”<sup>126</sup>

## 2. Performance Fees

Section 205(a)(1) of the IAA, read in conjunction with section 205(b)(2), provides that certain registered investment advisers may not enter into contracts to receive “compensation. . . on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of [a] client.”<sup>127</sup> However, if the client is a registered investment company or if “the contract relates to the investment of assets in excess of \$1 million,” and if the contract with the registered investment company for investment of assets in excess of \$1 million provides for what the industry calls a “fulcrum fee” arrangement, the restrictions of this section do not apply.<sup>128</sup> The congressional intent behind the prohibition on performance

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125. Fin. Counseling Corp., SEC No-Action Letter, 1974 WL 7071, at \*2 (Dec 7, 1974). This principle has also been applied by the SEC to an advisee waiving her right to the receipt of individualized advice. See Runyon & Assocs.-Prof’l Consultants, Inc., SEC No-Action Letter, 1974 WL 10993, at \*1 (Nov. 17, 1974) (stating “we have some doubt as to whether the adviser’s fiduciary duty [to render individualized advice] would be satisfied even if disclosure were made that no consideration will be given to other factors” besides “general stock market direction.”).

126. Donnelly, Clark, Chase & Haakh, SEC No-Action Letter, 1972 WL 12221, at \*2 (Apr. 27, 1973); accord Tex. Inv. Mgmt. Co. Inc., SEC No-Action Letter, 1973 WL 11847, at \*1 (Nov. 9, 1973) (stating that “an investment adviser has a fiduciary duty to deal fairly with . . . his clients” and directed brokerage conflicts with this duty); see also A. S. Hasen, Inc., SEC No-Action Letter, 1974 WL 10985, at \*5 (July 12, 1974) (asserting that subject to the investment adviser’s best execution obligations, directed brokerage was allowed where advance written notice was given of possible conflict of interest between the investment adviser and the advisee, and no brokerage transactions beyond those that would normally have occurred were carried out).

127. Investment Advisers Act of 1940, §§ 205(a)(1), (b)(2), 15 U.S.C. §§ 80b-5(a)(1), (b)(2) (2006).

128. *Id.* at § 205(a)(1), (b)(2), 15 U.S.C. §§ 80b-5(a)(1), 80b-5(b)(2). There are a number of other exceptions built into section 205: one for certain investment advisory



fees was to remove the temptation for investment advisers “to take undue risks with the funds of clients”<sup>129</sup> encouraged by “profit-sharing contracts which are nothing more than ‘heads I [the investment adviser] win, tails you [the advisee] lose’ arrangements.”<sup>130</sup> In other words, an investment adviser could be tempted to gamble with a client’s assets in order to make a profit because the gain for the investment adviser from the profit could be much larger than the loss of any ongoing asset management fee.<sup>131</sup> If the gamble was unsuccessful, then the client would lose some or all of her investments while, at most, the investment adviser would lose some or all of any ongoing asset management fee.<sup>132</sup>

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contracts with business development companies, one for advisory contracts with investment companies where securities holders are all “qualified purchases” at the time of purchase, and one for advisory contracts with a non-U.S. resident person. *Id.* at § 205(b)(3), (5), (e).

129. H.R. REP. NO. 76-2639, at 29 (1940).

130. S. REP. NO. 76-1775, at 22 (1940).

131. The original draft of the IAA contained a Declaration of Policy to the effect that “the national public interest and the interest [sic] of investors are adversely affected . . . when [, among other things,] the compensation of investment advisers is based upon profit-sharing contracts and other contingent arrangements conducive to excessive speculation and trading.” S. 3580, 76th Cong. § 202 (1940). This language disappeared from the bill that was finally enacted, which focused on establishing that investment advisers were engaged in interstate commerce and, thus, were subject to Congressional regulation. Investment Advisers Act of 1940 § 201. The constitutional basis for regulating investment advisers was explored in the Senate hearings prior to the finally-enacted bill through discussion about the predecessor bill. *See, e.g., Investment Trusts and Investment Companies: Hearings Before a Subcomm. of the Comm. on Banking and Currency on S. 3580, 77th Cong. 745–46 (1940)* (statement of Rudolf B. Berle, Gen. Counsel, Inv. Counsel Ass’n of Am., N.Y.C.) (testifying that because the industry was so new at the time, it should not be regulated by either state or federal authority).

132. The voluminous study of Investment Trusts and Investment Companies that the SEC released in 1938 and 1939 does not discuss investment counsel, as investment advisers were called at the time. The hearings on the proposed IAA do not provide any further illumination on the intent behind the fulcrum fee provisions. Rather, the hearings before the Senate focused on whether there should be any regulation of investment counsel, with investment counsel representatives raising concerns that federal regulation would have unintended consequences and, most importantly, that investment counsel were professionals whose regulation “would represent the first encroachment of the Federal government into the domain of personal, professional relationships.” *Investment Trusts and Investment Companies: Hearings Before a Subcomm. of the Comm. on Banking and Currency on S. 3580, 77th Cong. 738 (1940)* (statement of Dwight C. Rose, Partner of Brundage, Story & Rise, N.Y.C., and President, Inv. Counsel Ass’n of Am.). By the time the House of Representatives held hearings on H.R. 10065, which, with some amendments, was eventually enacted, the representative of the investment counsel industry had met with the SEC and resolved their objections to the IAA. *Investment Trusts and Investment Companies: Hearings before a Subcomm. on Interstate and Foreign Commerce on H.R. 10065, 76th Cong. 91–93 (1940)* (statement of Dwight C. Rose, Partner of Brundage, Story & Rise, N.Y.C., and President, Inv. Counsel Ass’n of Am.). The investment counsel representatives had succeeded in preventing incorporation into the IAA of certain provisions from the ICA that the representatives felt would give the SEC “unnecessarily broad”

The rationale behind the fulcrum fee concept seems clear, although the language on how a fulcrum fee arrangement operates is anything but clear.<sup>133</sup> The rationale is that an investment adviser will not be tempted to gamble with their client's assets if the investment adviser's fee can go down as well as up because of such a gamble. The mechanism of a fulcrum fee is easy to understand once one reads a typical industry disclosure on how a performance fee works. A fulcrum fee is the fee earned when the investment performance of a registered investment company or other fund referenced in section 205(b)(2)(B) equals that of an "index of securities prices or such other measure of investment performance as the Commission by rule, regulation, or order may specify" (the "benchmark").<sup>134</sup> From this "point," i.e., this fulcrum, compensation to the investment adviser is decreased or increased with the amount of such decrease or increase depending on how the registered investment company's or other fund's "investment performance" compares to that of the selected benchmark.

The SEC views an incentive-based fee as consisting of two parts: a fulcrum fee and a performance fee.<sup>135</sup> Sometimes, the term "fulcrum fee" is applied to the total fee to be paid to an investment advisor, with the fulcrum

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powers. *Id.* at 92. The original bill had proposed to incorporate sections from title I of S. 3580, the predecessor to the ICA, S. 3580 § 203 ("Sections 3, 34(b), 35(b), and (c), 36, 37 (e) and (f), 38, 39, 40, 41, 42, 43, 45, 46, and 47.").

133. A fulcrum fee arrangement is one where:

the contract provides for compensation based on the asset value of the company or fund under management averaged over a specified period and increasing and decreasing proportionately with the investment performance of the company or fund over a specified period in relation to the investment record of an appropriate index of securities prices or such other measure of investment performance as the Commission by rule, regulation, or order may specify.

Investment Advisers Act § 205(b)(2), 15 U.S.C. § 80b-5(b)(2) (2006). Measurement of changes in compensation is calculated as follows:

the point from which increases and decreases in compensation are measured shall be the fee which is paid or earned when the investment performance of such company or fund is equivalent to that of the index or other measure of performance, and an index of securities prices shall be deemed appropriate unless the Commission by order shall determine otherwise.

*Id.* at § 205(c). Finally, an "investment advisory contract" is defined as "any contract or agreement whereby a person agrees to act as investment adviser to or to manage any investment or trading account of another person other than an investment company registered under title I of this Act." *Id.* at § 205(d).

134. *Id.* at § 205 (b)(2).

135. 17 C.F.R. § 275.205-2(c) (2014) ("[T]he specified period over which the asset value of the company or fund is averaged for purpose of computing the *fulcrum fee* may differ from the period over which the asset value is averaged for computing the *performance related portion of the fee*. . .") (emphasis added).

fee being divided into two parts: the base fee and the performance fee.<sup>136</sup> The performance fee is determined according to a “formula [that] has matching maximum and minimum ranges in which the fees can be adjusted.”<sup>137</sup> Finally, if the company or other fund declines in value, but the decline is less than the decline in the benchmark, then the investment adviser will make more than the fulcrum or base fee.<sup>138</sup> In other words, to use a simplified example, if the company or other fund’s value were to increase from \$100 to \$110 while the benchmark stays stable at \$100, the investment adviser’s fee would be increased by ten percent. In contrast, if the company or other fund’s value fell to \$90, the investment adviser’s fee would be reduced by ten percent.

When enacted, the IAA contained no restriction on performance fees paid by an investment company.<sup>139</sup> In 1970, section 205 was amended to cover performance fees paid by a registered investment company, although the same set of amendments provided that registered investment

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136. Dunham Funds defines fulcrum fees globally in the following way:

A fulcrum fee basically has two parts—the base fee and the performance fee. In a typical fulcrum fee arrangement, the base fee is the pre-determined rate at which the sub-adviser is paid when its net performance is in line with that of the fund’s benchmark. The base fee is adjusted up or down by the performance fee, which is derived by comparing net fund performance versus that of the fund’s benchmark over a rolling twelve-month period, in accordance with pre-determined rates of adjustment. In a fulcrum fee arrangement, a sub-adviser is rewarded for out-performance or penalized for under-performance in equal measure. Depending on a fund’s net performance versus its benchmark, the sub-adviser will receive a fee adjustment in accordance with a formula that equates a percentage of out- or under-performance to a percentage of fee increases or decreases, respectively. This formula has matching maximum and minimum ranges in which the fees can be adjusted. In addition, most fulcrum fees employ a ‘null zone’ around the base fee, whereby very small differences in performance versus the benchmark will not trigger a fee increase or decrease. The basic idea of a fulcrum fee is that when fund performance is bad, the adviser or sub-adviser should sacrifice some of its fee, and when fund performance is good, the fee will increase while still permitting shareholders to reap most of the profit. Under a fulcrum fee arrangement, it is possible that a fund could pay a sub-adviser more than the Base Fee, even though the performance of the fund is negative. This situation may occur when the performance of the benchmark is worse than the fund’s net performance.

Dunham Funds, Statutory Prospectus 103 (Form N-1A) (June 15, 2012), available at [http://www.sec.gov/Archives/edgar/data/1420040/000091047212001880/dunham\\_497.htm](http://www.sec.gov/Archives/edgar/data/1420040/000091047212001880/dunham_497.htm).

137. *Id.*

138. *Id.*

139. Pub. L. No. 768, § 205, 54 Stat. 789, 852 (1940) (“As used in this section, ‘investment advisory contract’ means any contract or agreement whereby a person agrees to act as investment adviser or to manage any investment or trading account for a person *other than an investment company*.”) (emphasis added).

companies, as well as other persons, could be charged fulcrum fees.<sup>140</sup> Congress was concerned that, although performance fee arrangements “are not common in the investment company industry, some do exist, and the number of contracts appears to be increasing.”<sup>141</sup>

The limitation on performance fees is a significant restriction on investment advisers and, unlike many of the other restrictions discussed in this Article, the SEC has not allowed investment advisers to contractually vary their restrictions.

### B. *Principal Transactions*

Section 206(3) of the IAA provides that an investment adviser may not engage in a principal transaction with a client, or act as a broker for a third party effecting a transaction with a client, “without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.”<sup>142</sup> There is nothing in the legislative history to indicate Congress’ intent in enacting section 206(3). Originally, section 206, including subsection (3), was only applicable to registered investment advisers but, in 1960, the limitation to registered investment advisers was removed; the restriction now applies to all investment advisers, registered or not.<sup>143</sup>

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140. Pub. L. No. 91-547, § 205, 84 Stat. 1413, 1432 (1970).

141. S. REP. NO. 91-184, at 45 (1969); accord H.R. REP. NO. 86-2179, at 41 (1970) (proposing an amendment to section 205 of the Investment Advisers Act that would delete the exemption for advisory contracts with investment companies from the prohibition against contracts that provide for performance fee arrangements).

142. Investment Advisers Act of 1940, § 206(3), 15 U.S.C. § 80b-6(3) (2006). The Senate version of the IAA provided more flexibility to investment advisers with respect to principal transactions than the House version that was subsequently enacted. Although it required that investment advisers who made principal sales be members of the NASD, the Senate version did not require consent from the client and provided that disclosure of the investment adviser’s role in the transaction could be given “at or before completion of the sale” rather than “before the completion of such transaction.” S. 3580, 76<sup>th</sup> Cong. § 206(4) (1940).

143. Pub. L. No. 86-750, § 8, 74 Stat. 885, 887 (1960). The Senate report on the amendments provides the following explanation for the extension of section 206 to all investment advisers, registered or not: “[s]ection 8 of the bill would amend the introductory paragraph of section 206 of the act so as to make the antifraud provisions applicable to all investment advisers whether or not registered. Section 203(b) of the act exempts from registration certain investment advisers, primarily those whose business is wholly intrastate or whose only clients are investment and insurance companies, or those who have fewer than 15 clients and do not hold themselves out generally to the public as investment advisers. While it is reasonable to exempt this group from registration, the reasons for exemption from registration do not, in the view of the committee, support a corresponding exemption from prohibitions against fraud. Moreover, under the present wording of the

At first blush, section 206(3) would appear to provide an investment adviser with substantial flexibility as to such transactions. For example, on its face, the language of section 206(3) would be consistent with a client giving blanket permission for future principal transactions. Since 1945, however, the SEC has interpreted Section 206(3) so as to make it very restrictive in practice.

Since 1945, the SEC's position has been that section 206(3) requires "that the disclosure of the *capacity* in which the investment adviser is acting be given *in writing* and the client's consent obtained before the completion of the transaction."<sup>144</sup> In addition, "the requirements of written disclosure and of consent contained in this clause must be satisfied before the completion of *each* separate transaction."<sup>145</sup> The requirement of transaction-by-transaction consent would be particularly burdensome to an investment adviser who was also a broker-dealer and, therefore, regularly engaged in principal transactions.

In the current debate over whether a unified fiduciary duty standard should be adopted for brokers, dealers, and investment advisers, the possibility of the restrictions of section 206(3) being applied to brokers and dealers has aroused intense opposition from the broker-dealer community. The clearest evidence of this opposition are the comment letters that the leading American trade organization for broker-dealers, the Securities Industry and Financial Markets Association ("SIFMA"), has submitted to the SEC in connection with the SEC's consideration of a unified standard. From its very first comment letter in 2010 until its most recent comment letter in 2013,<sup>146</sup> SIFMA has consistently opposed imposition of any

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statute, an investment adviser not exempt from registration may escape liability for fraud simply by neglecting to register, so that the Commission can only proceed against him for having failed to register." S. REP. NO. 86-1760, at 7 (1960). The House report summarized the reasons behind the change as follows: "[t]his section is now applicable only to registered investment advisers. Fraud is no less vicious because it is perpetrated by an unregistered investment adviser. Just as the antifraud provisions of the Securities Exchange Act of 1934 are applicable to brokers and dealers irrespective of registration, so should the antifraud provisions of this act be applicable to all investment advisers. H.R. REP. NO. 86-2179, at 7 (1960).

144. Opinion of Director of Trading and Exchange Division, relating to section 206 of the Investment Advisers Act of 1940, section 17(a) of the Securities Act of 1933, and section 10(b) and 15(c)(1) of the Securities Exchange Act of 1934, Investment Advisers Act Release No. 40, 11 Fed. Reg. 10,997, 10,997 (proposed Feb. 5, 1945) (emphasis in original).

145. *Id.* (emphasis added).

146. Sec. Indus. & Fin. Mkts Ass'n (SIFMA), Comment Letter to the SEC on Data Relating to the Duties of Brokers, Dealers and Investment Advisers 13–14 (July 5, 2013), <http://www.sifma.org/issues/item.aspx?id=8589944317> [hereinafter 2013 SIFMA Letter]; SIFMA, Comment Letter to the SEC on the Framework for Rulemaking under the Fiduciary Duty Provision of the Dodd-Frank Act 2 (May 4, 2012), <http://www.sifma.org/issues/item.aspx?id=8589938634>; SIFMA, Comment Letter to the SEC on a Proposed Framework

restriction on brokers and dealers with respect to principal transactions that might arise from any unified fiduciary standard.

SIFMA has been concerned that applying the principal trading restriction to broker-dealers would prevent broker-dealers from “provid[ing] liquidity and best execution to retail customers” in the equity and fixed income markets, restrict “retail customers’ . . . access to” underwritten public offerings, and present obstacles to a broker-dealer’s offering “[a]ffiliated products such as affiliated mutual funds, structured products, private equity, and other alternative investments, [that] may represent a firm’s best intellectual capital and are important investment options for retail customers.”<sup>147</sup> The solution that SIFMA has suggested is “simple and clear disclosure and client consent to material conflicts of interest.”<sup>148</sup> This is exactly the solution that the SEC rejected in formulating its approach to principal transactions under section 206(3) of the IAA.

SIFMA relied in part on the fact that the Dodd-Frank Act’s provision that any new fiduciary duty standard for broker-dealers was to be “no less stringent than the standard applicable to investment advisers under sections 206(1) and (2) of” the IAA,<sup>149</sup> leaving out the specific restrictions contained in section 206(3).<sup>150</sup> In separating section 206(1) and (2) from section 206(3), SIFMA is following the reasoning of the 1945 opinion from the SEC’s Director of its Trading and Exchange Division. Although the version of section 206 in effect in 1945 applied only to registered investment advisers, the opinion read sections 206(1) and 206(2), as well as the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934, as requiring any investment adviser to obtain consent to any principal transaction after full disclosure by the investment adviser to the client. But *written* disclosure *prior* to such transactions was required only of registered investment advisers.<sup>151</sup>

One has to wonder how long it will take for this disclosure and

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for Rulemaking Under Section 913 (Fiduciary Duty) of the Dodd-Frank Act 23 (July 14, 2011), <http://www.sifma.org/issues/item.aspx?id=8589934675>; SIFMA, Comment Letter to the SEC on Obligations of Brokers, Dealers, and Investment Advisers 10–11 (Aug. 30, 2010), <http://www.sifma.org/issues/item.aspx?id=22263> [hereinafter 2010 SIFMA Letter].

147. 2010 SIFMA Letter, *supra* note 146, at 10.

148. *Id.* at 11.

149. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, H.R. 4173, 111th Cong. § 913(g) (2010).

150. 2013 SIFMA Letter, *supra* note 146, at 13 (“Importantly, in omitting any reference to Section 206(3) of the Advisers Act in Section 913 of the Dodd-Frank Act, Congress intended to preserve for BDs the ability to engage in principal transactions under the uniform fiduciary standard of conduct.”).

151. *See supra* note 144 and accompanying text (expressing the opinion of an SEC director regarding required consents for an investment adviser).

consent approach to seep into the SEC's approach to section 206(3). Some signs of the SEC's flexibility with respect to the proper approach to principal transactions is found in Rule 202(a)(11)-1, which "provided, among other things, that fee-based brokerage accounts were not advisory accounts and were thus not subject to the Advisers Act."<sup>152</sup> In response to the D.C. Circuit case that vacated this exemptive rule,<sup>153</sup> the SEC adopted a temporary rule to help entities dually-registered as broker-dealers and investment advisers to comply with section 206(3). Subject to a number of conditions, the temporary rule allows for prospective client consent to principal transactions and for oral client consent to any particular transaction.<sup>154</sup>

### C. *Limitations of Investment Adviser Liability*

The IAA and ICA prevent an investment adviser from contractually limiting liability to its advisees through three routes: statutory anti-waiver provisions,<sup>155</sup> expansive SEC interpretations of the anti-fraud provisions of the IAA to cover hedge clauses,<sup>156</sup> and limitations on indemnification by registered investment companies of their investment advisers.<sup>157</sup>

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152. Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Investment Advisers Act Release No. 2653, 72 Fed. Reg. 55,022, 55,022 (Sept. 28, 2007).

153. *Fin. Planning Ass'n v. S.E.C.*, 482 F.3d 481 (D.C. Cir. 2007).

154. 72 Fed. Reg. 55, 022, 55,027–028. The temporary rule has been extended a number of times, most recently through December 31, 2014. Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Investment Advisers Act Release No. 3522, 77 Fed. Reg. 76,854 (Dec. 31, 2012).

155. Investment Advisers Act of 1940 § 215(a), 15 U.S.C. § 80b-15(a); Investment Company Act of 1940 § 47(a), 15 U.S.C. § 80a-46(a) (2006). Both sections provide that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this subchapter or with any rule, regulation, or order thereunder shall be void." 15 U.S.C. §§ 80a-46(a), 80(b)-15(a). Similar provisions are found in the Securities Act of 1933 and the Securities Exchange Act of 1934. Securities Act of 1933 § 14, 15 U.S.C. § 77n (2006) ("Any condition, stipulation of provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."); Securities Exchange Act of 1934 § 29(a), 15 U.S.C. § 78cc(a) (2006) ("Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void.").

156. *See, e.g.*, Heitman Capital Mgmt., LLC, SEC No-Action Letter, 2007 WL 789073, at \*4 (Feb. 12, 2007) (stating that the SEC refuses to issue further no-action assurances regarding hedge clauses).

157. Investment Company Act of 1940 § 17(i), 15 U.S.C. § 80a-17(i) (2006). Section 17(i) also applies to a "principal underwriter." *Id.* ("[N]o contract . . . [for an] investment adviser of, or principal underwriter for, a registered investment company shall . . . protect such person against any liability to such company or its security holders . . . by reason of willful malfeasance, bad faith, or gross negligence . . ."). A similar provision, section

### 1. Statutory Anti-Waiver Provisions and Limitations on Indemnification

Statutory anti-waiver provisions prevent an advisee of an investment adviser from waiving compliance of the investment adviser with its obligations under the IAA and the ICA. In addition, under the ICA, an investment adviser to a registered investment company may not be protected against any liability arising from anything other than “ordinary negligence, mere mismanagement or vicarious fault.”<sup>158</sup> This prohibition normally arises in connection with indemnification provisions entered into by a registered investment company in favor of its investment adviser. In the SEC’s view, an indemnification provision that “is not prohibited by section 17(h) or (i) might nevertheless be [sic] invalid as contravening some other provision of the federal securities laws, such as section 47(a) of the [Investment Company] Act.”<sup>159</sup> In other words, section 47(a) may capture a wider range of prohibited conduct than does section 17(i).

Section 17(i) has developed a fair amount of SEC gloss, with the SEC

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17(h), applies to officers and directors of an investment company. *Id.* § 17(h) (“[N]either the charter, certificate of incorporation . . . nor the by-laws of any registered investment company . . . shall . . . protect any director or officer of such company against any liability to the company or to its security holders . . . by reason of willful malfeasance, bad faith, gross negligence, or reckless disregard of the duties involved in the conduct of his office.”).

158. *Brown v. Bullock*, 194 F. Supp. 207, 238 (S.D.N.Y. 1961), *aff’d*, 294 F.2d 415 (2d Cir. 1961).

159. Indemnification by Investment Companies, 45 Fed. Reg. 62,423, 62,423 n.4 (Sept. 4, 1980) (suggesting that a provision not prohibited by section 17(h) or (i) may still be voided by 47(a)). There does not appear to be any further authority on this point. The closest are two appellate briefs in *Sletten v. The Navellier Series Fund*, which involved an indemnity claim by a trustee arising out of a lawsuit alleging breach of fiduciary duty and waste under Delaware law and the ICA. The initial lawsuit was brought by one of the interested trustees and some shareholders of the Navellier Series Fund of which Sletten was one of three independent trustees. *Navellier v. Sletten*, 262 F.3d 923, 932 (9th Cir. 2001). Sletten brought a separate action to enforce his indemnity rights, which the fund resisted on the grounds that Sletten had already been paid his expenses by the fund’s insurer and his own homeowner’s insurer. *Id.* at 933. The district court held that the fund should receive no offset for the payments made by Sletten’s homeowner’s insurer but should receive an offset for expenses paid by its insurer. *Sletten v. The Navellier Series Fund*, 276 F. Supp. 2d 1067, 1075 (D. Nev. 2003). Cross-appeals to the Ninth Circuit followed. 172 Fed. Appx. 196 (9th Cir. 2006). During the cross-appeals, Sletten relied upon section 17(h) to support this claim for indemnification of all of his costs. Relying on sections 1(b)(1), 1(b)(8), 47(a) and 47(b) of the ICA, The Navellier Series Fund argued that paying all of his costs “would violate the purpose and policy of protecting investor interests and acting for the interests of investors.” Appellants’ Opening Brief (First Brief on Cross-Appeal) at 38, *Sletten v. Navellier Series Fund*, 172 Fed. Appx. 196 (9th Cir. 2006) (No. 03-16475). However, neither the district court opinion nor the Ninth Circuit’s opinion discussed this particular argument.



having firm views not only on the phrasing of such indemnities,<sup>160</sup> but also on the “reasonable and fair means for determining whether [such] indemnification shall be made,”<sup>161</sup> and on how advances of “attorneys’ fees

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160. The indemnity should exclude “any liability . . . arising by reason of willful misfeasance, bad faith, gross negligence, or reckless disregard of duties as described in section 17(h) and (i).” 45 Fed. Reg. at 62,423. This language tracks the language in section 17(i), and all of the conduct excluded from indemnification is labeled by the SEC as “disabling conduct.” *Id.*

161. *Id.*

[These] would include (1) a final decision on the merits by a court or other body before whom the proceeding was brought that the person to be indemnified (‘indemnitee’) was not liable by reason of disabling conduct or, (2) in the absence of such a decision, a reasonable determination, based upon a review of the facts, that the indemnitee was not liable by reason of disabling conduct, by (a) the vote of a majority of a quorum of directors who are neither ‘interested persons’ of the company as defined in section 2(a)(19) of the 1940 Act . . . nor parties to the proceeding . . . , or (b) an independent legal counsel in a written opinion.

*Id.* (footnote omitted). In appropriate circumstances, the SEC independently reviews whether “a reasonable determination, based upon a review of the facts,” has been made. *Id.*; see also *Steadman Sec. Corp.*, SEC No-Action Letter, 1983 WL 29854, at \*7 (Apr. 18, 1983) [hereinafter *Steadman No-Action Letter*] (stating that both “[a] majority of a quorum of disinterested, non-party trustees of each of the three Funds involved in this matter” adopted resolutions finding that the investment adviser had not engaged in any “disabling conduct” and legal counsel rendered an opinion that the investment adviser “ha[d] a legal right to indemnification, and that payment would be consistent with Section 17 of the Act.”). Additionally, in *Steadman*, payment under the resolutions was conditioned upon a court ordering such payment. *Steadman No-Action Letter*, *supra*, at \*2. The district court had denied a summary judgment motion by the investment adviser seeking indemnification from the registered investment companies and suggested that the investment adviser seek the SEC’s opinion on the legality of any indemnity payments. *Steadman Sec. Corp. v. Steadman Associated Fund*, No. 82-2241, 1982 WL 1357, at \*3 (D.D.C. Dec. 2, 1982). As the investment adviser’s summary judgment motion had been dismissed without prejudice, the implication was that the SEC’s opinion would influence the district court’s final determination of the indemnification issue. The investment adviser, rather than the registered investment companies, wrote to the SEC soliciting its opinion. *Steadman No-Action Letter*, *supra*, at \*2. The investment adviser made its argument based on the language of sections 17(h) and (i), the indemnity sections, and the language of the sections that the investment adviser had violated. *Id.* As the violated sections did not contain the same language that sections 17(h) and (i) use to describe the “disabling conduct,” the investment adviser argued that conduct forbidden by these violated sections was, at best, “parallel” or “equivalent” to “disabling conduct,” but was not covered as “disabling conduct” because Congress had not used the same language in the indemnity and violated sections. *Id.* The SEC rejected this argument, noting that “the nature and character of the conduct and violations must be analyzed.” *Id.* at \*8. On the basis of the administrative proceeding, *In re Steadman Security Corporation*, 46 S.E.C. 896 (June 29, 1977), the opinion of the Fifth Circuit reviewing the order arising from the proceeding, *Steadman v. S.E.C.*, 603 F.2d 1126 (5th Cir. 1979), the district court record, and the consent order that finally terminated the administrative proceeding, the SEC had no difficulty in finding that the facts support a “reasonable determination” that the investment adviser’s right to

or other expenses incurred by [a registered investment company's]. . . investment adviser” should be handled.<sup>162</sup>

## 2. Hedge Clauses

The SEC’s position on hedge clauses has evolved in light of the IAA’s anti-fraud provisions, culminating in the 2007 no-action letter of Heitman Capital Management, LLC,<sup>163</sup> which granted new and unexpected leeway to advisers. In Heitman Capital, the SEC stated that it would no longer provide no-action guidance on hedge clauses; therefore, the only avenues for further development of the law in this area are the courts and SEC enforcement actions.<sup>164</sup>

Although plaintiffs in a number of cases have raised hedge clauses, there has only been one case with a published opinion that addresses the effect hedge clauses have on a contract between an investment adviser and its advisee. The Ninth Circuit, in the recent case of *Hsu v. UBS Financial Services, Inc.*,<sup>165</sup> allowed an investment adviser to legally disclaim its liability—or create the perception in the mind of the advisee that the adviser has disclaimed its liability—for the actions of an investment manager to whom the investment adviser refers an advisee. This is a surprising outcome because recommending an investment manager can

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indemnification did not exist. *Id.* at \*1-\*2. The conduct of the investment adviser fell within the “disabling conduct” definition because the state of mind of “the president, chairman of the board, and sole beneficial owner” was imparted to the investment adviser, supporting the conclusion that the investment adviser acted willfully or with scienter. *Id.* at\*1, \*17.

162. 45 Fed. Reg. at 62,423. Advances of “attorneys’ fees or other expenses incurred by its. . . investment adviser” are not violations of section 17(i) if the investment adviser undertakes to repay any advance “unless it is ultimately determined that he is entitled to indemnification.” *Id.* In addition, the registered investment company may not make an advance unless it has assurance that such an undertaking will either be met or will be unnecessary. To meet this goal, the SEC has prescribed that one of three conditions must be met before an advance can be made:

“(1) the indemnitee shall provide a security for his undertaking, (2) the investment company shall be insured against losses arising by reason of any lawful advances, or (3) a majority of a quorum of the disinterested, non-party directors of the investment company, or an independent legal counsel in a written opinion, shall determine, based on a review of readily available facts (as opposed to a full trial-type inquiry), that there is reason to believe that the indemnitee ultimately will be found entitled to indemnification.”

*Id.*

163. Heitman Capital Mgmt., LLC, *supra* note 156.

164. *Id.* at \*4.

165. 2011 WL 3443942 (N.D. Cal. Aug. 5, 2011), *aff’d*, 507 Fed. Appx. 716 (9th Cir. 2013), *cert. denied*, 134 S. Ct. 266 (mem.) (2013).

constitute investment advice under the IAA,<sup>166</sup> and the disclaimer of liability for the recommended manager's actions is arguably inconsistent with the recommending adviser's broad fiduciary duties.<sup>167</sup>

The SEC has relied upon two IAA provisions in developing its position on hedge clauses. The first is section 206, the anti-fraud provisions, and the second is section 215, the provision voiding certain illegal advisory contracts. Sections 206(1) and 206(2) make it unlawful for an investment adviser "to employ any device, scheme, or artifice to defraud any client or prospective client," and/or "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," respectively.<sup>168</sup> Section 215(a) provides that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this subchapter or with any rule, regulation, or order thereunder shall be void."<sup>169</sup>

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166. See *S.E.C. v. Bolla*, 401 F. Supp. 2d 43 (D.D.C. 2005) *aff'd in relevant part*, *S.E.C. v. Wash. Inv. Network*, 475 F.3d 392, 400 (D.C. Cir. 2007) (stating that a company's business of advising clients about different investment managers fell within IAA's definition of investment advice); see also *Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services*, SEC Interpretive Letter, Investment Advisers Act Release No. 1092, 1987 WL 112702 at \*3 (Oct. 8, 1987) ("A person providing advice to a client as to the selection or retention of an investment manager or managers also, under certain circumstances, would be deemed to be 'advising' others within the meaning of Section 202(a)(11)."); *Capital Asset Program*, SEC No-Action Letter, 1974 WL 10950 at \*11 (Dec. 1, 1974) ("Since the placing of assets under the management of an investment adviser would normally involve investing in securities, advising a client to select or dismiss an investment adviser would inherently involve advising such a client as to the advisability of investing in securities in general . . ."); *William Bye Co.*, SEC No-Action Letter, 1973 WL 6670 at \*3 (Apr. 26, 1974) (describing the SEC's view that a company's "preparing a periodic quantitative evaluative analysis of the rates of return for investment managers it studies, would be 'advising others . . . as to the value of securities' and issuing 'analyses or reports concerning securities' within the meaning of Section 202(a)(11) of the Act."). *But see* *Sebastian Assocs., Ltd.*, SEC No-Action Letter, 1975 WL 10853 at \*3 (Aug. 7, 1975) (recommending no action based on representations that company assisted clients in retaining "outside specialists," including estate planning attorneys and "reputable investment advisers or financial consultants"); *Hudson Valley Planning, Inc.*, SEC No-Action Letter, 1978 WL 12359 at \*2 (Feb. 25, 1978) (stating that a "Consultant" to an employee benefit plan's clients is not required to register as an investment adviser, where the consultant primarily drafted and analyzed data-drive questionnaires of a client's investment advisers, and only incidentally provided, upon a client's request, generalized information as to investment advisers capable of fulfilling the client's needs, and did not recommend a specific adviser or provide general advice about investments.).

167. See *S.E.C. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (addressing the duties that investment advisers owe their clients).

168. 15 U.S.C. § 80b-6(1)-(2).

169. *Id.* at § 80b-15(a).

The SEC's first statement on hedge clauses came in a 1951 Opinion of the General Counsel.<sup>170</sup> The hedge clauses addressed in the general counsel's opinion related to literature used by both broker-dealer and investment advisers containing recommendations or information on particular securities. Such publications contained statements to the effect "that the information furnished is obtained from sources believed to be reliable but that no assurance can be given as to its accuracy," with occasional added language "to the effect that no liability is assumed with respect to such information."<sup>171</sup> Concerned that a hedge clause would "create in the mind of the investor a belief that he has given up legal rights and is foreclosed from a remedy which he might otherwise have either at common law or under the" federal securities laws, the general counsel opined that a hedge clause or similar provision violates section 206's anti-fraud provisions (and other SEC statutes) if it "is likely to lead an investor to believe that he has in any way waived any right of action he may have."<sup>172</sup>

Over time, the hedge clause language was generalized by broker-dealers and investment advisers to contracts with advisees beyond the literature context. The added language disclaiming liability mentioned in the general counsel's opinion is what the SEC has focused on in a series of no-action letters and enforcement actions. Hedge clauses remain very common in the investment adviser industry. In the first half of 2013, hedge clauses that triggered a finding of contractual deficiency were commonly found in state and Canadian provincial examinations of investment advisers.<sup>173</sup>

Until 2007, the SEC, through a series of no-action letters and enforcement actions, took a very restrictive position on what a permissible hedge clause was. Essentially, the SEC reasoned that the anti-fraud provisions of the IAA contained in sections 206(1) and 206(2) were

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170. Opinion of General Counsel, Relating to Use of "Hedge Clauses" by Brokers, Dealers, Investment Advisers, and Others, SEC Interpretive Letter, 16 Fed. Reg. 3387 (proposed Apr. 10, 1951).

171. *Id.*

172. *Id.* The general counsel was concerned with hedge clauses under the Securities Act of 1933 and the Securities Exchange Act of 1934 as well as the IAA. But, as indicated in the main text, this Article examines hedge clauses only in the context of the IAA.

173. N. Am. Sec. Adm's Ass'n, 2013 Coordinated Investment Adviser Exams (Oct. 2013), <http://www.nasaa.org/wp-content/uploads/2013/10/IA-Sweep-2013-Final.pdf>. One thousand one hundred thirty investment advisers were examined (primarily between January 1, 2013, and June 30, 2013), revealing 6,482 deficiencies. *Id.* at 5. Of the 6,482 total deficiencies, 791 were "Contract Deficiencies," 9% of which (approximately 71) involved hedge clauses. *Id.* at 12. From the figures it is impossible to tell whether 71 investment advisers used improper hedge clauses or whether there were multiple agreements involving the same investment advisers with improper hedge clauses.

violated any time a hedge clause attempted to limit investment adviser liability for negligence or malfeasance by using such adjectives as “gross” or “willful” to qualify what type of investment adviser negligence or malfeasance might trigger liability to an advisee.<sup>174</sup> The no-action letter issued to Heitman Capital Management, LLC in 2007 marked a turn in the SEC’s position and declared, for the first time, that such qualifications are not *per se* violations of sections 206(1) and 206(2).<sup>175</sup> Rather, the Heitman Capital no-action letter announced that whether a particular hedge clause is “mislead[ing] [as to] any particular [c]lient” can only be answered by a “fact-intensive . . . inquiry” that focuses on an advisee’s “particular circumstances,” the “relationship and communications between” the investment adviser and the advisee, and “the form and content of the hedge clause.”<sup>176</sup>

It was not until the 1970s that the SEC first began to give some content to the 1951 opinion of its general counsel. In various no-action letters, the SEC separately rejected attempts to disclaim investment adviser liability for “ordinary negligence,”<sup>177</sup> to limit such liability to “gross negligence or *willful* malfeasance,”<sup>178</sup> and to limit such liability to “acts done in bad faith.”<sup>179</sup> The SEC has pointed out that the use of adjectives to qualify liability for negligence or malfeasance may violate section 206 because there may be situations where applicable law requires a greater degree of care by a fiduciary, and that, accordingly, the agreement should at least state that the advisor was not disclaiming liability for “violation[s] of applicable law.”<sup>180</sup> One way used by an investment adviser to clarify such waivers has been to include a statement to the effect that an advisee has not waived his rights under the federal securities law or state law. The

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174. See, e.g., Auchincloss & Lawrence Inc., SEC No-Action Letter, 1974 WL 10979, at \*2 (Feb. 8, 1974) (noting that “the use of the adjectives ‘gross’ and ‘wilful’ [sic] in the second paragraph . . . appears to violate Section 206 of the Act . . .”).

175. Heitman Capital Mgmt., LLC, *supra* note 156.

176. Heitman Capital Mgmt., LLC, *supra* note 156, at \*5.

177. Jonathan-Forbes Inc., SEC No-Action Letter, 1972 WL 7681, at \*2 (Mar. 20, 1972).

178. Auchincloss & Lawrence Inc., *supra* note 174 at \*1 (Feb. 8, 1974) (emphasis added); see also Omni Mgmt. Corp., SEC No-Action Letter, 1975 WL 12077, at \*1 (Dec. 13, 1975) (determining it is impermissible to use “gross” to qualify negligence or malfeasance).

179. First Nat’l Bank of Akron, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 80,441 (Feb. 27, 1976).

180. Auchincloss & Lawrence Inc. No-Action Letter, *supra* note 174 at \*2; see also, First Nat’l Bank of Akron No-Action Letter, *supra* 179 (explaining that even a clause explicitly providing that rights under federal or state law cannot be relinquished may still be misleading; if the hedge clause purports to limit liability to bad faith or willful misconduct, a client who is unsophisticated in the law may not realize that he may still have a right of action under federal or state law even where the adviser acts in good faith.).

SEC has made clear that reference merely to the federal securities laws is not adequate.<sup>181</sup>

Even such a non-waiver statement was not necessarily adequate in the SEC's view, however. As the SEC understood fiduciary law, an advisee "may have a right of action under federal or state law even where his adviser has acted in good faith."<sup>182</sup> The SEC pointed out in one no-action letter that the combination of a non-waiver statement with a disclaimer of an investment adviser's liability for gross or willful conduct might lead an "unsophisticated" advisee to believe it had no legal rights for any actions undertaken by an investment adviser.<sup>183</sup>

The SEC has never addressed the issue of whether exculpatory clauses other than those discussed to this point might be permissible. But the State of Connecticut did so when it stated in a release that exculpatory provisions relieving an investment adviser of its "liability for losses caused by conditions and events beyond its control such as war, strikes, natural disasters, new government restrictions, market fluctuations, communications disruptions, etc. . . . are acceptable since they do not attempt to limit or misstate the adviser's fiduciary obligations to its

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181. James Inv. Research, Inc., SEC No-Action Letter, 1977 WL 12791, at \*1 (Apr. 10, 1977); Omni Mgmt. No-Action Letter, *supra* note 178, at \*1. As with all disclosure, the SEC is also concerned that a hedge clause not be misleading because it could be read in several different ways by an advisee. See O.T.C. Fact Sheets, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 78,926 (July 4, 1972) (declaring a statement in a publication providing information about certain companies that the information "'is believed reliable, but due to possible typesetting errors its accuracy and completeness cannot be guaranteed' is misleading inasmuch as it implies that typesetting errors are the only possible cause of inaccuracy or incompleteness . . ."); James Inv. Research, Inc., *supra*, at \*1 (suggesting moving the statement that an advisee did not waive any of its legal rights so that it was clear that this non-waiver also applies to a statement that the investment adviser was not liable for any act by an agent).

182. First Nat'l Bank of Akron, *supra* note 179; *accord* Auchincloss & Lawrence Inc., *supra* note 174, at \*1 (clarifying that the relationship between an investment advisor and his client is governed by statutory law as well as common law principles that apply to fiduciary relationships). In its response to the Auchincloss no-action request, the SEC suggested not only deleting the adjectives "gross" and "willful" from the hedge clause, but also adding the statement that "[t]he federal securities laws impose liabilities under certain circumstances on persons who act in good faith, and therefore nothing herein shall in any way constitute a waiver or limitation of any rights which the undersigned may have under any federal securities laws." *Id.*, at \*2. Although it is puzzling why this suggested addition did not include a reference to applicable state law, the SEC's concern about ensuring that there is no misunderstanding of the waiver by an advisee is clear. Shortly after the Auchincloss no-action letter, Auchincloss & Lawrence wrote to the SEC indicating that, rather than incorporate the revisions that the SEC no-action letter suggested, it was deleting and not replacing the subject exculpatory language from all of its existing and future proposed advisory contracts. Auchincloss & Lawrence Inc., SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 79,762 (Apr. 5, 1974).

183. First Nat'l Bank of Akron, *supra* note 179.

clients.”<sup>184</sup> This conclusion is consistent with the reasoning behind the SEC’s no-action letters.

In addition to the above-cited no-action letters, the SEC has instituted three enforcement actions that penalized advisors for using hedge clauses, among other violations, although none of these actions provides much additional guidance on what makes a hedge clause problematic. In the two earliest actions from 1979 and 1981, the SEC did not describe the content of the hedge clauses or why they were objectionable.<sup>185</sup> In 1994, the SEC brought an enforcement action alleging, among other violations, that the adviser’s agreements contained a paragraph purporting to limit the adviser’s liability to “gross negligence or willful misconduct,” although the SEC still provided no explanation of why the hedge clause was problematic.<sup>186</sup>

There also is a well-developed body of state administrative law adopting the SEC’s approach to limitations on hedge clauses and applying it to state registered investment advisers.<sup>187</sup> In part, this is a function of the facts that many state securities laws governing investment advisers are modeled on the IAA<sup>188</sup> and that the anti-fraud provisions of section 206 of the IAA are not limited to investment advisers registered with the SEC.

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184. CONN. DEP’T OF BANKING, SEC. AND BUS. INVS. DIV., INVESTMENT ADVISERS CAUTIONED ON USE OF HEDGE CLAUSES (May 1991), <http://www.ct.gov/dob/cwp/view.asp?a=2252&q=299222>.

185. See, e.g., Olympian Fin. Servs., Inc., Investment Advisers Act Release No. 659, 16 SEC Docket 801 (Jan. 16, 1979) (finding violations related to deceptive advertising, failure to maintain required books and records, etc.); William Lee Parks, Investment Advisers Act Release No. 736, 21 SEC Docket 342 (Oct. 27, 1980) (ordering administrative proceedings against William Lee Parks for overcharging clients, failure to refund clients, etc.).

186. Wall St. Money Mgmt. Grp., Inc., Investment Advisers Act Release No. 1464, 58 SEC Docket 1953, 1956 (Jan. 30, 1995).

187. For examples of state administrative law limitations on hedge clauses, see WASH. ADMIN. CODE § 460-24A-220(19) (2014); ALASKA DEP’T OF COMMERCE, THE DIVISION’S STATE INVESTMENT ADVISOR EXAM FUNCTION, <http://commerce.alaska.gov/dnn/dbs/Securities/ComplianceforStateInvestmentAdvisers.aspx>; CONN. DEP’T OF BANKING, *supra* note 184; Wall St. Money Mgmt. Grp., Inc., Ill. Secs. Dep’t, 1996 WL 390495 (Feb. 21, 1996); S.C. OFFICE OF THE ATT’Y GEN., SECS. DIV., INVESTMENT ADVISER EXAMINATION PROGRAM OVERVIEW, <http://2hsvz0174ah31vgcm16peuy12tz.wpengine.netdna-cdn.com/wp-content/uploads/2011/03/examoverview.pdf>; Henry C. Brock, Docket No. SD 03-0007, Utah Dep’t of Commerce (Apr. 17, 2006), *available at* <http://www.securities.utah.gov/dockets/03000732.pdf>; Jay Fishman, *Maine’s Take on Investment Adviser Hedge Clauses and Assets Under Management*, JIM HAMILTON’S WORLD OF SECS. REGULATION (Jan. 3, 2008), <http://jimhamiltonblog.blogspot.com/2008/01/maines-take-on-investment-adviser-hedge.html>.

188. CONN. DEP’T OF BANKING, *supra* note 184 (“Inasmuch as there appears to be no relevant Connecticut case law, it is appropriate to look to federal authorities since the antifraud provisions in Section 206 of the Investment Advisers Act . . . and Section 36b-5(a) of CUSA [the Connecticut Uniform Securities Act] are largely identical.”).

The “hedge clause” doctrine and the 1951 general counsel’s opinion have been cited by the SEC in other areas of investment adviser regulation where, in the SEC’s view, an advisee might be misled into believing that he or she had no rights arising from the fiduciary duties owed by an investment adviser to its advisees. For example, in a 1984 no-action letter, the SEC stated that a provision in a year-to-year advisory contract providing that the advisee could only elect to terminate the contract once a year (on the contract’s anniversary) was fraudulent and deceptive under the IAA.<sup>189</sup> The fiduciary relationship between investment adviser and advisee was built on confidence, the SEC explained.<sup>190</sup> If that confidence was lost, a provision in the contract requiring the further rendering of services, even if they were not satisfactory, “raise[d] serious questions” under the IAA’s anti-fraud provisions.<sup>191</sup> The SEC stated that a provision denying a client’s right to terminate the contract was invalid because “the contract might lead the client to believe that he is not entitled to terminate the contract when fiduciary principles indicate that he has that right.”<sup>192</sup>

Based on the SEC’s actions, and especially the no-action letters, one could have read the agency’s position on hedge clauses to be very restrictive in setting limits on the contractual rights of an investment adviser and its advisee to negotiate disclaimers of liability. But this is not the SEC’s current position on hedge clauses, as it made clear in Heitman Capital Management, LLC, a seminal no-action letter.<sup>193</sup> Heitman Capital sought guidance on a hedge clause in which an advisee indemnified Heitman Capital and other investment advisers affiliated with Heitman Capital. Exceptions were made, however, for “*grossly* negligent, reckless, *willfully* improper or illegal conduct in its performance”; “actions outside the scope of [the] Manager’s authority”; or “other material breach under”

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189. Robert D. Brown Inv. Counsel, Inc., SEC No-Action Letter, 1984 WL 48400, at \*2 (July 19, 1984).

190. *Id.* at \*1.

191. *Id.*

192. *Id.* at \*2. A similar sort of approach had been taken by the SEC in response to mandatory arbitration clauses in contracts between investment advisers and advisees. In a 1986 no-action letter, the SEC indicated that such clauses might violate section 206 of the IAA because they might “mislead clients to believe that they are barred from exercising their rights under the Act.” *McEldowney Fin. Servs.*, SEC No-Action Letter, 1986 WL 67330, at \*1 (Oct. 17, 1968). But the SEC has acknowledged that this position might no longer be good law: “Those positions, however, largely predated Supreme Court decisions upholding pre-dispute arbitration clauses under the federal securities laws, and a subsequent federal district court opinion citing those decisions upheld the validity of a pre-dispute arbitration clause in an advisory client agreement.” 2011 SEC Study on Investment Advisers & Broker-Dealers, *supra* note 9, at 43–44. The SEC was referring to *Bakas v. Ameriprise Fin. Servs., Inc.*, 651 F. Supp. 2d 997, 1000–1001 (D. Minn. 2009).

193. Heitman Capital Mgmt., LLC, *supra* note 163.



the advisory contract.<sup>194</sup> In addition to this hedge clause, the agreement also contained a “non-waiver of rights” provision: “Notwithstanding the foregoing, nothing” in the agreement was to “constitute a waiver” of any of the client’s “legal rights under applicable U.S. federal securities laws or any other laws whose applicability is not permitted to be contractually waived.”<sup>195</sup>

In its letter to the SEC, Heitman Capital asserted that its clients were primarily institutional investors such as large pension funds that were “sophisticated persons that have the resources and experience to understand the investment advisory agreements with the applicable Heitman Advisor, and the bargaining power to negotiate, and in some cases even dictate, the terms of the investment advisory agreements.”<sup>196</sup> In addition, some Heitman Capital investment advisers provided advice to wrap account and certain commingled fund entities that were represented by financial intermediaries with allegedly similar levels of sophistication and bargaining power.<sup>197</sup> Heitman Capital also contended that most of these financial intermediaries had a separate responsibility to negotiate with Heitman Capital in the best interests of their underlying clients and assist their clients in evaluating the advisory agreement, including the hedge clause and non-waiver disclosure.<sup>198</sup>

The SEC Division of Investment Management’s response noted Heitman Capital’s representations, and reiterated the general principle that “all of the surrounding facts and circumstances” must be taken into account in determining whether an adviser’s hedge clause purporting to limit adviser liability to acts of gross negligence or willful malfeasance violates section 206.<sup>199</sup> In this analysis, the SEC wrote that it would consider “[1] the form and content of the particular hedge clause (e.g., its accuracy) . . . [2] communications between the investment adviser and the client about the hedge clause, and [(3)] the particular circumstances of the client.”<sup>200</sup> Where a client was “unsophisticated” in the law, relevant factors would include whether the hedge clause was “written in plain English,” “individually highlighted and explained during an in-person meeting,” and whether “enhanced disclosure was provided to explain” when a client may still have a right of action.<sup>201</sup> In light of these general principles and Heitman Capital’s factual representations, the SEC’s response indicated

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194. *Id.* at \*1 (emphasis added).

195. *Id.* at \*2.

196. *Id.*

197. *Id.*

198. *Id.* at \*2–3.

199. *Id.* at \*4.

200. *Id.* (footnote omitted).

201. *Id.*

that Heitman Capital's use of a hedge clause and non-waiver disclosure "would not *per se* violate sections 206(1) and 206(2) of the [IAA]."<sup>202</sup> The letter emphasized, however, that the SEC was taking no position and could give no assurance on whether the advisory agreement was misleading (and therefore illegal) as applied to any particular client "because of the fact-intensive nature of the inquiry."<sup>203</sup>

In its no-action request, Heitman Capital relied on an interpretation of state law, including that of New York, to the effect that agreements relieving a party of liability for its negligence will be enforced. Although the SEC response made no mention of this interpretation, this type of reasoning is implicit in the SEC's statement that a hedge clause and non-waiver disclosure of the type used by the Heitman Capital investment advisers are not *per se* violations of the IAA. In other words, in the SEC's view, such limitations of liability are apparently permitted if the normal standards for modifying fiduciary duties, full disclosure and informed consent by the beneficiary are met.<sup>204</sup>

Since the SEC indicated in Heitman Capital that it would not be issuing further no-action or interpretive assurances under sections 206(1) or 206(2) of the IAA regarding an adviser's use of any particular hedge clause, the only places in which further developments can occur are SEC enforcement actions or court cases brought either by the SEC or advisees themselves. Since Heitman Capital, there have been no SEC enforcement actions on the subject. One published case briefly mentions a hedge clause issue, but was decided on other grounds.<sup>205</sup> In addition, there are a handful of cases in which the issue has been raised in the pleadings but have not resulted in decisions or orders in which the issue has been discussed.<sup>206</sup>

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202. *Id.* at \*5 (emphasis in original).

203. *Id.*

204. *See* Birnbaum v. Birnbaum, 539 N.E.2d 574, 576 (N.Y. 1989) ("We only reaffirm here the most basic principle that a court will not countenance the behavior of a fiduciary who, without full disclosure and consent, enters into a financial arrangement placing his spouse's interests at odds with the interests of those to whom he owes a duty of undivided loyalty.").

205. Kleinman v. Oak Assocs., Ltd., No. 5:07CV0698, 2007 WL 2071968 (N.D. Ohio July 16, 2007).

206. *See, e.g.,* Bruck v. Morgan Stanley Smith Barney, LLC, 967 F. Supp. 2d 418, 422 (D. Mass. May 23, 2013) (granting motion to compel arbitration of claims that defendants "created 'an unlawful and fraudulent scheme to avoid the fiduciary duties imposed upon them by the'" IAA, allegedly in connection with an account improperly designated "non-fiduciary" by defendants); Trial Pleading at 15, Bruck v. Morgan Stanley Smith Barney, LLC, 967 F. Supp. 2d 418 (D. Mass. 2013) (No. 12-12005), 2012 WL 5424954 (Count XII) (stating "[d]efendants falsely asserted, to avoid legal [scrutiny] that they were not subject to the IAA because they were 'brokers.'"); *see also* Gramercy Advisors, LLC v. Jones, No. 07 Civ. 2809 (LMM), 2007 WL 2729021 (S.D.N.Y. Sept. 13, 2007) (deferring consideration of plaintiff and defendants' motions pending a ruling on jurisdiction); Reply Memorandum in

There has been, however, one published case substantively treating hedge clauses: *Hsu v. UBS Financial Services, Inc.*<sup>207</sup>

In *Hsu*, the Ninth Circuit ultimately affirmed the district court determination that the plaintiff failed to state a claim under IAA when he contended that UBS had used an illegal hedge clause in its contracts with him and other clients.<sup>208</sup> The *Hsu* decisions reflect a failure by the plaintiff to clearly connect UBS' fiduciary obligations as an investment adviser, which it became by recommending a list of investment managers to its advisees, to its disclaimer of liability for the actions of the investment managers it recommended.

The plaintiff in *Hsu* was an individual investor advisee who was seeking class certification for similarly situated advisees. He had entered into a contract to participate in UBS' "wrap" fee program, which consisted of investment advisory, execution, clearing and custodial services for a single fee.<sup>209</sup> Under the arrangement, the plaintiff was provided the opportunity to select an investment manager for his wrap fee arrangement, and given a list of potential investment managers for this purpose by UBS.<sup>210</sup> Although the parties disputed whether UBS required participants in its wrap program to choose an investment adviser from lists created by UBS,<sup>211</sup> there is no doubt that UBS, as sponsor of the wrap fee program, did

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Further Support of Motion to Defer Motion for Partial Summary Judgment, *Gramercy Advisors, LLC v. Jones*, No. 07 Civ. 2809 (LMM), 2007 WL 2729021 (S.D.N.Y. Sept. 13, 2007) (requesting the court to rule on whether it has jurisdiction over Gramercy before ruling on the motion for partial summary judgment); Plaintiff's Amended Motion to Preliminarily Enjoin Arbitration Proceedings, *Wootten v. Fisher Invs., Inc.*, No. 4:10-cv-00598 SNLJ, 2010 WL 4062991 (E.D. Mo. July 9, 2010).

207. No. C 11-02076 WHA., 2011 WL 3443942, at \*7-10 (N.D. Cal. Aug. 5, 2011), *aff'd*, *Hsu v. UBS Fin. Servs. Inc.*, 507 F. App'x 716 (9th Cir. 2013), *cert denied*, 134 S. Ct. 266 (mem.) (Oct. 2013). The district court opinion also raised statute of limitations issues as to sections 206 and 251(a) of the IAA.

208. *Hsu*, No. 11-17131, 2013 WL 492443 at \*1 (9th Cir. Oct. 7, 2013) (concluding that the governing law on this hedge clause issue is unclear from the pleadings in *Hsu*).

209. *Hsu*, No. C 11-02076 WHA., 2011 WL 3443942, at \*1 (N.D. Cal. Aug. 5, 2011).

210. *Id.* at \*1-2.

211. *Compare* Appellee's Brief at 15, *Hsu*, 2012 WL 729581, No. 11-17131 ("UBS does not 'require that all investment managers be from its approved list,' nor does it make a 'manager referral.' Rather, as noted, the [Wrap Account] Agreement plainly states the client is free to select an Investment Manager that is not on the list and that UBS expresses no opinion about the capabilities of the listed firms.") with Appellant's Opening Brief at 22, *Hsu*, 2013 WL 492443, No. 11-17131 ("Investment Advisor [the Manager] and investment strategy must be on . . . the [MAC] Reviewed Advisor List.") (emphasis in original). The plaintiff attached to his complaint what were allegedly UBS' internal guidelines indicating that the advisee must select someone from the UBS pre-approved list. First Amended Class Action Complaint, Exhibit D, at 2, *Hsu*, 2011 WL 3443942 ("Investment Advisor and investment strategy must be on either the MAC Researched Advisor List or the Reviewed Advisor List.").

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provide the plaintiff with a list of UBS approved investment managers because the plaintiff selected Horizon Asset Management Services, LLC (“Horizon”) as its investment manager from the list that UBS provided.<sup>212</sup> The plaintiff’s complaint was based on UBS’ apparent disclaimer of liability for the third-party investment manager Horizon’s actions.<sup>213</sup>

The plaintiff sought rescission of the wrap fee contracts and “restitution [from UBS] of all fees and other consideration paid to Defendant” by all class members.<sup>214</sup> To show that UBS unlawfully limited its liability, the plaintiff’s main argument compared the language describing the wrap fee program and UBS’ obligations to advisees in different provisions of the wrap fee contract with a disclosure brochure describing the program.<sup>215</sup> On the one hand, the plaintiff noted the disclosure brochure stated that UBS was the plaintiff’s “[i]nvestment [a]dvisor” with a “fiduciary relationship” to the plaintiff, and subject to the legal standards of the IAA.<sup>216</sup> On the other hand, the plaintiff pointed out the wrap fee contract contained a hedge clause with respect to the third-party investment manager: UBS, the wrap fee contract stated, “may or may not have researched” the investment manager the plaintiff selected.<sup>217</sup> In addition, the wrap fee contract stated that UBS:

shall not be liable for and Client agrees to hold UBS Financial Services Inc. harmless against all losses to the Client from any error of judgment, mistake of law, negligence, willful misfeasance, or bad faith on the part of the Investment Manager or any other matter within the Investment Manager’s control such as . . . compliance with applicable law.<sup>218</sup>

The disclosure brochure contained a similar waiver of UBS’ fiduciary obligations:

[UBS’] analysis of MAC Reviewed Managers is limited in scope and does not provide enough information for us to express an opinion regarding the investment capabilities of the firm. The limited analysis is performed once and provides a broad overview of the manager’s organizational structure and history, together with information about their assets under management, net worth

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212. *Hsu*, No. C 11-02076 WHA., 2011 WL 3443942, at \*1 (N.D. Cal. Aug. 5, 2011).

213. *Id.*

214. Class Action Complaint at 2, ¶ 4, *Hsu*, 2011 WL 1593366 (N.D.Cal. filed Apr. 27, 2011) (Trial Pleading).

215. *Id.* at 6–8, ¶¶ 23–31.

216. *Id.* at 6, ¶ 24.

217. *Id.* at 6, ¶ 25.

218. *Id.* at 7, ¶ 27.

and regulatory record, and is not updated.<sup>219</sup>

The district court granted UBS' motion to dismiss for failure to state a claim, agreeing with UBS that it did not disclaim any duties owed to the plaintiff and that it had not required the plaintiff to waive any rights under the IAA.<sup>220</sup> Essentially, the district court observed, the plaintiff's argument was that UBS stated that it was a fiduciary and that its hedge clause disclaimed liability for conduct by Horizon, Hsu's investment manager. The plaintiff argued that while these two provisions may have been clear when read in isolation, they were contradictory and misleading when read together. The district court, however, held that the hedge clause was not "incongruous" with the other terms of the contract, and, therefore, was not deceptive.<sup>221</sup> The district court explained: "[t]he contract never disclaimed liability for UBS's own role as an investment advisor [sic]. Rather, it disclaimed liability for any misconduct on behalf of Horizon, Hsu's separate investment manager."<sup>222</sup>

In ruling that UBS was permitted to disclaim liability for Horizon's misconduct under these circumstances, the district court's ruling seemed vulnerable to appeal. Recommendations regarding whether to select a particular investment adviser can qualify one as an investment adviser under the IAA. If a fiduciary recommends a particular investment adviser who should not have been recommended, then there could be a violation of the recommender's fiduciary duties, and, specifically, the recommending fiduciary's duty of care. As an agent, the fiduciary "has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances," and, in evaluating whether that standard has been met, "[s]pecial skills or knowledge possessed by [the] agent" are to be taken into account.<sup>223</sup> On the one hand, while fiduciaries are generally not deemed "insurers" of a particular result or the acts of others,<sup>224</sup> the duty of care can impose liability for the acts of others, provided the injurious act of the third party was foreseeable and the imposition of liability is fair under the circumstances.<sup>225</sup>

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219. *Id.* at 7–8, ¶ 28.

220. *Hsu*, 2011 WL 3443942, at \*1, 7.

221. *Id.* at 9.

222. *Id.* at 9–10.

223. RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006); *see also* Sec. & Exch. Comm'n v. Capital Gains Research Bureau, 375 U.S. 180, 194 (1963) (noting that fiduciaries have "an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading . . . .'" (citations omitted)).

224. *Francis v. United Jersey Bank*, 432 A.2d 814, 820 (N.J. 1981) ("Generally directors are accorded broad immunity and are not insurers of corporate activities.").

225. *See, e.g., Call v. Czaplicki*, No. 09-6561, 2010 WL 3724275 (D.N.J. Sept. 16,

In the investment advisory context, it can be argued that the damaging actions of another adviser recommended by the principal adviser are foreseeable. The principal adviser's professional responsibilities necessarily relate to the advisory services the third party is to provide to the client. The disclaimer of liability by an investment adviser for the actions of another investment manager whom the adviser recommends seems potentially inconsistent with the investment adviser's fiduciary obligations. Additionally, applying the Heitman Capital principles to *Hsu*, if UBS had a fiduciary duty of care with respect to its selection of recommended investment managers, then it seems likely that the various exculpatory statements could confuse an advisee into thinking that he or she had no cause of action against UBS for its choosing to include specified investment managers in its recommended list.

At the motion to dismiss stage, the plaintiff did not expressly argue, and the district court did not render a ruling on, whether UBS owed a fiduciary duty to the plaintiff in connection with the list of investment managers UBS provided. Rather, the district court held that there was "no contradiction" between the statements that UBS owed a fiduciary duty to the plaintiff and the exculpatory provisions in its hedge clause.<sup>226</sup> Implicit in the district court's conclusion is that UBS and the plaintiff had the contractual power to limit UBS' fiduciary duties to the plaintiff. The limitation of UBS' fiduciary duties is demonstrated by the apparent lack of UBS' responsibility for its list of recommended investment managers or the actions of any such investment manager selected by one of UBS' clients.

On appeal to the Ninth Circuit, the plaintiff did clearly argue that "the recommendation of an investment manager to a client generally qualifies as an advisory service and is subject to" the IAA.<sup>227</sup> UBS countered that "Hsu erroneously assumes that UBS engages in investment advisory services merely by providing a list of Investment Managers to clients," and that, "irrespective of whether UBS's mere provision of a list of Investment Managers constitutes an advisory service," its "disclaimer of liability" for Horizon's conduct did not contradict the other contract provisions of UBS'

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2010) (motion granted in part and denied in part) (declining to rule that an insurance agent has a duty of reasonable investigation of an attorney who insurance agent refers to a client because, in contrast to insurance agent's duty to procure adequate insurance, the insurance agent does not have qualifications to understand whether a particular attorney is competent); *Call v. Czaplicki*, 2011 WL 2532712 (D.N.J. June 23, 2011) (reconsideration granted in part and denied in part).

226. *Hsu*, No. C 11-02076 WHA., 2011 WL 3443942, at \*10 (N.D. Cal. Aug. 5, 2011).

227. Appellant's Reply Brief, *Hsu v. UBS Fin. Servs., Inc.*, No. 11-17131, 2013 WL 492443 (9th Cir. filed Feb. 11, 2013), at \*6; *see also* Appellant's Opening Brief at 6, *Hsu*, 2013 WL 492443.

fiduciary duties.<sup>228</sup>

It was UBS' argument that ultimately prevailed, as the Ninth Circuit affirmed the dismissal of the complaint. In a brief, four-paragraph decision not selected for publication, the court ruled that the plaintiff failed to satisfy the pleading requirements of Rule 9 by stating what is false or misleading about a statement and why it is misleading. The plaintiff, therefore, failed to put UBS on fair notice of the claim.<sup>229</sup>

According to the Ninth Circuit, while the plaintiff asserted that UBS deceived clients by leading them to believe that they waived certain "unwaivable fiduciary duties" through the hedge clauses, the plaintiff "never identifies or explains what those 'unwaivable fiduciary duties' are . . . HSU's claim fails because the clauses he points to do not waive compliance with any provision of the IAA."<sup>230</sup> Judging by the Ninth Circuit's decision, it appears that despite the plaintiff's references to the fiduciary duty owed by UBS to the plaintiff, based on its list of recommended investment managers in both the plaintiff's opening and reply briefs to the Ninth Circuit, the point was lost on the panel.

The Ninth Circuit also refused to consider the plaintiff's argument that, in practice, UBS allegedly required clients to use an investment manager from the UBS pre-approved list, calling this an argument raised for the first time on appeal.<sup>231</sup> This is puzzling because the plaintiff, in both his complaint and his opposition to UBS' motion to dismiss, had cited an internal UBS document that ostensibly required that the investment manager be on UBS' pre-approved list.<sup>232</sup> It can be argued, from the pleadings and opposition to the motion to dismiss, that UBS' policy requiring the plaintiff to select an adviser from the list was not central to the plaintiff's contention that UBS violated the anti-fraud provision (that was the language of the hedge clauses themselves). The Ninth Circuit's refusal to consider the argument, however, worked a particularly harsh result, given that the plaintiff referenced the point below, and its close relation to the hedge clauses and fiduciary duty issues raised in the

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228. Appellee's Brief, *supra* note 211, at \*19.

229. *Hsu v. UBS Fin. Servs. Inc.*, 507 F. App'x, 716 (9th Cir. 2013)

230. *Id.* at 716-17.

231. *Id.* at 717.

232. First Amended Class Action Complaint, Exhibit D, at 2, *Hsu*, 2011 WL 3443942 ("Investment Advisor and investment strategy must be on either the MAC Researched Advisor List or the Reviewed Advisor List."); Pl's Mem. of P. & A. in Opp'n to Def.'s Mot. to Dismiss First Am. Class Action Compl., at 2, *Hsu*, 2011 WL 7562118 ("Defendant's gloss that Plaintiff 'had freedom to choose his Investment Manager' . . . is inconsistent with the FAC, which makes clear (through Defendant's own documents) that Plaintiff's selection of an investment manager is wholly circumscribed by *Defendant's recommendations from a pre-determined list of managers.*") (emphasis original).

complaint.

On paper, the *Hsu* plaintiff's case seemed solid under the principles elucidated in *Heitman Capital*: the plaintiff was not an institutional investor, and there were no facts suggesting that he was a sophisticated person, that he had any bargaining power to negotiate with UBS over the hedge clause, or that the hedge clause was ever explained to him by UBS or any intermediary. But the *Hsu* opinions reflect the practical difficulty that plaintiffs may have in stating claims under the IAA for deceptive practices based on hedge clauses. In the section of its decision summarizing the parties' respective arguments, the district court noted, in a manner suggesting skepticism, that the plaintiff was seeking rescission of "all of UBS's contracts for this particular 'wrap' fee program."<sup>233</sup> Although the district court never gave grounds for its skepticism, perhaps it grew out of several facts, some of which UBS pointed out in its motion to dismiss or on appeal: the plaintiff utilized Horizon as his investment manager for approximately two-and-one half years in the program; the plaintiff never exercising his apparent right to switch his investment manager at any time;<sup>234</sup> and the plaintiff never alleged that "he was ever *actually* misled" by the hedge clause, or anything else, into believing that he was actually unable to sue UBS for Horizon's conduct.<sup>235</sup>

*Heitman Capital* clarified that disclaimers for a variety of conduct such as mere negligence are potentially permissible if the advisee is sufficiently sophisticated and possesses bargaining power, or is represented by a financial intermediary with these qualities. Without regard to the identity of the advisee or the financial intermediary, *Hsu* allowed a hedge clause disclaiming an adviser's liability for the acts of an investment manager recommended by the investment adviser, even though that recommendation in itself constitutes investment advice.

Further developments in this area will have to await further litigation or SEC enforcement actions. But, as the courts have proven to be inhospitable venues for complaints about hedge clauses, we may be waiting for quite some time.

#### D. *Restrictions on Assignments*

Both the IAA and the ICA contain restrictions on assignments of an investment advisory contract by an investment adviser. The IAA is more

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233. *Hsu*, 2011 WL 3443942, at \*2 (emphasis in original).

234. Defendant UBS Financial Services, Inc.'s Notice of Motion and Motion to Dismiss; Memorandum of Points & Authorities in Support Thereof at 9, No. 3:11-cv-02076-WHA, 2011 WL 7562119 (N.D. Cal. filed June 3, 2011).

235. *Id.*



permissive as it allows, in subsection 205(a)(2), such an assignment with “the consent of the other party to the contract.”<sup>236</sup> This requirement for consent did not apply to an advisory contract with an investment company in the original 1940 version of the IAA.<sup>237</sup> The 1970 amendments preserved this exemption from the consent requirement for an assignment of an investment advisory contract with an investment company, although it was limited to investment advisory contracts with registered investment companies.<sup>238</sup>

Although the legislative history provides no reason for why subsection 205(a)(2) does not address assignments of investment adviser contracts with registered investment companies, it seems likely that this exemption in the IAA is meant to ensure that the more restrictive assignment provisions of the ICA cannot be evaded. In subsection 15(a)(4), the ICA provides that any investment advisory contract with a registered investment company must “provide[], in substance, for its automatic termination in the event of its assignment.”<sup>239</sup> Once an assignment has occurred, any new contract between an investment adviser and a registered investment company must be approved by both the shareholders of the investment company<sup>240</sup> and the members of the board of directors of the investment company who are independent of the investment adviser.<sup>241</sup>

#### IV. LIMITED SEC RESOURCES HAVE LED TO INADEQUATE REGULATORY OVERSIGHT OF INVESTMENT ADVISERS

To the extent that there are either explicit restrictions on investment advisers under the IAA or implicit restrictions arising from their position as fiduciaries for their advisees under the IAA, the effectiveness of these restrictions rests on enforcement by the SEC. As described in Part V.B. of this Article, the Supreme Court in *Transamerica* spoke very clearly on this

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236. 15 U.S.C. § 80b-5(a)(2) (2006). Subsection 205(a)(3) provides that an investment adviser that is organized as a partnership must “notify the other party to the contract of any change in the membership of such partnership within a reasonable time after such change.” *Id.* § 80b-5(a)(3).

237. Investment Advisers Act of 1940, Pub. L. No. 768, § 205, 54 Stat. 789, 852 (“As used in this section, ‘investment advisory contract’ means any contract or agreement whereby a person agrees to act as investment adviser or to manage any investment or trading account for a person *other than an investment company.*”) (emphasis added).

238. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 25, 84 Stat. 1413, 1432–33 (1970). In 1987, section 205 was subdivided into the current structure and the fourth sentence of section 205 became subsection 205(d). Pub. L. 100-181, § 205, 101 Stat. 1249, 1263–64 (1987).

239. Investment Company Act of 1940 § 15(a)(4), 15 U.S.C. § 80a-15(a)(4) (2006).

240. *Id.* § 80a-15(a).

241. *Id.* § 80a-15(c).

issue, holding that the only private cause of action under the IAA is one for rescission under section 215(b).<sup>242</sup> Later cases have not attempted to find a way around this restriction.

The SEC has historically been unable to properly regulate investment advisers due to a lack of resources and the sheer number of investment advisers.<sup>243</sup> This lack of effective oversight led Congress in the Dodd-Frank Act to direct the SEC to prepare a report on the oversight of investment advisers.<sup>244</sup>

This Article does not intend to take a position on the debate about the proper means to regulate investment advisers. But it does intend to point out that we are in the worst possible position. Currently, there is no effective regulatory oversight and there is no effective private legal recourse for advisees if there is a breach of an investment adviser's duties.<sup>245</sup> Suggestions on how to remedy this problem have included a self-regulatory organization ("SRO") for investment advisers, more resources for the SEC, increased state regulation of investment advisers, and legislation creating a private cause of action for advisees under the IAA.<sup>246</sup> Reading the history of these debates is a bit like reading about the Battle of Verdun. The same set of arguments have gone over the top and been shot down several different times over the past fifty years. The only major suggestion that has been adopted is the regulation of smaller investment advisers by state, rather than SEC, regulation.<sup>247</sup> The ground is indeed muddy and full of shell holes and dead bodies.

Concerns about the SEC's practical ability to properly regulate investment advisers have been raised regularly over the past fifty years. In its 1963 Report of the Special Study of Securities Markets, the SEC advocated for a self-regulatory organization of investment advisers or, if this was impossible, "added cost of governmental supervision should be passed on and directly borne by those in the industry who are not members

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242. *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 19 (1979).

243. Elisse B. Walter, Chairperson, Sec. & Exch. Comm'n, Statement on Study Enhancing Investment Adviser Examinations, 1–2 (Jan. 2011), *transcript available at* <http://www.sec.gov/news/speech/2011/spch011911ebw.pdf>.

244. 2011 SEC Study on Investment Advisers & Broker-Dealers, *supra* note 9.

245. *Id.* at 44.

246. GEN. ACCOUNTING OFFICE (GAO), CURRENT LEVEL OF OVERSIGHT PUTS INVESTORS AT RISK 27, GAO/GGD-90-83 Investment Advisers (1990), <http://www.gao.gov/assets/150/149341.pdf> [hereinafter GAO, INVESTMENT ADVISERS].

247. See SEC & EXCH. COMM'N OFFICE OF INVESTOR EDUC. AND ADVOCACY, INVESTOR BULLETIN: TRANSITION OF MID-SIZED INVESTMENT ADVISERS FROM FEDERAL TO STATE REGISTRATION 1 (2011), *available at* <http://www.sec.gov/investor/alerts/transition-of-mid-sized-investment-advisers.pdf> (advising that state securities authorities would have primary regulatory authority over many investment advisers that were previously subject to primary regulation by the SEC).

of such a [self-regulatory] body, through fees or other assessments.”<sup>248</sup> Much of the SEC’s concern in 1963 was focused on the lack of qualification standards for investment advisers,<sup>249</sup> rather than on the more current concern about compliance with general fiduciary duties and regulatory obligations. But the general point remains that there was a concern that investment advisers were not being properly regulated.

When *Transamerica* was being briefed in 1979, the SEC submitted an amicus brief that argued in favor of private causes of action, noting that “[t]he Commission’s examination and enforcement capabilities have not grown proportionately” with the number of investment managers and the assets under management.<sup>250</sup> “In the fiscal year that ended September 30, 1977, 4,823 persons were registered with the Commission as investment advisers.”<sup>251</sup> In that year, the SEC “conduct[ed] only 459 inspections of investment advisers.”<sup>252</sup> The dissent in *Transamerica* relied upon these facts to argue that “[w]hile the Act empowers the SEC to take action to seek equitable relief to prevent offending investment advisers from engaging in future violations, in the absence of a private right of action for damages, victimized clients have little hope of obtaining redress for their injuries.”<sup>253</sup>

In 1990, the GAO produced a report that concluded that, “[i]f the oversight program [for investment advisers] is not improved, the 1940 Act may be doing more harm than good by giving investors the illusion that SEC-registered advisers have a ‘seal of approval.’”<sup>254</sup> Although the GAO identified some measures that the SEC could take without significant new resources, such as creating a central database of information about inspections of investment advisers, it did explicitly identify the SEC’s lack

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248. SEC. & EXCH. COMM’N, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 88-95, pt. 1, at 159 (1963).

249. *Id.* at 158 (“Neither the Federal Government nor any self-regulatory body exercises any controls over the competence of these persons for the performance of their advisory work. . . . Furthermore, the proprietors of registered investment advisers who confine their activities to the giving of investment advice need not pass any examination at all, except in a few States, even though they may be responsible for advising individual clients or subscribers to their publications to engage in particular securities transactions.”).

250. Brief for the SEC as Amicus Curiae Supporting Respondent at 33, *Transamerica Mortg. Advisers, Inc. v. Lewis*, 444 U.S. 11 (1979) (No. 77-1645).

251. *Id.* at 32.

252. *Id.* at 33.

253. *Transamerica Mortg. Advisers, Inc. v. Lewis*, 444 U.S. 11, 34–35 (1979) (White, J., dissenting) (footnote omitted) (citing Brief for the SEC, *supra* note 250, at 32–33) (“Moreover, the SEC candidly admits that, given the tremendous growth of the investment advisory industry, the magnitude of the enforcement problem exceeds the Commission’s limited examination and enforcement capabilities.”).

254. GAO, INVESTMENT ADVISERS, *supra* note 246, at 3.

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of resources as an important problem.<sup>255</sup> The most startling of GAO's discussions of the SEC's lack of resources is the comparison between the number of investment advisers and the total amount of assets under management to the number of field examiners who did investment adviser inspections.<sup>256</sup> The GAO reported that, since 1980, "the number of [registered investment] advisers has tripled from about 4,600 to about 14,000, and the assets they manage have increased 10-fold . . . to about \$4.6 trillion."<sup>257</sup> In contrast, the number of field examiners had not changed from 1980: it continued during this period to be approximately forty-one.<sup>258</sup>

The GAO reported that newly-registered investment advisers were, on average, not inspected for three years after their registration and that many investment advisers had never been inspected.<sup>259</sup> The SEC, in its comment letter to the GAO on the initial version of the report, stated that "the frequency with which advisers are inspected declined steadily from about once every 7.5 years in 1983 to once every 12.5 years in 1990 . . . ."<sup>260</sup> The lack of resources impacted not only inspections but also the initial registration and amendments to registrations.<sup>261</sup> For example, the SEC did not have the resources to verify that the information reported by a registering investment adviser was accurate.<sup>262</sup> The SEC in its comment letter reported that two to three thousand new advisers were registering each year.<sup>263</sup> And the GAO reported that there were over 10,000 amendments to prior registrations in fiscal year 1988.<sup>264</sup>

The GAO considered four different proposals to deal with the inadequacy of the regulatory regime: creating an SRO; increasing funding for the SEC, requiring that small investment advisers register within their state; and Congress' creating a private cause of action under the IAA.<sup>265</sup> The story of these proposals is a story of failure. None of these proposals, other than state regulation, have come to fruition, although it does appear that an SRO might be created through Congressional action.<sup>266</sup> As state

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255. *Id.* at 27 ("The numbers of SEC-registered investment advisers are growing faster than the resources available to regulate them."); *id.* at 28 ("Lacking adequate staff to effectively regulate the industry . . . .").

256. *Id.* at 2.

257. *Id.*

258. *Id.* at 10.

259. *Id.* at 19.

260. *Id.* at 47.

261. *Id.* at 4, 17, 19.

262. *Id.* at 16.

263. *Id.* at 41.

264. *Id.* at 18.

265. *Id.* at 27.

266. See Melanie Waddell, *As Congress Keeps SEC Budget Flat, SRO Specter Still*

regulation of smaller investment advisers has been the preferred solution to the problems of the SEC's resources since 1995, it is discussed first in this Article. A private cause of action, the subject of at least two legislative pushes in Congress, is discussed second.

It is worth noting that the exact parameters of the current resource problem are unclear. We do not have figures about the number of Office of Compliance Inspections and Examinations (the "OCIE") staff<sup>267</sup> who are currently devoted primarily to examining investment advisers. We do have these figures for 1992. At the end of fiscal year 2010, there were 460 staff members who examined both registered investment advisers and investment companies.<sup>268</sup> In 1992, each field inspector completed approximately twenty-five inspections of registered investment advisers each year.<sup>269</sup> This rate was considerably higher than the rate in the early 1980s.<sup>270</sup> Today, on average, an OCIE inspector completes less than three examinations per year of investment advisers, although this figure does not include examinations of investment companies.<sup>271</sup> In addition, the SEC is sensitive to the issue of examining investment advisers who have newly registered pursuant to the requirements of the Dodd-Frank Act.<sup>272</sup> OCIE's goal is to examine all such newly-registered investment advisers within a

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*Lurks*, ADVISORONE (Sept. 24, 2012), <http://www.thinkadvisor.com/2012/09/24/as-congress-keeps-sec-budget-flat-sro-specter-stil> (suggesting that failure to increase the SEC's budget might lead to the introduction of a bill calling for the creation of an SRO).

267. OCIE administers the SEC's examination and inspection program by conducting examinations of registered entities, including: broker-dealers, transfer agents, investment advisers, investment companies, the national securities exchanges, clearing agencies, SROs like the Financial Industry Regulatory Authority ("FINRA") and the Municipal Securities Rulemaking Board, and the Public Company Accounting Oversight Board. *National Exam Program: Offices and Program Areas*, SEC.GOV (Jan. 7, 2013), <http://www.sec.gov/ocie/Article/about.html#VIPGUmRdXIM> ("OCIE's mission is to protect investors, ensure market integrity and support responsible capital formation through risk-focused strategies that: (1) improve compliance; (2) prevent fraud; (3) monitor risk; and (4) inform policy.").

268. SEC. & EXCH. COMM'N, STUDY ON ENHANCING INVESTMENT ADVISER EXAMINATIONS 11 (2011), <http://www.sec.gov/news/studies/2011/914studyfinal.pdf> [hereinafter 2011 SEC Study on Enhancing Examinations].

269. GAO, INVESTMENT ADVISERS, *supra* note 246, at 25.

270. *Id.* at 47 ("[T]he inspection staff increased its productivity by over 100% between 1981 and 1985 in terms of the number of inspections done annually per examiner . . .").

271. 2011 SEC Study on Enhancing Examinations, *supra* note 268, at 11, 14. The total number of examiners in chart 3 is 460, while the total number of examinations of investment advisers in chart 6 is 1,083. *Id.* Dividing 1,083 by 460 yields 2.35 examinations per examiner. This calculation was suggested by David Tittsworth. To get to 25 examinations per examiner, the 1992 figure, there would have to be only forty-three examiners devoted to investment adviser examinations, with the rest of the 460 examiners' time devoted to investment companies.

272. *Id.* at 19.

two-year period starting in October 2012.<sup>273</sup>

A. *State Regulation of Smaller Investment Advisers*

Prior to 1996, all investment advisers were subject to registration both with the SEC and the states.<sup>274</sup> In the National Securities Markets Improvement Act of 1996 (the “NSMIA”), Congress moved investment advisers with less than \$25 million in assets under management from SEC to state regulation.<sup>275</sup> Nothing had changed since the 1990 GAO report. If anything, the SEC was spread even more thinly. Investment advisers who had discretion over client assets were inspected about once every nine years, while the average adviser was not inspected more than once every twenty-two years.<sup>276</sup>

Congress was concerned that both the SEC and the state regulators were overwhelmed with the burden of regulating more than 22,000 registered investment advisers.<sup>277</sup> The goal was to split the burden between the SEC and the state regulatory authorities, allowing for more effective regulation of all investment advisers.<sup>278</sup>

In 2010, Congress once again reallocated responsibility between the SEC and state regulators to make for more effective regulation of investment advisers. In the Dodd-Frank Act, Congress created a new category of “mid-sized” investment advisers; those with assets under

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273. Letter from Drew Bowden, SEC Deputy Dir. of OCIE, to the Senior Executives or Principals of a Newly Registered Investment Advisor (Oct. 9, 2012), *available at* <http://www.sec.gov/about/offices/ocie/letter-presence-exams.pdf>.

274. See Howard M. Friedman, *The Impact of NSMIA on State Regulation of Broker-Dealers and Investment Advisers*, 53 BUS. LAW. 511, 531 (1998) (discussing the reallocation of registration authority under federal law).

275. See 15 U.S.C. § 80b-3a(a) (2006 & Supp. V 2011) (restricting federal regulation of investment advisers).

276. See *SEC’s New Approach to Examinations of Advisers Focuses on Risk to Clients*, 27 SEC. REG. & L. REP. (BNA) No. 42, at 1704 (Oct. 27, 1995) (discussing the SEC’s examination practices for investment advisers).

277. See S. REP. NO. 104-293, at 2 (1996) (stating that regulation by both the SEC and states is unnecessary).

278. *Id.* at 2–3 (“Title I of the bill creates a clear division of labor between the states and the federal government for supervision of investment advisers. Currently, while investment advisers are nominally supervised by the SEC and by most states, both are overwhelmed by the size of the task, with more than 22,000 investment advisers currently registered with the SEC. The reality has been that while investment advisers may boast of their registration with the SEC, the SEC has been unable to conduct active supervision of more than a fraction of the advisers registered with the Commission. State securities commissioners have similarly found their resources spread thin. Title I would improve supervision by focusing SEC supervision on investment advisers most likely to be engaged in interstate commerce and focusing state supervision on advisers whose activities are most likely to be centered in their home state.”) (footnote omitted).

management of \$25 million or more but less than \$100 million were now regulated by the states.<sup>279</sup> Putting aside the marvelous Rube Goldberg drafting that led to two different provisions for state registration when one would have done, and the incredibly scant legislative history,<sup>280</sup> “[t]he apparent purpose of this reallocation was to allow the SEC to focus its examination resources on larger investment advisers.”<sup>281</sup> In 2010, the SEC estimated that approximately 4,100 advisers would switch from SEC to state registration.<sup>282</sup> In addition, the SEC estimated that 750 investment advisers would lose their exemptions from registration under the IAA<sup>283</sup> because Title IV of the Dodd-Frank Act provided that investment advisers with fewer than fifteen clients were no longer exempt from registration.<sup>284</sup> This swept in many investment advisers to hedge funds, defined in Dodd-Frank as “private equity fund[s].”<sup>285</sup>

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279. See 15 U.S.C. § 80b-3a(a) (describing the regulatory oversight of mid-sized investment advisers).

280. See generally H.R. REP. NO. 111-517 (2010) (Conf. Rep.) (listing the provisions of the Dodd-Frank amendments). The sole Congressional report on the Dodd-Frank Act contains only fifteen pages devoted to a Joint Explanatory Statement of the Committee of Conference, compared to 865 pages of the report devoted to reprinting the act itself. *Id.* at 865–880. There is no explanation for why investment advisers with assets under management of up to \$100 million should be under state regulation. There is only a one-sentence description of this change with no explanation of the purpose behind the change: “The conference report raises the assets threshold for federal regulation of investment advisers from \$30 million to \$100 million.” *Id.* at 867. There is nothing in the congressional record that sheds any additional light on the congressional intent behind the new “mid-sized” investment adviser provision.

281. Davis Polk Client Memorandum, SEC Issues Final Rules Implementing Dodd-Frank Amendments to the Investment Advisers Act of 1940, at 11 (June 29, 2011), [http://www.davispolk.com/sites/default/files/files/Publication/4c1a63de-64be-4051-a955-00faeaf7fe53/Preview/PublicationAttachment/0c0cb405-27c8-451d-abaf-06c40e076bc0/062911\\_Investment\\_Advisers\\_Dodd\\_Frank\\_Final\\_Rules.pdf](http://www.davispolk.com/sites/default/files/files/Publication/4c1a63de-64be-4051-a955-00faeaf7fe53/Preview/PublicationAttachment/0c0cb405-27c8-451d-abaf-06c40e076bc0/062911_Investment_Advisers_Dodd_Frank_Final_Rules.pdf).

282. 2011 SEC Study on Enhancing Examinations, *supra* note 268, at 16 n.31.

283. *Id.*

284. Congress did provide a new exemption for a “foreign private adviser” that meets certain criteria, including having “fewer than 15 clients and investors in the United States in private funds advised by the investment adviser.” 15 U.S.C. § 80b-2(a)(30)(B) (2006 & Supp. IV 2010). In addition, section 2(a)(30) provides that a foreign adviser is only “private” and thus exempt if it has no domestic office, has less than \$25 million in domestic assets under management, does not hold itself out as an investment advisor, and does not advise a registered investment company. *Id.* at § 80b-2(a)(30).

285. See 12 U.S.C. § 1851(h)(2) (2006 & Supp. IV 2010) (defining private equity funds). By eliminating the exemption from registration for investment advisers to fewer than 15 clients, many formally exempt investment advisers were threatened with registration under the IAA. In response to concerns about such increased registration, Congress, in the Dodd-Frank Act, exempted investment advisers of certain types of private funds from registration, notably venture capital funds and private funds with less than \$150 million in assets under management in the United States, though private funds still have reporting requirements. In addition, the Dodd-Frank Act added an adviser to a “family office” as a

In fact, more investment advisers that lost their exemption became SEC registered and fewer mid-sized advisers switched to state regulation.<sup>286</sup> As of October 19, 2012, 1,504 investment advisers, hedge funds, and other private funds that were formerly exempt from registration had registered with the SEC, and more than 2,300 mid-sized investment advisers had switched to state regulation.<sup>287</sup> The net effect of these changes is that the number of SEC registered investment advisers dropped from 12,622 to approximately 10,700.<sup>288</sup> Meanwhile, the assets under management of SEC registered investment advisers increased from approximately \$48.73 trillion

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type of entity that was not an “investment adviser,” as such term is used in the IAA. *See* 15 U.S.C. § 80b-2(a)(11) (2006 & Supp. IV 2010) (defining an investment adviser). Family offices are largely those established by wealthy families to manage the assets of, and provide other services to, its own family members. To be exempt as an adviser to a family office, the investment adviser is not permitted to have any investment advisory clients other than “family clients.”

286. *See* Davis Polk Client Memorandum, *supra* note 281, at 1 (discussing the implications of the Dodd-Frank Amendments).

287. *See* SEC Press Release, *supra* note 102 (discussing SEC registration trends since Dodd-Frank). An additional 293 investment advisers were identified by the SEC either as having gone out of business or as having failed to switch to state registration. *Id.* (citing Notice of Intention to Cancel Registrations of Certain Investment Advisers Pursuant to Section 203(h) of the Investment Advisers Act of 1940). More investment advisers would have switched to state registration if the numerous New York State investment advisers were eligible for SEC registrations. *See* INV. ADVISER ASS’N & NAT’L REGULATORY SERVS., EVOLUTION REVOLUTION 2010: A PROFILE OF THE INVESTMENT ADVISOR PROFESSION 20 (2011), available at [http://www.nrs-inc.com/Global/White%20Papers/NREvolutionRevolution\\_2011\\_WhitePaper\\_Screen\\_final.pdf](http://www.nrs-inc.com/Global/White%20Papers/NREvolutionRevolution_2011_WhitePaper_Screen_final.pdf) [hereinafter EVOLUTION REVOLUTION 2010] (noting the 1,552 SEC registered investment advisers located in New York State in 2010). The Dodd-Frank Act amended section 203A of the IAA to provide that mid-sized investment advisers cannot register with the SEC if the adviser “is required to be registered as an investment adviser with the securities commissioner (or any agency or office performing like functions) of the State in which it maintains its principal office and place of business and, if registered, would be subject to examination as an investment adviser by any such commissioner, agency, or office.” H.R. REP. NO. 111-517, at 205–06. The Dodd-Frank Act did not define what it means to be “required to be registered” or to be “subject to examination.” *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. 42,950, 42,960 (June 22, 2011) (discussing the SEC’s adoption of amendments under the Investment Advisers Act of 1940). The SEC provides guidance on what states do not meet its requirements through a website that is referenced in Form ADV, the registration form for both state and SEC registered investment advisers. *See* Form ADV (Paper Version), at Part 1A Item 2.A.(2), available at <http://www.sec.gov/about/forms/formadv-part1a.pdf> (describing the registration process for investment advisers). New York and Wyoming are the two states that fail to meet these requirements. *Frequently Asked Questions Regarding Mid-Sized Advisers*, SEC.GOV, <http://www.sec.gov/divisions/investment/midsizedadviserinfo.htm> (last updated Jun. 28, 2011).

288. *See* SEC. & EXCH. COMM’N, DODD-FRANK ACT CHANGES TO INVESTMENT ADVISER REGISTRATION REQUIREMENTS, 5 fig. 7 (2012), <http://sec.gov/divisions/investment/imissues/df-iaregistration.pdf> (noting the impact of Dodd-Frank on investment adviser registration).



to \$49.50 trillion.<sup>289</sup>

It is frustrating that the legislative history is so opaque on the new “mid-sized” investment adviser provision. But it is hard to imagine anything motivating this provision other than Congress’ decision that scarce SEC resources were best used to examine the larger investment advisers rather than the smaller investment advisers.<sup>290</sup> When the Dodd-Frank Act was passed, there was publicly-available evidence that the SEC, as it had in the past, was overstretched and failed to examine investment advisers with regularity.<sup>291</sup> In addition, two witnesses at the 2009 Senate hearing on Enhancing Investor Protection and the Regulation of Securities

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289. *Id.*

290. *See generally* DEP’T OF TREASURY, THE FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 2-9 (2009), [http://www.treasury.gov/initiatives/Documents/FinalReport\\_web.pdf](http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf) (noting how the financial regulatory infrastructure might be improved). The 2009 report prepared by the Department of the Treasury highlights the need for many statutory changes that were embodied in the Dodd-Frank Act. *Id.* There is, however, nothing in the report about moving mid-sized investment advisers to state regulation.

291. *See, e.g.*, INV. ADVISER ASS’N & NAT’L REGULATORY SERVS., 2009 EVOLUTION REVOLUTION — A PROFILE OF THE INVESTMENT ADVISER PROFESSION 2 (2009) (“Our previous reports . . . have chronicled the growth in the number of investment advisor registrations since 2001. A key question in the current regulatory reform debate is whether the SEC’s resources are adequate to provide effective oversight of the advisory profession.”); SEC, PUTTING INVESTORS FIRST: 2009 PERFORMANCE AND ACCOUNTABILITY REPORT 18–30 (2009), <http://www.sec.gov/about/secpar/secpar2009.pdf> (discussing the SEC’s regulatory performance). As the SEC noted,

[i]n recent years, the number of registered advisers has increased by nearly 50 percent and the assets under management by these advisers have nearly doubled . . . . While OCIE staff has not increased proportionally, OCIE continues to target high-risk firms and activities as resources permit. During the past year, OCIE examined the operations, or some portion thereof, of nearly 10 percent of all registered advisers and 30 percent of all registered fund complexes.

*Id.* at 18. The SEC did not meet its 2009 target for examinations of “high risk” investment advisers. *Id.* at 30. Only 22 percent were examined, whereas the target had been 35 percent. *Id.* The SEC explained this failure by noting the OCIE had adopted “improved risk-based processes” for identifying high risk firms, which increased the number of such firms identified. *Id.* “In addition, OCIE introduced more rigorous exam procedures, improved its surveillance techniques, and enhanced staff training.” *Id.* The combination of these factors led to an increase in “the time it took to complete examinations and [a drop in] the overall number of examinations completed.” *Id.* The SEC was more successful in responding to no-action and interpretive requests and exemptive order requests from the investment management industry. In the year ending on September 30, 2009, the Division of Investment Management “[p]rovide[d] initial comments on . . . [100%] percent of interpretive and no-action requests within three weeks of receipt of the letter request” and “[p]rovide[d] initial comments on . . . [95] percent of exemptive applications within 120 days after receipt of an application.” *Id.* at 44–45. Both figures considerably exceeded the targets of 75 and 80 percent, respectively. *Id.* at 44.

Markets testified in favor of some type of mid-sized investment adviser exemption from SEC registration.<sup>292</sup> Senator Dodd explicitly referenced this possible exemption in one of his comments.<sup>293</sup> It is impossible to state with certainty whether Congress took into account evidence of this type when considering the Dodd-Frank Act, particularly in section 203A.<sup>294</sup>

The clearest evidence of this overstretch is the report that the SEC prepared on enhancing examinations of investment advisers pursuant to Section 914 of the Dodd-Frank Act (the “Section 914 Report”).<sup>295</sup> The report does not shed direct light on the legislative purpose behind the amendments to section 203A, as it was issued subsequent to the passage of the Dodd-Frank Act but, it is an eloquent plea for the need for more resources to be devoted to regulating investment advisers. As the SEC itself concluded, “[a]s the number of registered investment advisers and the assets managed by them have increased and the number of OCIE staff dedicated to examining registered investment advisers has decreased over the past six years, the number of examinations of registered investment advisers has decreased.”<sup>296</sup> In 2004, the typical investment adviser was examined about once every six years.<sup>297</sup> By 2010, this had become about once every eleven years.<sup>298</sup> Comparable examination period figures are not available for fiscal year 2011, but the SEC has reported a target of eleven percent for all types of examinations of investment advisers. The SEC

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292. *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 86 (2009) (statement of Fred J. Joseph, President, N. Am. Secs. Adm’rs Ass’n) (“[T]his increase [from \$25 to \$100 million] will reduce the number of federally registered investment advisors, thereby permitting the SEC to better focus its examination and enforcement resources on the largest advisors.”); *Id.* at 217–18 (statement of David G. Tittsworth, Exec. Dir. & Exec. Vice President, Inv. Advisers Ass’n) (“An increase in the threshold would reduce the number of SEC-registered advisers and permit the SEC to focus on the appropriate universe of advisers on a risk-adjusted basis in its examination program.”).

293. Former Senator Christopher J. Dodd, chairman of the committee, noted, after the Statement by Fred J. Joseph, President, North American Securities Administrators Association, that “I think we all have some questions about various proposals and raising from 25 to 100 million and so forth, what that involves.” *Id.* at 32.

294. The SEC is of the view that this was the congressional intent. “Congress twice has responded to capacity challenges to the Commission’s investment adviser examination program by reallocating federal and state responsibilities for the regulation of registered investment advisers, first in 1966 with the enactment of NSMIA and next in 2010 with the enactment of the Dodd-Frank Act.” 2011 SEC Study on Enhancing Examinations, *supra* note 268, at 23.

295. *See id.* (noting the personnel challenges presented by the expected increase in registered investment advisers).

296. *Id.* at 14.

297. *Id.*

298. *Id.*

actually examined only eight percent.<sup>299</sup>

Although the SEC will be able to devote more resources to SEC registered investment advisers, the SEC has new examination responsibilities under the Dodd-Frank Act and it is concerned that the number of SEC-registered investment advisers will start to grow again, as it did after the NSMIA.<sup>300</sup> The SEC attempted to solve the problems associated with insufficient resources in the Section 914 Report by considering all of the traditional solutions: an SRO for investment advisers, including the more limited version of having FINRA take responsibility for examining its members that were dually registered as investment advisers and broker-dealers in their capacity as investment advisers, and a type of self-funding relying upon user fees to give the SEC additional financial resources.<sup>301</sup> The SEC did reject “periodic reallocation of investment adviser regulatory responsibilities” to the states as a solution because it was concerned about the resources that states could or would devote to these responsibilities.<sup>302</sup>

The SEC’s concerns about reallocations to state registration are well taken. Prior to the switch of mid-size investment advisers to state regulations mandated by the Dodd–Frank Act, there was “one full-time licensing/exam [state] staff member for approximately every 37 state–registered [i]nvestment advisers.”<sup>303</sup> In contrast, prior to the switch, the SEC had approximately one SEC OCIE staff member for every 26 investment advisers.<sup>304</sup> The differences in regulatory functions can give

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299. SEC. & EXCH. COMM’N, FY 2011 PERFORMANCE AND ACCOUNTABILITY REPORT 59 (2011), <http://www.sec.gov/about/secpar/secpar2011.pdf>. But it is hard to make this argument because we do not know whether the eight percent includes repeat examinations of particular investment advisers. The published figures also show a decline from fiscal year 2007 to fiscal year 2009 in some examinations from 33% of high-risk investment advisers to 22%. *Id.*

300. See 2011 SEC Study on Enhancing Examinations, *supra* note 268, at 25 (addressing options to consider when facing capacity constraints).

301. *Id.*

302. *Id.* at 24.

303. N. AM. SEC. ADM’RS ASS’N (“NASAA”), STATE SECURITIES REGULATORS REPORT ON REGULATORY EFFECTIVENESS AND RESOURCES WITH RESPECT TO BROKER-DEALS AND INVESTMENT ADVISERS 12 (2010), *available at* <http://www.sec.gov/comments/4-606/4606-2789.pdf> [hereinafter NASAA Report]. The number of investment advisers per state staff member will have increased with the state registration of mid-sized advisers. One important qualification is that this is an average figure covering all states, (except New York) Puerto Rico, the U.S. Virgin Islands, and the District of Columbia. The easily available public information does not break out this figure by jurisdiction. There is a Memorandum of Understanding Concerning the Examination of Investment Advisers whereby a state that has elected to participate may request the help of investment adviser examiners from other participant states. *Id.* at 4.

304. See 2011 SEC Study on Enhancing Examinations, *supra* note 268, at 12 (charting

some comfort that state regulators are not as under-resourced as they appear. The OCIE staff examines registered investment companies as well as SEC-registered investment advisers.<sup>305</sup> The states examine broker-dealers and investment adviser representatives in addition to state-registered investment advisers.<sup>306</sup> With respect to broker-dealers, states have relied on FINRA and the SEC as the front-line regulators, focusing more on risk-based exams and exams of small, geographically remote offices that might be harder to reach for the SEC's regional offices and FINRA.<sup>307</sup> In addition, the states have conducted routine examinations of the state-registered investment advisers "with much greater frequency than the [SEC] has historically examined" SEC-registered investment advisers.<sup>308</sup>

#### B. *Private Causes of Action Under the IAA*

In *Transamerica Mortgage Advisors*, the Supreme Court restricted private causes of action under the IAA to certain equitable remedies under section 215 if a contract with an investment adviser is "void."<sup>309</sup> Specifically, a plaintiff can seek to rescind such a contract and "obtain restitution of consideration paid" to the offending investment adviser.<sup>310</sup> Although such restitution "could provide by indirection the equivalent of a private damages remedy that we have concluded Congress did not confer," it "would not . . . include [any] compensation for any diminution in the value of the rescinding party's investment alleged to have resulted from the

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the number of OCIE staff who monitor registered investment advisers and investment companies from 2004 to 2010).

305. *Id.* at 5.

306. See 2011 SEC Study on Investment Advisers & Broker-Dealers, *supra* note 9, at 84 (summarizing state regulation of investment-advisers and broker dealers).

307. See NASAA Report, *supra* note 303, at 10 (discussing NASAA's regulatory strategy).

308. *Id.* at 8. Their conclusion should be taken with a bit of skepticism as it is based on goals for reporting cycles and there is no easily available public information that compares goals with achievements of these goals.

309. 15 U.S.C. § 80b-15(b) (2006) ("Every contract made in violation of any provision of this subchapter and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of any provision of this subchapter, or any rule, regulation, or order thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, regulation, or order, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision.").

310. *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 18 (1979).

adviser's action or inaction."<sup>311</sup>

The Supreme Court has not made a similar blanket holding under the ICA concerning private causes of action and, in fact, has recognized them under two sections of the ICA, section 36(b)<sup>312</sup> and section 30(h).<sup>313</sup> In addition, in the context of derivative actions brought by shareholders on behalf of their investment companies, the Supreme Court has twice assumed, without deciding, that a derivative action may be brought under certain sections of the ICA.<sup>314</sup> Having said all of this, the recent trend of lower federal court decisions has been against implying private causes of action by shareholders of investment companies where the ICA does not expressly provide for a private cause of action. Only sections 36(b) and 30(h) provide for a private cause of action, although cases remain that would support implying a private cause of action and have not been explicitly overruled or limited.<sup>315</sup>

Congress has been no more receptive than the courts to a private cause of action under the IAA or the ICA. Looking specifically at the IAA,

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311. *Id.* at 24 n.14.

312. *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418 (2010). For a discussion of section 36(b), see *infra* notes 312-315 and accompanying text.

313. *Transamerica*, 444 U.S. at 20 n.10 (citing 15 U.S.C. § 80a-29(f) (1970)) (“Investment advisor[s] . . . shall . . . be subject to the same duties and liabilities as those imposed by [section 16 of the Securities Exchange Act of 1934] upon certain beneficial owners, directors, and officers in respect of their transactions in certain equity securities.”).

314. *Kamen v. Kemper Fin. Servs., Inc.*, 111 S. Ct. 1711, 1717 n.4 (1991) (“Because the question whether § 20(a) supports a derivative action is not jurisdictional, and because we do not ordinarily address issues raised only by *amici* [such as the SEC in this case], we leave this question for another day.” (citations omitted)); *Burks v. Lasker*, 90 S. Ct. 1831, 1836 (“As petitioners never disputed the existence of private, derivative causes of action under the [ICA and IAA], and as in this Court all agree that the question has not been put in issue, we shall assume without deciding that respondents have implied, derivative causes of action under [sections 13(a)(3) and 36(a) of] the ICA and [section 206 of the] IAA.” (citations and footnote omitted)).

315. *Compare* *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, 615 F.3d 1106, 1108 (9th Cir. 2010) (holding that no private cause of action exists under ICA section 13(a)), *Bellikoff v. Eaton Vance Corp.*, 481 F.3d 110, 114 (2d Cir. 2007) (holding that no private cause of action exists under ICA sections 34(b), 36(a) and 48(a)) *and* *Olmsted v. Pruco Life Ins. Co. of N.J.*, 283 F.3d 429, 431 (2d Cir. 2002) (holding that no private cause of action exists under ICA sections 26(f) and 27(i)), *with* *Scalisi v. Fund Asset Mgmt., L.P.*, 380 F.3d 133, 136 n.4 (2d Cir. 2004) (affirming dismissal of shareholders' derivative action brought, in part, under ICA section 36(a) on grounds that demand was not excused without mentioning private cause of action issue or citing to *Olmsted*); *Fogel v. Chestnutt*, 668 F.2d 100, 112 (2d Cir. 1981) (“[T]here is no reason to conclude that, by adopting [in section 36(b)] a modified version of the SEC's proposal to afford an express private remedy with respect to one problem as to which the 1940 Act had proved ineffective, the 1970 Congress meant to withdraw the implied private cause of action in other areas which had been recognized over the previous decade by four courts of appeals . . .”).

starting in 1976,<sup>316</sup> there have been a number of SEC proposals and Congressional bills providing for some type of private cause of action under the IAA, all of which have failed.<sup>317</sup> There is nothing in our current political climate that would lead one to expect Congress to now be more receptive to creating private causes of action under either the IAA or the ICA.

### C. Self-Regulatory Organization

One solution proposed for the problems of SEC oversight of investment advisers is a self-regulatory organization of investment advisers. This was one of the three proposals in the report that the SEC issued pursuant to section 914 of the Dodd-Frank Act. This is not a new proposal. It has been a topic of discussion since at least 1963 and, over the years, Congress has considered several bills providing the SEC with the authority to create such a self-regulatory organization.<sup>318</sup> The SEC's Section 914 Report summarizes the history: "The concept of an SRO for investment advisers is not new. Proposals to create one or more SROs for investment advisers have been considered by Congress, the Commission and members of the investment advisory industry for over 45 years."<sup>319</sup>

The recent consideration of a self-regulatory organization for investment advisers has been quite controversial, attracting fierce opposition from certain members of the investment adviser industry.<sup>320</sup> Opponents have argued that such a self-regulatory organization would suffer from a variety of defects. Among the concerns have been (1) the possibility that a self-regulatory organization might not be subject to the

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316. Kevin F. Brady & Mark Rockwell, Note, *The Investment Advisers Act of 1940 and the Supreme Court: Private Rights of Action Under the New Cort Test*, 6 DEL. J. CORP. LAW 54, 61 (1981).

317. *See id.* at 62 (describing how 1976 proposed amendment was reintroduced in 1977); GAO, INVESTMENT ADVISERS, *supra* note 246, at 33-34 (describing 1990 bill to amend the IAA to add a private cause of action). As one article summarized, the changes made in the 1960s and 1970s to the IAA to cover more than a census of investment advisers, "Congress has now had five opportunities to rectify the confusion concerning private rights of action [under the IAA]. Congress has apparently chosen not to act on the situation." Brady & Rockwell, *supra* note 316, at 62.

318. 2011 SEC Study on Enhancing Examinations, *supra* note 268, at 29-30 n.54.

319. *Id.* at 29.

320. *See, e.g.,* David G. Tittsworth, *H.R. 4624: The Pitfalls of a Self-Regulatory Organization for Investment Advisers and Why User Fees Would Better Accomplish the Goal of Investment Adviser Accountability*, 87 ST. JOHN'S L. REV. 477 (2013) (critiquing a bill mandating investment adviser membership in a SRO). Tittsworth is the Executive Director and Executive Vice President of the Investment Adviser Association, the largest trade organization representing investment advisers. *Id.* at 477 n.d1

Administrative Procedure Act or the Freedom of Information Act;<sup>321</sup> (2) increased costs that investment advisers would bear because of a second regulatory agency besides the SEC overseeing their activities;<sup>322</sup> and (3) increased costs that might be incurred by the SEC for overseeing such a self-regulatory organization.<sup>323</sup>

There has been particular opposition to FINRA's assuming of the role of self-regulator for investment advisers.<sup>324</sup> This opposition arises in large part from the fact that FINRA historically is an organization of broker-dealers, which have different business models from many investment advisers.<sup>325</sup> In addition, opponents view FINRA as an organization that is not accountable in any meaningful way to the public, the SEC, or its members.<sup>326</sup>

The Cato Institute summarized one view of FINRA when it wrote, in a recent amicus brief, that "FINRA's extra-constitutional operation has fostered significant policy failures including agency capture, lax regulation, and biased arbitration. . . . The proliferation of substantial financial industry scandals over the past decade is evidence that FINRA is, at best, a hands-off regulator and, at worst, a corrupt and self-serving company."<sup>327</sup>

#### D. *Increased Funding for the SEC*

One can always dream. Self-funding for the SEC either of a general kind or of a more limited kind, as in user fees charged to investment advisers, has been proposed numerous times.<sup>328</sup> The political likelihood of

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321. *Id.* at 499.

322. *Id.* at 504.

323. *Id.*

324. *Id.* at 496–99.

325. *Id.* at 497 ("Broker-dealers are the 'sell side' of the securities industry, while advisers are the 'buy side.' The potential for conflict is demonstrated by FINRA's explicit advocacy of extending the broker-dealer regulatory framework to advisers. Conflicts may arise in that broker-dealers engage in arms-length transactions with investment advisers in various capacities, including as service providers, counterparties, market makers, and syndicators and underwriters. An association representing private fund advisers has observed that these competing relationships 'would present challenges to an SRO responsible for overseeing these types of firms fairly and equitably.'" (footnotes omitted)).

326. *Id.* at 498–99.

327. Brief for CATO Institute and the Competitive Enterprise Institute as Amici Curiae Supporting Petitioner at 9–11, *Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers*, 637 F.3d 112 (2d Cir. 2011). *Standard Investment Chartered* involved an alleged misrepresentation in the 2006 proxy statement produced in connection with the consolidation of the National Association of Securities Dealers, Inc. with the regulatory arm of the New York Stock Exchange, which resulted in the formation of FINRA. 637 F.3d at 114.

328. See 2011 SEC Study on Enhancing Examinations, *supra* note 268, at 25–29

any sort of self-funding being enacted is vanishingly small.

The recent controversy over the Consumer Financial Protection Bureau (the “CFPB”) shows that self-funding remains deeply unpopular in Congress.<sup>329</sup> The CFPB receives funds by requesting monies from the self-funding Board of Governors of the Federal Reserve System.<sup>330</sup> While section 1017 of the Dodd-Frank Act caps the available funds at twelve percent of the total operating expenses of the Federal Reserve System, the Federal Reserve has no discretion over transferring the requested funds.<sup>331</sup> The CFPB also collects filing fees under the Interstate Land Sales Full Disclosure Act and may keep whatever fines it levies.<sup>332</sup> Republican lawmakers have decried the agency’s budgetary freedom, citing the lack of oversight and attendant potential for abuse.<sup>333</sup> While possessing the power to “question” the agency, Congress will not be able to influence the direction and initiatives of the CFPB through the typical appropriations process.<sup>334</sup>

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(describing a 1992 bill introduced in the House of Representatives providing that investment advisers pay a user fee to fund SEC oversight and making several novel recommendations regarding self-funding).

329. DAVID H. CARPENTER, CONG. RESEARCH SERV., R425700, THE CONSUMER FINANCIAL PROTECTION BUREAU (CFPB): A LEGAL ANALYSIS (2012), available at <http://www.fas.org/sgp/crs/misc/R42572.pdf>.

330. *Id.* at 26.

331. *Id.*

332. CONSUMER FIN. PROT. BUREAU, FY 2013 BUDGET JUSTIFICATION 6–7 (2013), available at <http://files.consumerfinance.gov/f/2012/02/budget-justification.pdf>; Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1017(a)(2), 124 Stat. 1376, 1975–76 (2010); see Kevin Wack, *Something to Watch: The CFPB’s Civil Penalty Fund*, NAT’L MORTG. NEWS (Aug. 6, 2012), <http://www.nationalmortgagenews.com/dailybriefing/CFPB-Civil-money-penalty-fund-1031666-1.html>. (discussing concerns that the CFPB will impose large fines in order to generate revenue and then award the money to consumer groups that are political allies).

333. Wack, *supra* note 332.

334. Ronald D. Orol, *Republicans: CFPB’s Funding ‘Recipe for Disaster’*, MARKETWATCH (Feb. 15, 2012), [http://articles.marketwatch.com/2012-02-15/economy/31062099\\_1\\_million-on-paper-clips-consumer-financial-protection-bureau-financial-crisis](http://articles.marketwatch.com/2012-02-15/economy/31062099_1_million-on-paper-clips-consumer-financial-protection-bureau-financial-crisis). Beyond the self-funding issue, the lack of checks-and-balances with respect to the CFPB has been controversial. The CFPB is led by a sole director, rather than a board of commissioners. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1011(c)(1), 124 Stat. at 1924. In addition, the director serves a five-year term and can be removed by the President only for cause. *Id.* § 1011(b)(2). Further, the only available appeal of a CFPB regulation is to the Financial Services Oversight Committee, which can only overturn a regulation that endangers the “safety and soundness of the United States banking system . . .” *Id.* §§ 1023(a), 1011(a). However, judicial review is available for parties subject to CFPB administrative enforcement actions by appealing to either the court of appeals “for the circuit in which the principal office of the covered person is located,” or to the Court of Appeals for the District of Columbia, requesting that the court “modify, terminate, or set aside” the decision of the Bureau on the grounds provided for in the



As financial service firms are such an important fund raising source for Congress, it is particularly unlikely that their regulatory preferences will be ignored.<sup>335</sup> The regulatory preferences of financial services firms are not always for less regulation. In fact, the history of the ICA is a good example of an industry seeking more regulation in order to signal to the world that past misdeeds are behind it and that, in the future, it would operate in the interests of its customers.<sup>336</sup> But, regardless of financial services firms' preferences as to any particular regulatory regime, one can be sure that they do not want their regulators to be immune from political influence.

This Article does not take a position on whether self-funding is good public policy. Rather, it argues the more limited point that it will never occur.

#### CONCLUSION

As we think about investment adviser regulation, we should focus on the practices that we want to regulate rather than using disclosure as our primary tool. We then should focus on the mechanisms by which these

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Administrative Procedure Act. *Id.* at § 1053(b)(4), 124 Stat. at 2026–27.

335. In 2010, individuals employed in finance, insurance and real estate (so-called FIRE) industries donated a total of \$178.2 million to political campaigns, parties, and independent expenditure groups. Lee Drutman, *On FIRE: How the Finance, Insurance and Real Estate Sector Drove the Growth of the Political One Percent of the One Percent*, SUNLIGHT FOUNDATION (Jan. 26, 2012, 12:01 AM), <http://sunlightfoundation.com/blog/taxonomy/term/one-percent>. In addition, through the second quarter of 2012, federal candidates received over 15% of their total contributions from FIRE industries, which was the largest contribution made by any industry. Lee Drutman, *Federal Candidates Depend on Financial Sector More Than Any Other for Campaign Money*, SUNLIGHT FOUND. (Sept. 20, 2012, 4:05 AM), <http://sunlightfoundation.com/blog/2012/09/20/fire-giving/>. In contrast, the next largest contributor was the health sector with only 8.9%. *Id.* Finally, the lobbying expenditure for the FIRE industries is closing in around \$500 million per year and has been steadily rising, ranking its lobbying budget in third place. Ctr. for Responsive Politics, *Influence & Lobbying: Finance, Insurance & Real Estate*, OPENSECRETS.ORG, <http://www.opensecrets.org/lobby/indus.php?id=F&year=> (last updated Jan. 28, 2013). The top two sectors, Health and Miscellaneous Business, are also around the \$500 million mark, but there is a \$100 million drop-off compared to the next largest industry, Energy. Ctr. for Responsive Politics, *Influence & Lobbying: Ranked Sectors*, OPENSECRETS.ORG, <http://www.opensecrets.org/lobby/top.php?showYear=2011&indexType=c> (last visited Feb. 4, 2013).

336. See John Morley, *Collective Branding and the Origins of Investment Fund Regulation*, 6 VA. L. & BUS. REV. 341, 398 (2012) (“The Investment Company Act of 1940 and its related tax and regulatory statutes were not simply forced upon the fund industry—they were also crafted or at least accepted by the industry for reasons that were largely internal to the industry itself. These reasons vary from simple apathy, to collective brand-building, to pure rent-seeking. But we cannot understand modern fund regulation or its quirks and contours without understanding how the fund industry itself shaped its own regulatory regime.”).

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practices should be regulated. Obviously the two are interrelated. Without an effective regulatory process, it does not matter what is regulated. And, without the proper subject being regulated, it does not matter how well-structured the regulatory process is. But what is regulated may relieve some of the pressure on how it is regulated. A ban on certain compensation practices for advisers to retail clients, as has been done in Australia and the U.K., is easier to police than a partial ban on conflicted practices combined with disclosure. The perfect example of this is soft dollar commissions under section 28(e) of the Securities Exchange Act. Instead of just banning this practice, Congress has created a situation where the SEC has engaged in a process of drawing fine distinctions that can make no one, except a lawyer, happy.

We should be skeptical about whether pushing the regulation of smaller investment advisers onto the States is an effective means of dealing with the resource problems of the SEC. As this Article has discussed, nothing in the history of state regulation suggests that it has been a particularly effective substitute for SEC regulation. And, going forward, there is nothing to suggest that the financially-challenged state governments of today will devote any additional resources to this issue.

We also should be skeptical about whether any of the procedural fixes discussed in this Article will be adopted. Certainly, significantly increased funding for the SEC, much less self-funding, is a politically dead issue. Although creating a private cause of action for advisees under the IAA might help bridge the SEC's lack of resources, it too is probably a politically dead issue. Nothing that Congress or the Supreme Court has done over the past twenty years has demonstrated any receptiveness to private causes of action to enforce the federal securities laws.

The one procedural change that has a realistic chance of succeeding is the creation of an SRO for investment advisers. While an SRO might have the resources to more closely regulate investment advisers, it will be hampered in its effectiveness if regulation continues to be focused on disclosure rather than substantive regulation of conflicts.

