

Introduction to the Investment Advisers Act of 1940

John Bronson
Vice President and Corporate Counsel
The Prudential Insurance Company of America
Newark, NJ

Steven A. Yadegari
Senior Vice President and General Counsel
Cramer Rosenthal McGlynn, LLC
New York, NY

Clifford E. Kirsch
Sutherland
1114 Avenue of the Americas- 40th Floor
New York, NY 10036
212.389.5052
clifford.kirsch@sutherland.com

Topics that we will cover

- Overview of Regulatory Structure
- Who Is An Adviser?
- The Advisory Business
- Registration Under the Advisers Act
- Disclosure Requirements
- Conduct Standards
- Attracting Clients
- The Adviser-Client Relationship
- Brokerage Practices
- Compliance
- Administration of the Adviser Act
- Applicability of State Securities Law

Overview of the Advisers Act

- Adviser Conduct Shaped by Fiduciary Duty
 - Not Specifically Mentioned in the Advisers Act
 - Arises from Section 206 and Case Law
- Supplemented by Targeted Rules
- Limited Private Rights of Action
- Compliance Infrastructure
- Exams and Enforcement
- Sources of Law and Regulation
 - Advisers Act
 - No action letter
 - Rule Making
 - Enforcement Actions
 - Administrative Actions
 - Speeches
- State Securities Laws
- Other
 - The Investment Company Act of 1940
 - ERISA

3

The Advisory Business

- Advisers come in various shapes and sizes - individuals and entities can be advisers;
- Various Business Models
 - Retail
 - Institutional
 - Mutual funds
 - Retirement plans
 - Hedge funds
- Various Business Structures
 - Stand-Alone Advisers
 - Subsidiary of Larger Organization
 - Broker-Dealer Dual Registrants

4

Broker-Dealer-Adviser Dually-Registered Firms

- Many firms are dually registered with the SEC as investment advisers and as broker-dealers, and are subject to two different, and sometimes overlapping regulatory schemes. The application of these laws to a dually registered firm depends on whether the firm is acting as a broker-dealer or as an investment adviser with respect to a particular client, product or transaction.
- Whether IA or BD Rules Will Apply. Which hat is the broker wearing? See, e.g., In re IFG Network Securities, Inc., Admin. Proc. Initial Decision (Feb. 10, 2005) (finding that “there is no case precedent that holds that an associated person of an investment adviser cannot change hats...and act in the capacity of a broker-dealer without the higher obligations of an adviser”).
- Proposed Interpretative Rule 202(a)(11) – 1 would codify long standing SEC Position that permits a BD also registered as an adviser to distinguish its brokerage clients from its advisory clients.

5

Registration Under the Investment Advisers Act

- Registration under the Advisers Act is effected by filing the Form ADV with the SEC and paying a fee.
- A distinction needs to be made between the adviser itself and individuals with the adviser.
- Registration is required of the adviser itself
- Individuals associated with the adviser (which includes employees and those otherwise associated) are not separately registered as advisers.
- The Form ADV consists of two parts
 - Part I is principally for use by regulators.
 - Part II serves as the basis for the disclosure document the adviser must provide to each of its advisory clients.

6

Disclosure

- Duty to Disclose Potential Conflicts
- Form ADV
- An adviser must disclose to clients conditions that are reasonably likely to impair its ability to honor its obligations to clients
 - Disclosure of Financial and Disciplinary Information-Rule 206(4)-4

7

Conduct Standards

Adviser Fiduciary Duty

- Section 206 of the Advisers Act contains the anti-fraud provisions of the Advisers Act. That section provides that is unlawful for an adviser directly or indirectly to:
 - employ any device, scheme, or artifice to defraud any client or prospective client (Section 206(1));
 - engage in any transaction, practice, or course of business that operates as a fraud or deceit upon any client or prospective client (Section 206(2)); and
 - engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative (Section 206(4))
 - In *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, the Supreme Court noted that in applying the antifraud provision, an adviser is to be held to a fiduciary standard. This fiduciary standard will guide an adviser throughout its course of conduct.
- Among the most important requirements of Sections 206(1) and (2) is making full and adequate disclosure to clients regarding matters that may have an impact on the adviser's independence and judgment.

8

Conduct Standards

The Advisers Act restricts certain specific activities that may be grouped into the following categories:

- Attracting Clients
- Components of the Advisory Relationship
- The Advisory Contract
- Compensation
- Suitability
- Custody
- Proxy Voting
- Brokerage Transactions and Trading Practices

9

Attracting Clients

Advertising

- Rule 206(4)-1 is the primary rule covering advertising under the Advisers Act. The Rule includes four specific categories of misleading advertising and one catch-all provision
- The most significant of the four specific categories are:
 - No Testimonials
 - Past Specific Recommendations (cannot refer to successful securities recommendations without referring to unsuccessful recommendations)
- The catch-all category prohibits the use of any advertisement that “contain any untrue statement of a material fact, or which is otherwise false or misleading.” One particular kind of advertising - performance advertising - has been the source of many interpretative questions under the catch-all category.

10

Referral Fees

- Many advisers rely on parties providing referrals – commonly known as “solicitors” – as sources of new business. Adviser cash payments to solicitors are governed by Rule 206(4)-3
- Written agreement between solicitor and adviser is required
- Disclosure statement must be provided to the client and a signed acknowledgement received from the client when the solicitor is not affiliated with the adviser.

11

The Adviser-Client Relationship

Advisory Agreements

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

12

Compensation

- Generally, advisers are given wide latitude in structuring advisory fees, except for performance fees. The prohibition against the deduction of performance fees is contained in Section 205(a)(1) of the Advisers Act.
- Exceptions to the performance-fee prohibition
- Asset-based fees
- Fulcrum fees (popular arrangement with mutual funds. Allows adviser to adjust its base fee up or down depending on performance of the fund compared to an index)
- Wealthy client (Rule 205-3)
- Qualified Purchaser Fund
- Foreign Clients

13

Suitability

- Advisers owe their clients a duty to provide only suitable investment advice. This duty generally requires an adviser to make a reasonable inquiry into the client's financial situation, investment experience and investment objectives, and to make a reasonable determination that the advice is suitable in light of the client's situation, experience and objectives.

14

Custody

- The Advisers Act imposes various requirements when an adviser maintains custody of client assets.
- A registered adviser that holds, directly or indirectly, client funds or securities or has authority to obtain possession of clients' funds or securities, is deemed to have "custody" of those funds or securities. Rule 206(4)-2 establishes standards that apply when an adviser has or is deemed to have custody.
 - Qualified custodian
 - Delivery of account statements
 - Surprise Audit; Internal Control Report (if custody by adviser or affiliate).
 - Special rules for pooled investment vehicles
 - Adoption of policies and procedures

15

Proxy Voting

- Rule 206(4)-6 provides that Proxy voting policies and procedures must be adopted that are reasonably designed to ensure that the adviser votes proxies relating to clients' securities in the best interest of clients

16

Brokerage and Trading Practices

Duty of Best Execution

- As a fiduciary, an adviser is required to carry out its selection of brokers subject to the standard of “best execution.”
- The advisory contract typically specifies whether the adviser or the client will be responsible for selecting the broker to execute orders on behalf of the client.

17

Soft Dollars

- As fiduciaries, advisers should negotiate with broker-dealers for lower commissions for its clients. In practice, brokers are reluctant to lower their usual commissions to clients, instead providing rebates that are paid in kind (by “soft” dollars) rather than in cash. An adviser’s receipt of soft dollars could constitute a breach of the adviser’s fiduciary duty.
- Section 28(e) of the Securities Exchange Act of 1934 provides that advisers fall within the safe harbor when they pay more than the lowest available brokerage commissions if they receive eligible research and benefits from the brokers.
- The limits of Section 28(e) have been addressed in various SEC releases and letters, most recently in 2006.

18

Trading

- Section §206(3) of the Advisers Act restricts advisers from acting in ways in which the advisers' interest conflicts with clients' interests. This includes principal transactions and agency cross transactions
- In a principal transaction the adviser buys securities for the adviser's own inventory from a client or sells securities from the adviser's own inventory to the client.
- Agency cross-transactions involve the adviser operating on behalf of its advisory clients and those of the party on the other side of the brokerage transaction.
- The Investment Advisers Act regulates principal transactions and agency-cross transactions by requiring that an adviser disclose the conflict and receive the consent of the client before effecting the transaction. (Section 206(3) of the Advisers Act)
- Rule 206(3)-2 provides for safe harbor for agency cross transactions. Allows for blanket consent

19

Compliance

Record-keeping Obligations

- Rule 204-2 under the Advisers Act requires that a broad range of books and records be maintained. The types of books and records required to be maintained include:
 - The registered adviser's accounting records;
 - The registered adviser's corporate records;
 - Records relating to the compliance policies and procedures records relating to clients, including transactions information, portfolio records and contracts;
 - Records relating to advertising and performance presentations;
 - Records relating to clients' assets that are, or are deemed to be, in the custody of the adviser;
 - Records relating to personal securities transactions by principals and employees of the adviser;
 - Books and records must generally be maintained and preserved in an easily accessible place for five years from the end of the fiscal year during which the last entry was made on such record, and the first two years in an appropriate office of the adviser.
 - Books and records relating to advertisements or performance information used in marketing materials must be maintained for a period of not less than five years from the end of the fiscal year during which the adviser last published or disseminated the materials.
 - Articles of incorporation, charters, minute books, and stock certificate books of the adviser and of any predecessor, must be maintained in the principal office of the adviser and preserved until at least three years after termination of the enterprise.
- Rules written many decades ago and do not specifically address things like email and forms of social media.

20

Compliance Program: Rule 206(4)-7

- A registered adviser must adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act by the registered adviser or any of its supervised persons.
- These policies and procedures must be reviewed annually by the registered adviser to determine their adequacy and effectiveness.
- Registered advisers are required to designate a chief compliance officer that has a position of sufficient seniority and authority within the organization to administer the compliance policies and procedures.

21

Insider Trading and Code of Ethics

- Under Section 204A of the Advisers Act, an adviser must establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material, non-public information by the adviser or any person associated by the adviser.
- Each registered adviser must adopt a code of ethics that:
 - Sets out a standard of business conduct for the adviser and its supervised persons;
 - Prevents access to material nonpublic information of the adviser's securities recommendations and client services, unless needed by personnel of the adviser for their duties; and
 - Requires periodic reporting and review of the personal trading reports from "access persons" of the adviser and the implementation of personal trading procedures.

22

Privacy

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

23

Business Continuity Planning

-
- The SEC has taken the position that a registered adviser's fiduciary obligations to its clients include the obligation to take steps to protect the clients' interests from being placed at risk as a result of significant business disruptions.

24

Administration of the Advisers Act

- Securities and Exchange Commission
- Division of Investment Management (“IM”)
- Office of Compliance Inspections and Examination (“OCIE”)
- Division of Enforcement
- Regional Offices
- Adviser Exams

25

Applicability of State Securities Law

- Prior to 1997 investment advisers were regulated directly by both the U.S. Securities and Exchange Commission and the securities commissions in each state in which the adviser transacted business.
- The National Securities Markets Improvement Act (NSMIA) established a new regulatory framework requiring advisers to determine its status as an SEC registered adviser or alternatively, as a state registered adviser.
- Very generally, large investment advisers (e.g., advisers with at least \$25 million of “assets under management” and advisers to an investment company registered under the Investment Company Act of 1940) are registered with the SEC, smaller advisers are registered with the states.
- States retain some jurisdiction over SEC registered advisers. Most notably, each state continues to have the authority to require the licensing, registration, or qualification of an “investment adviser representative” of the SEC-registered adviser who has a “place of business” in the state.

26