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## The Varieties of Investment Management Law

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## The Varieties of Investment Management Law

### Cover Page Footnote

This Article is based in part on the authors' treatise HARVEY E. BINES & STEVE THEL, INVESTMENT MANAGEMENT LAW AND REGULATION (3d ed. 2015), and the subject of this Article is analyzed more extensively therein. Material from that treatise is reproduced herein with the permission of the publisher. We appreciate the helpful comments of Norman Stein and the help of the editors of the Fordham Journal of Corporate & Financial Law.

## THE VARIETIES OF INVESTMENT MANAGEMENT LAW

*Harvey Bines<sup>\*</sup> & Steve Thel<sup>\*\*</sup>*

The duty of prudence enunciated by the Supreme Judicial Court of Massachusetts in 1830 in *Amory v. Harvard College* has come to stand as a talisman for the duties of investment managers. However, the variety of arrangements that are now used to manage other people's money could not have been foreseen in 1830. Investment management is now subject to a collection of largely self-contained statutory and common-law systems. Although related in principle, they differ extensively in the investment management activities they affect and in the specific obligations they impose. Now seldom does a single statutory or common-law system cover all of an investment manager's responsibilities, whether with respect to obtaining new business, setting proper investment objectives, choosing particular investments or obtaining execution of its investment decisions.

To understand modern investment management, it is necessary to deal with many and complex rules that, at least in spirit, cross jurisdictional bounds. This Article identifies some of the several statutory and common-law schemes directed at the regulation of investment managers and briefly explain how each applies to matters of concern to those managers. Some of these schemes attach to almost all managers, others only to certain types of managers and some others only to managers serving certain types of clients.

Notwithstanding the apparently ever-expanding variety of regulatory schemes, three principles that govern investment management law—the duty of care, the duty of loyalty and the public duty—remain the common conduct postulates underlying investment management law. In the fullness of time, however, the means for promoting and

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measuring fiduciary conduct have changed remarkably. Whereas the particulars of enforcement of fiduciary conduct and remedying breaches were once mainly the product of common-law developments and scholarly commentary, statutory controls and regulatory oversight in separately defined spheres of activity now dominate. Compliance seems both to govern the boundaries of investment responsibility for investment fiduciaries and to protect against after-the-fact challenges. To be sure, professionally indefensible investment management and classic self-dealing will likely transgress both statutory and regulatory requirements, on the one hand, and common-law precedent, on the other. Yet, satisfaction of legislative and administrative requirements, coupled with defined contractual undertakings are so much the focus of attention that often it is lost how dependent statutory and regulatory requirements are on the common-law history. Appreciation of this history should promote broader recognition that planning and structuring legal responsibilities and risks associated with new or evolving investment management practices depends on engineering that crosses jurisdictional lines.

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## INTRODUCTION

In 1830, the Supreme Judicial Court of Massachusetts addressed the question of whether a trustee may invest in the common stock of manufacturing companies in *Harvard College v. Amory*.<sup>1</sup> The holding may have been less important than the way the court explained it:

Do what you will, the capital is at hazard. . . . All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.<sup>2</sup>

*Harvard College* has come to stand as a talisman for the duties of investment managers. However, the variety of arrangements that are now used to manage other people's money could not have been foreseen in 1830. Indeed, since then, the institutionalization of professionalized investment management has changed the very nature of American capitalism.<sup>3</sup>

Over time, investment management has become subject to a collection of largely self-contained statutory and common-law systems. Although related in principle, they differ extensively in the investment management activities they affect and in the specific obligations they

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1. *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446, 454 (1830).

2. *Id.* at 461.

3. See, e.g., Robert Charles Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 HARV. L. REV. 561 (1981).

impose. Now seldom does a single statutory or common-law system cover all of an investment manager's responsibilities, whether with respect to obtaining new business, setting proper investment objectives, choosing particular investments or obtaining execution of its investment decisions.

In view of the diversity and cross-jurisdictional reach of these statutory and common-law schemes, investment managers need to understand how each connects with the investment management activities it regulates. Knowing the various systems by which investment management is regulated simplifies identification of the controls that might be imposed in any case. It may be that:

[T]he legal rules governing financial intermediaries are so many and so complex that no one can hope to know them all in the detail and timeliness that a seasoned practitioner advising only one kind of intermediary would desire. Even to gain a thorough grasp of the legal structure of one kind of intermediary seems to preclude, or at least to make very difficult, a sophisticated grasp of the ideas and information supplied by other disciplines, such as modern finance theory.<sup>4</sup>

To understand modern investment management, it is nonetheless necessary to deal with many and complex rules that, at least in spirit, cross-jurisdictional bounds. In this Article, we identify some of the several statutory and common-law schemes directed at the regulation of investment managers and briefly explain how each applies to matters of concern to those managers. We also discuss recent controversies about investment management law, including some that have yet to be resolved. These often highlight contemporary disagreement about long-standing practices and principles, even when these have ended with regulatory initiatives being quashed.

## **I. COMMON-LAW REGULATION OF THE RELATIONSHIP BETWEEN MANAGER AND CLIENT**

Almost all investment management relationships are the product of an express contract or an instrument creating a trust. A contract to provide management services triggers agency law; a trust instrument

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4. *Id.* at 582.

triggers trust law. Even where an investment management arrangement is not documented, however, either agency or trust doctrine governs the acts of the manager. Together, agency and trust law cover every investment management service for which an investment manager expressly or impliedly has any discretion to act on behalf of and bind a client or beneficiary.

#### A. TRUST RELATIONSHIPS

A trust is a relationship in which legal title to property resides in one party who is subject to equitable duties to deal with the property for the benefit of another.<sup>5</sup> Individuals, partnerships, associations, and corporations may all assume the office of trustee.<sup>6</sup> Compensation for assuming the duties of trustee is not required, although a trustee is assumed to be entitled to reasonable compensation unless a provision to the contrary appears in the trust instrument or the trustee otherwise agrees to forgo compensation.<sup>7</sup> Once engaged in administering the trust,

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5. RESTATEMENT (THIRD) OF TRUSTS § 2 (AM. LAW. INST. 2003) (“Definition of Trust”); *see also* RESTATEMENT (SECOND) OF TRUSTS § 348 (AM. LAW. INST. 1959) (“Definition of Charitable Trust”); RESTATEMENT (THIRD) OF TRUSTS §28 (“Charitable Purposes”).

6. RESTATEMENT (THIRD) OF TRUSTS §§ 32-33. The general principle is that natural persons can hold property in trust and administer it to the extent they could if they owned the property beneficially. A corporation, association, partnership or other entity can administer a trust only to the extent permitted by state or federal law. Although a corporate trustee has the same responsibilities as an individual trustee with respect to performing or delegating the administration of the trust, a corporation may properly administer the trust through its directors, officers and appropriate employees. RESTATEMENT (THIRD) OF TRUSTS § 80 cmt. d (AM. LAW. INST. 2007). Use of common trust funds is supported under state laws either by special systems of statutory and administrative regulation or by enabling legislation (usually the Uniform Common Trust Fund Act) that relies essentially on Regulation 9 of the U.S. Comptroller of the Currency, 12 C.F.R. Part 9, to govern the operation of these bank funds. Some statutes also authorize the creation of mutual investment companies, in the shares of which participating banks and trust companies may invest the funds of individual trusts under their administration. These various practices are intended to facilitate economical fund management and diversification of investments for small trusts and, in some states, for small corporate trustees. On the use of common trust funds, *see* RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. m, and the reporter’s notes thereto.

7. RESTATEMENT (THIRD) OF TRUSTS § 38; UNIF. TRUST CODE § 708 (UNIF. LAW COMM’N 2000). In some jurisdictions, trustee compensation is determined by statute. The English rule is that a trustee is not entitled to compensation unless the terms of the

the trustee assumes the duties determined by the terms of the trust instrument, plus all general duties normally incident to trusteeship except those expressly excluded by the trust instrument.<sup>8</sup> Those duties normally incident to the trust include loyalty,<sup>9</sup> administration,<sup>10</sup> fair dealing among beneficiaries and between beneficiaries and remaindermen,<sup>11</sup> and, with respect to the selection of investments, the duty to invest prudently.<sup>12</sup>

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trust provide otherwise. *See* 5 AUSTIN WAKEMAN SCOTT, WILLIAM FRANKLIN FRATCHER & MARK L. ASCHER, SCOTT & ASCHER ON TRUSTS § 21.1 (5th ed. 2006); HARVEY E. BINES & STEVE THEL, INVESTMENT MANAGEMENT LAW AND REGULATION § 5.03 (3d ed. 2015) (compensation of investment managers). Note that restrictive compensation rules may pressure investment managers to increase their revenues through additional services to their managed accounts. The provision of these extra services can create conflicts of interest that are more subversive of an account's net return than higher management fees would be. Before active cash management became customary, for example, the efficiency with which a trust officer in a bank managed the uninvested cash of its trust accounts sometimes depended on whether the fees for trust management provided enough independent compensation to enable the trust department to retain the personnel necessary to use uninvested cash effectively by removing it from commercial department time and demand deposits and investing it in more productive short-term debt instruments. *See, e.g.*, EDWARD S. HERMAN, CONFLICTS OF INTEREST, COMMERCIAL BANK TRUST DEPARTMENTS: REPORT TO THE TWENTIETH CENTURY FUND STEERING COMMITTEE ON CONFLICTS OF INTEREST IN THE SECURITIES MARKETS (Twentieth Century Fund 1975). As another example, the power to hire an associated adviser raises the question of whether the adviser should be paid by the trustee or the trust. *See* UNIF. TRUST CODE §§ 709 ("Reimbursement of Expenses"), 807 ("Delegation by Trustee"), 816(15) (expenses of administration); *see also* RESTATEMENT (THIRD) OF TRUSTS § 90, cmt. m & reporter's notes. *Compare* *Stillman v. Watkins*, 325 N.E.2d 294, 295 (Mass. App. Ct. 1975) (trustee not empowered to compensate retained investment adviser from estate), *with* *Chase v. Pevear*, 419 N.E.2d 1358, 1364-65 (Mass. 1981) (trustee, who took no fee, properly retained his firm as investment adviser for its customary fee).

8. RESTATEMENT (THIRD) OF TRUSTS §§ 70, 85.

9. *Id.* § 78.

10. *Id.* §§ 80, 90, 91. A trustee may not properly commit the entire administration of the trust to an agent, cotrustee, or other person, unless permitted to do so by the terms of the trust. *Id.* § 80; *see also id.* §§ 39, 81. If there are several trustees, each is under a duty to the beneficiaries to participate in the administration of the trust and to use reasonable care to prevent a co-trustee from committing a breach of trust, and if necessary to compel a cotrustee to redress a breach of trust. *Id.* § 81.

11. *Id.* §§ 79, 90, 109-111.

12. *Id.* § 90 (the "Prudent Investor Rule"). The Prudent Investor Rule applies the prudence norm to investing and managing the trust assets. *See* BINES & THEL, *supra*



Institutional trusts, such as the endowments of educational and charitable organizations, often receive special treatment. Unlike individual trusts, they rarely involve remaindermen who can realistically expect to receive trust assets.<sup>13</sup> Moreover, they are usually larger than individual trusts and hence more likely to rely upon professional assistance in managing their investments. These characteristics of institutional trusts often raise problems concerning the delegation of investment responsibility and the application of capital gains and income to preservation of the trust corpus or to current expenses.<sup>14</sup> As a result, state law in most jurisdictions treats institutional trusts differently from individual trusts. Many states, for example, have adopted the Uniform Management of Institutional Funds Act<sup>15</sup> or its replacement, the Uniform Prudent Management of Institutional Funds Act, both of which are discussed below. In general, they permit both delegation of investment management and the expenditure of capital appreciation,<sup>16</sup>

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note 7, at § 8.03. The prudent investing standards of Section 90 are codified in the UNIF. PRUDENT INV’R ACT § 7, 7B U.L.A. 16 (Supp. 1995), the UNIF. MGMT. PUB. EMP. RET. SYS. ACT § 7 (UNIF. LAW COMM’N 1997), and in comparable nonuniform legislation. For a discussion, see John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641 (1996).

13. See *Saint Joseph’s Hosp. v. Bennett*, 22 N.E.2d 305, 306 (N.Y. 1939) (defining an endowment as money permanently bestowed, “the income of which is to be used in the administration of a proposed work”); cf. UNIF. TRUST CODE § 103 cmt. (“The great majority of the Code’s provisions apply to both charitable and noncharitable trusts without distinction. The distinctions between the two types of trusts are found in the requirements relating to trust creation and modification.”).

14. See WILLIAM L. CARY & CRAIG B. BRIGHT, *THE LAW AND THE LORE OF ENDOWMENT FUNDS* (1969) [hereinafter, CARY & BRIGHT, *ENDOWMENT FUNDS*]; WILLIAM L. CARY & CRAIG B. BRIGHT, *THE DEVELOPING LAW OF ENDOWMENT FUNDS: “THE LAW AND THE LORE” REVISITED* (1974) [hereinafter, CARY & BRIGHT, *ENDOWMENT FUNDS REVISITED*]; see also William L. Cary & Craig B. Bright, *The Delegation of Investment Responsibility for Endowment Funds*, 74 COLUM. L. REV. 207 (1974). As a general matter, the trustee cannot properly commit the entire administration of the trust to an agent, co-trustee, or other person, unless permitted to do so by the terms of the trust. RESTATEMENT (THIRD) OF TRUSTS § 80. If there are several trustees, each is under a duty to the beneficiaries to participate in the administration of the trust and to use reasonable care to prevent a co-trustee from committing a breach of trust, and if necessary to compel a co-trustee to redress a breach of trust. *Id.*

15. The Act was approved in 1972 largely in response to the arguments of Cary & Bright. See CARY & BRIGHT, *ENDOWMENT FUNDS*, *supra* note 14.

16. UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT §§ 2, 5 (NAT’L CONFERENCE OF COMMISSIONERS ON UNIF. STATE LAWS 1972) (repealed 2006); UNIF. PRUDENT MGMT.

and are supportive of trustees seeking more discretion in applying endowment-fund assets to current expenditures and retaining professional investment management services than traditional trust law may permit. Nonetheless, they still require the exercise of ordinary skill and care,<sup>17</sup> and the allowance of discretion carries with it the risk of liability.<sup>18</sup>

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OF INSTITUTIONAL FUNDS ACT §§ 4, 5 (NAT'L CONFERENCE OF COMMISSIONERS ON UNIF. STATE LAWS 2006).

17. UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT § 6 (requiring "ordinary business care and prudence"); UNIF. PRUDENT MGMT. OF INSTITUTIONAL FUNDS ACT § 3. The Commissioners' comment to Section 6 of the Uniform Management of Institutional Funds Act stated:

Officers of a corporation owe a duty of care and loyalty to the corporation, and the more intimate the knowledge of the affairs of the corporation the higher the standard of care. . . . This is a proper standard for the managers of a nonprofit institution, whether or not it is incorporated.

UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT § 6 cmt. In *Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses and Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974), the court held that trustees of a charitable corporation owe a higher duty of care with respect to management of investments than do corporate investors in matters of judgment, the standard applicable to trustees being mere negligence. *Stern* raised questions both of mismanagement and self-dealing. For a useful analysis of the practical application of *Stern*, see Myles L. Mace & Charles T. Stewart, *From the Boardroom: Standards of Care for Trustees*, HARV. BUS. REV., Jan.-Feb. 1976, at 14-16, 21, 24, 28, 148.

18. The Prudent Investor Rule creates greater (not less) potential for liability, to the extent it imposes higher investment standards for fiduciaries than did the prior system of laws. RESTATEMENT (THIRD) OF TRUSTS § 90. There is clearly no longer a safe harbor or a statutory list of safe investments in which a fiduciary can invest. Instead, the Prudent Investor Rule emphasizes diversification and thoughtful analysis—and reanalysis—of the performance of a portfolio in relation to the objectives of the account. The damage provisions of Section 100 of the Third Restatement exacerbate this exposure, since they measure damages for a breach of trust by constructing a hypothetical portfolio and then calculating how that portfolio would have grown over the period in question. *Id.* § 100. Although this theory also allows for the possibility that the hypothetical portfolio would drop in value, this affords small comfort in light of the historical upward trend in asset prices, especially since breaching trustees are subject to the argument that prudent investing would have produced less of a loss.

## B. AGENCY RELATIONSHIPS

An agency relationship is created when one party, the principal, manifests assent to another party, the agent, that the agent shall act on the principal's behalf and subject to its control, and the agent assents or otherwise consents so to act.<sup>19</sup> Any person or entity legally empowered to contract may be an agent.<sup>20</sup> An investment management arrangement that is not a trust thus subjects the manager to the constraints of the common law of agency. Unless otherwise agreed, principals are obligated to compensate their agents for the services they provide, but compensation is not required to create an agency relationship.<sup>21</sup> Consequently, agency law would apply, for example, to voluntary investment management services provided by an eleemosynary institution.<sup>22</sup>

Agents owe duties of loyalty, care, competence and diligence to their principals.<sup>23</sup> The Restatement (Second) of Agency (which has been replaced by the Restatement (Third)), separately addressed the duties of investment managers, and specified three general duties they owe investors in selecting investments:

- (1) To invest promptly;
- (2) To invest prudently; and
- (3) To shift investments according to changes in the safety of existing investments or the needs of the investor.<sup>24</sup>

In addition to these specific duties, agency law imposes on investment managers the other duties normally incident to an agency relationship. Thus, an investment manager owes its client duties of

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19. RESTATEMENT (THIRD) OF AGENCY § 1.01 (AM. LAW. INST. 2006).

20. *Id.* § 3.05. A person acting as agent can bind the principal to a third party even though, due to an incapacity, the agent cannot be held to fiduciary duties. *Id.*

21. *Id.* § 8.13 cmt. d. Consideration is not a necessary element of an agency relationship either, nor is it necessary that there be an actual contract. *Id.* at §§ 1.01 cmt. d, 7.07 cmt. f.

22. Many nonprofit institutions are operated as charitable trusts. Although the general trust rule is that despite a trustee's authority to appoint agents, trustees may not delegate investment management authority, it is now recognized (and legislatively affirmed) that trustees of nonprofit institutions may delegate such authority to professional investment managers. *See supra* notes 8, 9, 17 and accompanying text.

23. *See* RESTATEMENT (THIRD) OF AGENCY §§ 8.01-8.12.

24. RESTATEMENT (SECOND) OF AGENCY § 425 (AM. LAW. INST. 1958).

service and obedience,<sup>25</sup> loyalty,<sup>26</sup> and any additional duties imposed by the investment contract.<sup>27</sup> Agency law is ancient doctrine, and, as a result, has a well-developed scheme of liabilities and remedies.<sup>28</sup> Absent contrary contractual arrangements that a court will enforce, they all apply to investment management relationships that are not purely trusts in nature.

## II. REGULATION BY TYPE OF TRANSACTION: THE GENERALLY APPLICABLE ANTIFRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS

The antifraud provisions of the Securities Act of 1933 (the “Securities Act”) and the Securities Exchange Act of 1934 (the “Exchange Act”) apply broadly to a variety of activities in which investment managers engage. These provisions are triggered by the activity of the manager rather than anything deriving peculiarly from the fact of investment management. That is, the activities to be regulated taken together may represent an investment management relationship, but the antifraud provisions themselves apply to each of these activities severally, and without regard to whether the actor is acting for his own or a managed account. If the existence of investment management is relevant at all, it is only to strengthen the resolve of a reviewing authority to insist on a high degree of fairness toward a client.<sup>29</sup>

The general antifraud provisions from which the federal courts and the Securities and Exchange Commission (the “SEC”) derive open-ended authority to regulate securities practices are Section 17(a)<sup>30</sup> of the Securities Act, and Sections 10(b)<sup>31</sup> and 15(c)<sup>32</sup> of the Exchange Act.

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25. RESTATEMENT (THIRD) OF AGENCY §§ 8.01-8.06.

26. *Id.* §§ 8.02-8.06.

27. *Id.* § 8.07.

28. *See generally* RESTATEMENT (THIRD) OF AGENCY. Depending on the injury, a principal may sue in law or in equity. The principal’s choice of remedies is broadest for breaches of duty of loyalty. *See id.* §§ 8.01 cmt. d, 8.02-8.06.

29. *See, e.g.,* Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1170-73 (2d Cir. 1970) (broker-dealer, complying with rules in disclosing principal status, held liable to customer relying on its recommendations and advice for failing to disclose status as market-maker).

30. 15 U.S.C. § 77q(a) (2012).

31. *Id.* § 78j(b).

32. *Id.* § 78o(c).

Although they are similar in the non-distinct character of their reach, they are different in certain respects that can affect their application in a given case:

(1) Both Sections 17(a) and 10(b) apply to “any person.” Section 15(c) applies only to brokers, dealers, and municipal securities dealers.

(2) Section 10(b), and its primary implementing regulation, Rule 10b-5, proscribe manipulative and fraudulent practices “in connection with the purchase or sale of any security.” Section 17(a) applies to such practices “in the offer or sale of any securities.” This means a trade must take place to trigger Section 10(b),<sup>33</sup> whereas an offer to sell is enough under Section 17(a). On the other hand, Section 17(a) does not reach fraud in a purchase, whereas Sections 10(b) and 15(c) do.<sup>34</sup>

(3) Section 17(a) of the Securities Act and Section 15(c) of the Exchange Act are self-executing, whereas Section 10(b) must be implemented by rule. Section 15(c)(1) also authorizes the SEC to promulgate rules defining manipulative and deceptive contrivances, and section 15(c)(2) authorizes it to adopt rules reasonably designed to prevent fraud, both of which powers are more extensive than those under Section 10(b). Rules 10b-5 and 15c1-2<sup>35</sup> substantially incorporate the language of Section 17(a).

(4) The Supreme Court has held that scienter is an element of Section 10(b) of the Exchange Act and Rule 10b-5.<sup>36</sup> Scienter is required only under the first clause of section 17(a) of the Securities Act, but not under the other two clauses.<sup>37</sup> All courts of appeal that have considered the matter have held that recklessness is sufficient to satisfy the scienter requirement.<sup>38</sup>

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33. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731-34 (1975).

34. On the relation between Section 17 and Rule 10b-5, see Steve Thel, *Taking Section 10(b) Seriously: Criminal Enforcement of SEC Rules*, 2014 COLUM. BUS. L. REV. 1 (2014).

35. 17 C.F.R. § 240.15c1-2 (2015).

36. *Aaron v. SEC*, 446 U.S. 680, 689-95 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

37. *Aaron*, 446 U.S. at 695-97.

38. See, e.g., *Meadows v. SEC*, 119 F.3d 1219, 1226-27 (5th Cir. 1997); *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809, 814-15 (11th Cir. 1989); *Hackbart v. Holmes*, 675 F.2d 1114, 1117-18 (10th Cir. 1982); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44-47 (2d Cir. 1978). The leading description of recklessness is “extreme departure from the standards of ordinary care . . . .”

Although the antifraud provisions are transaction-oriented, they can apply to a course of dealing. With respect to investment management relationships in particular, a management arrangement may be deemed a statutory investment contract, and hence a statutory security.<sup>39</sup> In that event, the activities leading to the creation of an investment management relationship and the circumstances under which it is carried out would be both “an offer of” a security and “in connection with” the purchase or sale of a security, and thus, the antifraud provisions would be available as a regulatory tool. Even if an investment management arrangement is not deemed a statutory investment contract, Section 10(b) and Rule 10b-5 may nonetheless apply to a manager’s activities. Since one of the functions of investment management is expert assistance in selecting suitable securities, the very existence of a management arrangement suggests a connection with the purchase or sale of securities. Thus, Rule 10b-5 applies to the marketing of management services,<sup>40</sup> suitability determinations,<sup>41</sup> investment recommendations,<sup>42</sup> and execution practices.<sup>43</sup> While Rule 10b-5 has been the primary federal law vehicle for imposing obligations on broker-dealers in dealing with their customers, as discussed below, the SEC is now considering imposing fiduciary-like duties on broker-dealers who provide personalized investment advice.<sup>44</sup>

The antifraud provisions may create special problems for investment managers in two respects. The first concerns the enforcement of a client’s rights against persons other than the manager. The law of trusts and the law of agency require trustees and agents to protect the legal rights of beneficiaries and principals, at least by informing them that legal steps may be available.<sup>45</sup> An investment manager, having

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McDonald, 863 F.2d at 814. *See generally* NORMAN S. POSER, *BROKER DEALER LAW & REGULATION* § 3.01[D][4] (2d ed. 2001).

39. *See* BINES & THEL, *supra* note 7, at § 3.03.

40. *See id.* at § 3.02.

41. *See id.* at § 4.01[B].

42. *See id.* at § 8.02[B][2][b].

43. *See id.* at §§ 11.02[C], 11.02[D], 11.03.

44. *See infra* Part IV.B.2; *cf.* Labaty v. UWT, Inc., No. SA-13-CV-389-XR, 2015 WL 4716087 (W.D. Tex. Aug. 7, 2015) (RICO).

45. RESTATEMENT (THIRD) OF AGENCY § 8.11 (AM. LAW INST. 2006); RESTATEMENT (THIRD) OF TRUSTS §§ 76, 78, 82 (AM. LAW INST. 2007); *see also* Auchincloss & Lawrence Inc., [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH)

expertise in the operation of the securities markets and the application of securities laws, may be under an obligation to use reasonable diligence to identify and preserve the legal rights of its managed accounts, particularly where the client is unsophisticated with respect to these matters. The second concerns the antifraud provisions that may create obligations that override a manager's common-law fiduciary obligations to its clients. A manager may not use inside information unlawfully simply because of its duty to its clients.<sup>46</sup> Also, a manager may have conflicting fiduciary obligations if it manages a number of accounts or acts as agent for both parties to a transaction. In that event, the manager is under a duty of fair dealing to both clients, and cannot cite fiduciary obligation to one as an excuse for ignoring fiduciary obligation to the other.<sup>47</sup>

The antifraud provisions of the Exchange Act are supplemented by two provisions that, although transaction-oriented, deal with the substance of investment management issues far more narrowly than do the antifraud provisions. Section 11(a) of the Act requires consent and

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¶¶ 79,762, 79,686 (1974) (exculpatory language must be removed from advisory contract which might be construed to relieve adviser from fiduciary duty); *Mennen v. Wilmington Trust Co.*, No. 8432-ML, 2015 WL 1914599 (Del. Ch. Master's Report, Apr. 24, 2015) (however broad, exculpatory clause cannot excuse bad faith or flagrant self-dealing), *adopted by* No. 8432-VCL, 2015 WL 4935373 (Del. Ch. Aug. 18, 2015).

46. Broker-dealers and investment advisers must establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information by persons associated with them. Securities Exchange Act of 1934 § 15(g), 15 U.S.C. § 78o(g) (2012); Investment Advisers Act of 1940 § 204A, 15 U.S.C. § 80b-4a; *see also* Securities Exchange Act § 21A, 15 U.S.C. § 78u-1 (control person liability); 12 C.F.R. § 9.5(b) (2015) ("A national bank exercising fiduciary powers shall adopt and follow written policies and procedures adequate to maintain its fiduciary activities in compliance with applicable law. Among other relevant matters, the policies and procedures should address, where appropriate, the bank's . . . [m]ethods for ensuring that fiduciary officers and employees do not use material inside information in connection with any decision or recommendation to purchase or sell any security . . . ."); *In re Investors Mgmt. Co.*, Exchange Act Release No. 9267 (July 29, 1971), [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,163; *In re Oppenheimer & Co.*, Exchange Act Release No. 12319 (April 2, 1976), [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,551. *But cf.* MELANIE L. FEIN, *SECURITIES ACTIVITIES OF BANKS* § 5.04[B] (3d ed. 2000); *Frigitemp Corp. v. Fin. Dynamics Fund, Inc.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,907 (S.D.N.Y. 1974).

47. *See* BINES & THEL, *supra* note 7, at § 10.06[D]; *see also* RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. c ("Prudent Investor Rule").

reporting for combined institutional brokerage and management for certain transactions on national securities exchanges. Section 28(e) enables investment managers to pay excess commissions for supplementary services. Ostensibly added to federal law to ameliorate perceived conflicts of interest, Sections 11(a) and 28(e) have a complex genesis that was heavily connected to the transition from fixed to negotiated commission rates.<sup>48</sup>

### III. REGULATION BY TYPE OF CLIENT

Several statutes, discussed below, regulate investment management activities only for specific types of clients deemed worthy of extra concern as a matter of public policy. The principal effect of these statutes is to create rules of compliance and prohibitions or restrictions on conduct that apply only to statutory clients (though, of course, such rules, prohibitions, and limitations have been used as models for standards to be imposed under other statutory and common-law schemes). This is not to say that these statutes are entirely technical in character. On the contrary, they impose obligations that are as open-ended and indefinite as the antifraud provisions of the Securities Act and the Exchange Act. The distinction is that these statutes apply only to statutory clients and their managers. Investment managers may fail to consider the possibility that their clients are the beneficiaries of special statutory protections, and indeed management activities may themselves create such clients. Thus, even though the status of a client may be clear in most cases, errors on the issue resulting in regulatory action occur often enough to underline the hazard of providing investment management for a client that is an inadvertent statutory client.

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48. See BINES & THEL, *supra* note 7, at §§ 9.01-11.03. Investment management activities are also subject to the antifraud provisions of state Blue Sky legislation and other legislation, which, as a refinement of common-law deceit and unfair competition, can apply to securities transactions. As a general rule, the federal antifraud provisions are broader than state provisions, but state law has become increasingly responsive to securities matters, especially with respect to investment management activities. See Antifraud Initiatives, 1 Blue Sky L. Rep. (CCH) ¶ 57,217; JOSEPH C. LONG, BLUE SKY LAW § 6:6 (CCH 2002).



A. PUBLICLY OWNED CORPORATE INVESTORS: THE INVESTMENT  
COMPANY ACT OF 1940

The Investment Company Act of 1940 (the “Investment Company Act”)<sup>49</sup> is a comprehensive statute that regulates publicly owned corporate investors and face-amount certificate companies. Because they occupy the dominant position in the pooled-agency account market, however, open-end investment companies (mutual funds) and closed-end investment companies have been the principal objects of regulation under this statute. Usually organized as specialized corporations or business trusts, these companies buy and sell securities and commodities in accordance with investment programs previously constructed by their promoters. Typically, external advisers handle their selection of investments and their trading activities, though in some cases investment management is an internal operation conducted by officers and employees of the company. In any event, either because of their occasional notoriety or because so many of their activities are a matter of public record, given their role as repositories mostly of the savings and retirement of individual investors, investment companies have been responsible for much legislative and regulatory activity not only in connection with administration of the Investment Company Act, but also with respect to the administration of other securities laws.

The Investment Company Act defines an investment adviser to a registered investment company in Section 2(a)(20).<sup>50</sup> The definition includes anyone regularly furnishing the company advice concerning investments in securities and other property, anyone empowered to determine the securities to be bought or sold by the company, and anyone under contract with a statutory investment adviser to perform substantially all duties of the adviser. The most serious danger facing one not deliberately evading regulation under the Investment Company Act is that it will provide sufficient advisory assistance to a statutory investment adviser that it is brought within Section 2(a)(20).<sup>51</sup>

Another difficult area concerns changes in the composition of the investment adviser. Assignment of the investment advisory contract

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49. Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-64).

50. Investment Company Act § 2(a), 15 U.S.C. § 80a-2(a)(20).

51. *See, e.g.,* Lutz v. Boas, 171 A.2d 381, 388-90 (Del. Ch. 1961) (holding that a broker-dealer to whom the advisers of an investment company delegated responsibility for selecting securities for the company’s portfolio was a statutory investment adviser).

terminates the contract.<sup>52</sup> Thus, one assuming investment management duties for an investment company must be properly approved or qualify for one of the exclusions in Section 2(a)(20).<sup>53</sup>

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52. See Investment Company Act § 15(a)(4), 15 U.S.C. § 80a-15(a)(4). When an investment advisory agreement is assigned, the item of value being transferred is the discounted value of the advisory fee over the life of the fund. Complaining mutual fund shareholders sometimes asserted that this value belonged to them, and that the fund's directors should use it as a means to buy less expensive advice. See, e.g., *Rosenfeld v. Black*, 445 F.2d 1337 (2d Cir. 1971), *superseded by statute*, 15 U.S.C. § 80b-15(f), *as recognized in* *Meyer v. Oppenheimer Mgmt. Corp.*, 895 F.2d 861, 865 (2d Cir. 1990). But see *SEC v. Ins. Sec., Inc.*, 254 F.2d 642 (9th Cir. 1958); *Kukman v. Baum*, 346 F. Supp. 55 (N.D. Ill. 1972) (profits above book value realized on sale of the advisory office do not involve a breach of fiduciary duty under the Investment Company Act); see also *Sec. Mgmt. & Research, Inc.*, [1969-1973 Transfer Binder] (CCH) Mut. Funds Guide ¶ 9400 (1971); *Lexington Research Fund, Inc.*, [1969-1973 Transfer Binder] (CCH) Mut. Funds Guide ¶ 9258 (1971). In response to *Rosenfeld*, Section 28(1) of the Securities Acts Amendments of 1975, Pub. L. 94-29 (June 4, 1975), amended Section 15(f) of the Investment Company Act to permit transfer of an interest in the advisory office if certain statutory conditions are met. See *Wexler v. Equitable Capital Mgmt. Corp.*, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,118 at 98,924 (S.D.N.Y. 1994); 7 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, *SECURITIES REGULATION* § 8[C][4] (4th ed. 2006). In connection with Citigroup's plan to transfer management of certain closed-end investment companies to Legg Mason, Inc., in return for certain Legg Mason assets, the New York Exchange ruled that shareholder approval of a new investment adviser agreement is not a routine matter, so that brokers may not vote shares on account of holders who do not give instructions. See Angela Pruitt, *Citigroup Dealt Blow on Asset Swap*, WALL ST. J., Sept. 6, 2005, at C15.

Investment Company Act Rule 2a-6, 17 C.F.R. § 270.2a-6 (2015), provides that a transaction that would not result in the change of actual control of management of an investment adviser or principal underwriter of an investment company is not an "assignment" terminating an investment advisory or underwriting contract. Rule 15a-4, 17 C.F.R. § 270.15a-4, allows a person to act as an investment adviser to an investment company, under certain circumstances, for an interim period without prior shareholder approval. See generally Timothy P. Harris & Marc C. Cozzolino, *Change of Control and Contract Assignment: Ramifications for Investment Advisers and Investment Companies*, 5 INV. LAW. 1 (Apr. 1998).

53. Excluded are persons distributing their publications to subscribers, persons providing statistical information without regularly furnishing advice or making recommendations concerning specific securities, persons compensated under the supervision of a court, and persons excluded by rule or regulation. See Investment Company Act § 2(a)(20), 15 U.S.C. §§ 80a-2(a)(20). None of these exclusions would ordinarily apply to an assignment, defined in Section 2(a)(4), to include "any direct or indirect transfer or hypothecation of a contract . . . or of a controlling block of the

As serious as mistaking one's status as a statutory investment adviser is the possibility of unwittingly providing investment management services to a client that should register as a statutory investment company. Section 3(a) of the Investment Company Act,<sup>54</sup> the statutory definition of investment company, is broad enough to include every organization engaged in investing at least forty percent of its assets in the securities of other issuers.<sup>55</sup> In fact, Sections 3(a)(1) and 3(b)(1) also capture so-called "inadvertent" and "transient" investment companies and parent/subsidiary arrangements. For companies not holding securities primarily for passive investment, regulatory relief is essential.<sup>56</sup> Section 3(b)<sup>57</sup> excludes certain holding companies, and

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assignor's outstanding voting securities . . . ." Investment Company Act § 2(a)(4), 15 U.S.C. § 80a-2(a)(4).

Ironically, the Investment Company Act's strictness with respect to assignment and approval of the advisory contract made it extremely difficult for a statutory company to rid itself of an unsatisfactory adviser and hire a new one. Section 15(a) makes it unlawful to serve as a statutory investment adviser except "pursuant to a written contract, which . . . has been approved by the vote of a majority of the outstanding voting securities of such . . . company . . . ." Investment Company Act § 15(a), 15 U.S.C. § 80a-15(a). Thus, except when the SEC obtained the appointment of a receiver (see 15 U.S.C. § 80a-41(e)), an investment company had to obtain an exemption under Section 6(c), 15 U.S.C. § 80a-6(c), to permit an interim adviser to serve. Rule 15a-4, 17 C.F.R. § 270.15a-4, allows engagement of an investment adviser for up to 150 days under an interim contract that maximizes compensation of the interim adviser at the level received by the previous adviser, receiving board approval, including a majority of disinterested directors and, in the case of termination by assignment (see *BINES & THEL*, *supra* note 7, at § 8.02[B][2][b]), incorporates additional restrictions.

54. Investment Company Act § 3(a), 15 U.S.C. § 80a-3(a).

55. See *SEC v. Nat'l Presto Indus.*, 486 F.3d 305 (7th Cir. 2007) (finding that an operating company was not an inadvertent investment company).

56. For example, companies organized with multiple subsidiaries may not qualify for the exemption provided in Section 3(b)(1) and, case-by-case must apply for an exemptive order under Section 3(b)(2). Also, in a sale of substantially all of a company's assets, where the consideration is paid in securities of the buyer, the transaction could convert an operating company into an investment company. Three rules under the Investment Company Act, reflecting previous orders of exemption and no-action assurances, deem certain issuers not to be investment companies. Rule 3a-1, 17 C.F.R. § 270.3a-1, is a "safe harbor" rule which deems certain "prima facie investment companies" having more than forty percent of their assets invested in investment securities not to be investment companies. This relief is conditioned upon such a company's having no more than forty-five percent of the value of its total assets (exclusive of government securities and cash items) consisting of and receiving no

Section 3(c)<sup>58</sup> contains special exclusions for various defined organizations.

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more than forty-five percent of its net income after taxes from securities other than: (1) government securities; (2) securities issued by employees' securities companies; (3) securities issued by certain majority-owned subsidiaries of the issuer that are not investment companies; and (4) securities issued by certain controlled companies through which an issuer engages in a noninvestment company business. Rule 3a-2, 17 C.F.R. § 270.3a-2, relates to "transient investment companies," deeming an issuer not to be engaged in securities activities for purposes of Section 3(a)(1) or Section 3(a)(3) of the Investment Company Act during a period of time not to exceed one year, provided the issuer has a bona fide intent to be engaged primarily, as soon as is reasonably possible, in a business other than that of investing, reinvesting, owning, holding, or trading in securities. This intent must be evidenced by the company's business activities and an appropriate resolution of the issuer's board of directors or persons performing similar functions. Rule 3a-2 may not be relied on by an issuer more frequently than once during any three-year period. Rule 3a-3, 17 C.F.R. § 270.3a-3, is another safe harbor deeming certain issuers having corporate parents as not being investment companies for purposes of the Act, provided that the parent and its subsidiary have no more than forty-five percent of their consolidated assets invested in, and received no more than forty-five percent of their consolidated net income after taxes from, investment securities. These rules of general application still proved inadequate to accommodate developments in corporate finance techniques that technically run afoul of Section 3(a)(1) or Section 3(b)(1) of the Investment Company Act, or at least are not clearly excluded. Active investment activities in support of the business objectives of operating companies can press on the statutory definition. Also, technology companies frequently rely on strategic alliances, and the interests created might well be considered investment securities. Accordingly, the SEC has adopted rules to exempt parent financing of subsidiary activities, Rule 3a-5, 17 C.F.R. § 270.3a-5, issuance of asset-backed securities, Rule 3a-7, 17 C.F.R. § 270.3a-4, and research and development companies, Rule 3a-8, 17 C.F.R. § 270.3a-8. Particularized exemption applications pursuant to § 3(b)(2) continue to be frequent, however.

57. Investment Company Act § 3(b), 15 U.S.C. § 80a-3(b) excludes companies holding securities in wholly-owned subsidiaries not in the business of investing in securities, and companies the SEC finds to be not in the business of investing in securities either through majority-owned subsidiaries or controlled companies conducting similar types of business. "Control" means the power to exercise a controlling interest and is presumed for ownership of more than twenty-five percent of an issuer's voting securities. Investment Company Act § 2(a)(9), 15 U.S.C. § 80a-2(a)(9).

58. Investment Company Act § 3(c), 15 U.S.C. § 80a-3(c). Among the more significant organizations excluded under this provision are "so-called private investment companies," §§ 3(c)(1) and 3(c)(7), investment banking operations, § 3(c)(2), banks and insurance companies, including common trust funds, § 3(c)(3), certain finance and real estate companies, §§ 3(c)(5)-(6), oil and gas companies, §

Two exclusions of particular importance are for so-called private investment companies. An issuer is not an investment company for most purposes of the Investment Company Act if it does not publicly offer its securities and its securities are beneficially owned by 100 persons or less.<sup>59</sup> Venture capital, leveraged buyout and hedge funds often used this so-called private investment company exemption, but its 100-investor ceiling began to chafe. In a major study of the Investment Company Act's first fifty years, the SEC's Division of Investment Management recommended that a new exception should be added for companies owned exclusively by high net-worth investors.<sup>60</sup> The statute was duly amended, and since 1996, an issuer has been excluded from the statutory definition of investment company if it does not publicly offer its securities and those securities are owned exclusively by "qualified purchasers."<sup>61</sup> Broadly speaking, qualified purchasers include natural persons with \$5 million or more in investments and other persons that own and invest not less than \$25 million on a discretionary basis.<sup>62</sup> The amendment also set out a procedure that older private companies could use to convert to qualified-purchaser companies. Moreover, in recognition that some older private companies would want to set up parallel qualified-purchaser companies, the Investment Company Act

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3(c)(9), charitable organizations, § 3(c)(10), and qualified pension and profit-sharing plans, § 3(c)(11).

59. Investment Company Act § 3(c)(1), 15 U.S.C. § 80a-3(c)(1).

60. SEC, DIV. OF INV. MGMT., PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION (1992).

61. Investment Company Act § 3(c)(7), 15 U.S.C. § 80a-3(c)(7). Funds that had relied on the § 3(c)(1) exclusion could convert to funds excluded under § 3(c)(7). *See* A.B.A. No-Action Letter, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,548 (Apr. 22, 1999); Paul S. Stevens & Craig S. Tyler, *Mutual Funds Investment Advisers and the National Securities Markets Improvement Act*, 52 BUS. LAW. 419, 469-74 (1997).

62. Investment Company Act § 2(a)(51), 15 U.S.C. § 80a-2(a)(51); *see also* 17 C.F.R. §§ 270.2a51-1 to 2a51-3 (2015). Rule 2a51-1(h), 17 C.F.R. § 270.2a51-1(h), provides that a "qualified purchaser" for purposes of § 3(c)(7) includes any person who the exempt company or a person acting on its behalf reasonably believes meets the definition. For a discussion of problems presented by the definition when securities are issued in book-entry form, *see* Barry Barbash et al., *Book-Entry Deposit Procedures for Certain Offerings by Non-US Issuers under Section 3(c)(7) of the Investment Company Act*, INV. LAW., Jul. 2008, at 3; Barry Barbash et al., *New Developments in Procedures for Book-Entry Deposit of Rule 144A Securities by 3(c)(7) Issuers*, INV. LAW., Mar. 2003, at 3.

contains an unusual no-integration provision that keeps such issuers separate for purposes of determining the availability of the exemptions.<sup>63</sup>

In December 2006, the SEC proposed to amend its regulations under the Securities Act to make it more difficult for hedge funds to market their securities to less-affluent investors without registration.<sup>64</sup> However, changes to the general-solicitation prohibition of Regulation D that the SEC was directed to make by the Jumpstart Our Business Startups Act, enacted in 2012, have made it easier for hedge funds to market their securities.<sup>65</sup>

Whatever precision the definition of statutory investment company now has, it has been accomplished over a long time and with great confusion. For many years, the SEC sought with some success to restrict the exclusions. For example, the ectoplasmic theory, which concentrated on the structure of an investment vehicle instead of the structure of its sponsor, enabled the SEC to reach variable annuities and variable life insurance despite the specific exclusion provided insurance companies in Section 3(c)(3) of the Investment Company Act, and an exemption for insurance policies in the Securities Act.<sup>66</sup> Similarly, collectively

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63. Investment Company Act § 3(c)(7)(E), 15 U.S.C. § 80a-3(c)(7)(E).

64. See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Sec. Act Release No. 8766 (Dec. 27, 2006); see also BINES & THEL, *supra* note 7, at § 2.05[B][3].

65. See *infra* notes 351-54 and accompanying text. Registration as an investment adviser, however, has become a statutory requirement with the passage of Dodd-Frank. See *infra* notes 351-54 and accompanying text.

66. Benefits under variable life insurance (“VLI”) are not fixed, but are determined according to the asset value of a portfolio of securities. Although the insurance industry claimed that VLI was an insurance contract and hence should not be subject to regulation under the federal securities laws, the SEC insisted that VLI was a security and that the policyholders were investors in an investment company. Based on the SEC’s successes in obtaining jurisdiction under the Securities and Investment Company Acts over the sale of variable annuities, see *SEC v. Variable Annuity Life Ins. Co. of Am.*, 359 U.S. 65 (1959), the industry capitulated and sought and received exemptive relief from various provisions in the federal securities laws, and especially from the Investment Company Act. See, e.g., Rules 6c-3, 6e-2, 17 C.F.R. §§ 270.6c-3, 6e-2. Other exemptions have been granted to accommodate new products and marketing conditions. See Rules 6c-6, 6c-7, 6c-8, 6e-3(T), 17 C.F.R. §§ 270.6c-6, 6c-7, 6c-8, 6e-3(T). Other rules, listed at Rule 0-1(e), 17 C.F.R. § 270.0-1(e), also apply. The Commission’s efforts to regulate so-called fixed indexed annuities under the Securities Act have been less successful. See BINES & THEL, *supra* note 7, at § 3.02[B][4].

managed individual accounts may constitute a statutory investment company.<sup>67</sup>

The Investment Company Act provides for broad and pervasive regulation of the activities and governance of registered investment companies. This oversight was enhanced in the National Securities Markets Improvement Act of 1996,<sup>68</sup> the same statute that created the exemption for funds made up of qualified purchasers.<sup>69</sup> Thus, for example, the SEC has broad authority to require registered investment companies to file information, documents and reports,<sup>70</sup> and to determine the contents of reports to shareholders.<sup>71</sup> The best indication of the breadth of existing regulatory authority over registered investment companies may be the way they were treated in the Sarbanes-Oxley Act of 2002.<sup>72</sup>

The Sarbanes-Oxley Act was enacted after a string of remarkably bold corporate scandals, and represented an attempt by Congress to restore corporate accountability and provide tools for improved corporate governance. While investment companies were not responsible for those scandals, one might have expected them to be subject to Congress' reforms. Even after the adoption of the 1996 Act, the SEC continued to discuss the importance of independent directors in investment company governance and the need for investment companies

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67. See BINES & THEL, *supra* note 7, at § 3.04. Perhaps the best-known instance of the SEC's taking action under this theory is the *First National City Bank* case. SEC Litigation Release No. 4534, 1970 WL 104562 (Feb. 6, 1970).

68. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.). See generally Stevens & Tyler, *supra* note 61.

69. See *supra* notes 61-63 and accompanying text.

70. Investment Company Act § 30(b), 15 U.S.C. § 80a-29(b).

71. Investment Company Act § 30(d), 15 U.S.C. § 80a-29(d); see also Investment Company Act § 31(a), 15 U.S.C. § 80a-30(a) ("Accounts and records").

72. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.). The Act quickly engendered a substantial commentary. See, e.g., Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915 (2003); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 IOWA J. CORP. L. 1 (2002); Brian Kim, *Recent Development, Sarbanes-Oxley Act*, 40 HARV. J. LEGIS. 235 (2003).

to improve their disclosures of information necessary to investors,<sup>73</sup> and it has proposed rules requiring investment companies to give investors more extensive information about fees and expenses, and to disclose their portfolio investments more frequently.<sup>74</sup> Nevertheless, even though these issues of disclosure and governance have been on the table for some time and attracted legislative attention, many of the most important provisions of the Sarbanes-Oxley Act requiring improved financial disclosures and mandating changes in governance do not apply to investment companies registered under the Investment Company Act.<sup>75</sup> Congress apparently concluded that investment companies were already sufficiently regulated.<sup>76</sup>

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73. See DIV. OF INV. MGMT., REPORT ON MUTUAL FUND FEES AND EXPENSES, SEC (2000), <http://www.sec.gov/news/studies/feestudy.htm#item> [<http://perma.cc/G4RU-KEDB>]; Role of Independent Directors of Investment Companies, 66 Fed. Reg. 3734 (Jan. 16, 2001).

74. See, e.g., Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 7038 (Feb. 11, 2003) (proposed rules requiring investment companies and advisers to implement compliance programs); Investment Company Act Release, 68 Fed. Reg. 160 (Jan. 2, 2003) (proposed rules on portfolio disclosure); Staff Report: Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds (Mar. 2003), <http://www.sec.gov/news/studies/breakpointrep.htm> [<http://perma.cc/FZQ3-WLWS>].

75. See Sarbanes-Oxley Act § 405, 15 U.S.C. § 7263. Registered Investment Companies are subject to the officer certification provisions of the Sarbanes Oxley Act. See Sarbanes-Oxley Act § 906, 15 U.S.C. § 1350. The SEC has adopted a rule implementing this requirement. See Rule 30a-2, 17 C.F.R. § 270.30a-2 (2015); see also Investment Company Act Release 25722, 67 Fed. Reg. 57,276 (Aug. 28, 2002); Investment Company Act Release 25967, 68 Fed. Reg. 15600 (Mar. 21, 2003); Kimberly L. Sachse, *Welcome to Form N-CSR!*, INV. LAW., June 2003, at 1.

76. See REPORT OF THE SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, PUBLIC COMPANY ACCOUNTING REFORM AND INVESTOR PROTECTION ACT OF 2002, S. REP. NO. 205-107 (2002) (“The bill exempts investment companies from certain disclosure requirements. The Committee feels that the objectives of those disclosure sections are adequately addressed by existing Federal securities laws and the rules thereunder affecting investment companies.”); REPORT OF THE HOUSE COMM., CORPORATE AND AUDITING ACCOUNTABILITY, RESPONSIBILITY, AND TRANSPARENCY ACT OF 2002, H.R. REP. NO. 414-107 (2002) (“[C]ertain provisions of the bill are not meant to apply to investment companies registered with the Commission under the Investment Company Act of 1940. Because those companies are already subject to a thorough regulatory regime, the application of these provisions would be inappropriate.”). Based on legislative and regulatory activity in reaction to the market



As Sarbanes-Oxley was being adopted, late trading, market timing, preferential access to fund securities holdings and sources, and amounts of adviser compensation were almost daily headlines in the financial news. State and federal regulators who had been occupied with spectacular corporate frauds turned their attention to mutual funds. As the SEC summed it up at the end of 2003:

In recent months, the Commission and State securities authorities have discovered unlawful conduct involving a number of fund advisers, broker-dealers, and other service providers that confirms the need for [new] rules. Fund advisory or distributor personnel have engaged in, or actively assisted others in engaging in, inappropriate market timing, late trading of fund shares, and the misuse of material, nonpublic information about fund portfolios. These personnel, including in some cases senior executives of fund advisers, have placed their personal interests or the business interests of the fund adviser ahead of the interests of fund shareholders, thus breaching their fiduciary obligations to the funds involved and their shareholders. These individuals have harmed the funds, their management organizations, and the confidence of fund investors.<sup>77</sup>

The controversy surrounding market timing and late trading of privileged investors in mutual funds led regulators to re-examine the regulatory regime for mutual funds and investment advisers. The SEC, working to refine traditional approaches to duty-of-loyalty problems, began an extensive examination of its rules under the Investment Company Act and the Investment Advisers Act, and subsequently amended a number of its rules.<sup>78</sup> Some of the changes were challenged in court and Congress.

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timing activities of privileged investors in mutual funds breaking as this edition is published, these earlier observations may have been premature.

77. Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, 68 Fed. Reg. 74,714 at 74714-15 (Dec. 24, 2003). For surveys of the investigation of and reaction to mutual fund late trading, market timing and compensation that began in 2003, see Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. ECON. PERSP. 161 (2004), Stephen J. Crimmins et al., *The Mutual Fund Crisis—Beginning to See a Resolution*, 36 SEC. REG. & L. REP. 349 (Feb. 23, 2004), and Stephen J. Crimmins, David U. Gourevitch & Joseph V. Del Raso, *The Mutual Fund Probes—What We Can Tell So Far*, 35 SEC. REG. & L. REP. 1834 (2003).

78. See Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, Investment Company Act Release No. 26,533, 69 Fed. Reg. 52,788 (Aug. 27, 2004) (adopting rule changes requiring greater disclosure of identity

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of managers, compensation, and security ownership); Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Investment Company Act Release No. 26,486, 69 Fed. Reg. 39,798 (June 23, 2004); Mandatory Redemption Fees for Redeemable Fund Securities, Investment Company Act Release No. 26,375A, 69 Fed. Reg. 11,762 (Mar. 5, 2004); Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Investment Company Act Release No. 26,350, 69 Fed. Reg. 7852 (Feb. 11, 2004) (proposing release); Investment Adviser Codes of Ethics, Investment Company Act Release No. 26,492, 69 Fed. Reg. 41,696 (July 2, 2004); Investment Adviser Codes of Ethics, Investment Company Act Release No. 26,337, 69 Fed. Reg. 4040 (Jan. 20, 2004) (proposing release); Disclosure of Breakpoint Discounts by Mutual Funds, Investment Company Act Release No. 26,464 69 Fed. Reg. 33,262 (June 7, 2004); Disclosure of Breakpoint Discounts by Mutual Funds, Investment Company Act Release No. 26,298, 68 Fed. Reg. 74,732 (Dec. 17, 2003) (proposing release); Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26,418, 69 Fed. Reg. 22,300 (Apr. 19, 2004); Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26,287, 68 Fed. Reg. 70,402 (Dec. 11, 2003) (proposing release); Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26,288, 68 Fed. Reg. 70,388 (Dec. 11, 2003).

The SEC also proposed rules to create a hard close for mutual fund trades at 4 p.m. Eastern Time; see Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26,288, 68 Fed. Reg. 70,388 (Dec. 17, 2003); to impose a 2% fee on short-term mutual fund trades, see Mandatory Redemption Fees for Redeemable Fund Securities, Investment Company Act Release No. 26,375A, 69 Fed. Reg. 11,762 (Mar. 5, 2004), and to require greater disclosure of mutual fund fees and conflicts at the point of sale and in confirmations, see Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Sec. Act Release No. 8358, Sec. Exchange Act Release No. 49,148, Investment Company Act Release No. 26,341, 69 Fed. Reg. 6438 (Feb. 10, 2004). In the end, the Commission chose not to require redemption fees. Mutual Fund Redemption Fees, Investment Company Act Release No. 26,782, 70 Fed. Reg. 13,328 (Mar. 18, 2005). Instead, the Commission adopted Investment Company Act Rule 22c-2, which makes it unlawful to redeem shares of most investment companies within seven days of their purchase unless the directors of the investment company, including a majority of disinterested directors, have either approved a redemption fee or determined that one is either not necessary or not appropriate. Such redemptions are also prohibited unless the investment company has entered into a written agreement with all financial intermediaries in which the intermediaries agree to provide the investment company, upon its request, with certain information about trades in the investment company's shares and to restrict trading of an investment company shareholder upon the company's request. Rule 22c-2(c), 17 C.F.R. § 270.22c-2, broadly defines "financial

In the light of the controversy over market timing, the SEC focused on the role of independent investment company directors as investor guardians, responsible for ensuring that fund assets are used for the sole benefit of investors and not for managers.<sup>79</sup> In one of its first rule changes, the SEC adopted Investment Company Act Rule 38a-1<sup>80</sup> and its companion Rule 206(4)-7 under the Investment Advisers Act of 1940,<sup>81</sup> which require investment companies and investment advisers to adopt compliance controls to be administered by chief compliance officers.<sup>82</sup>

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intermediary” to include “[a]ny broker, dealer, bank, or other entity that holds securities of record issued by the fund, in nominee name . . .” and, in “the case of a participant-directed employee benefit plan that owns the securities issued by the fund, a retirement plan’s administrator under Section 3(16)(A) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. [§] 1002(16)(A)) or any entity that maintains the plan’s participant records.”

While Rule 22c-2 became effective on May 23, 2005, the Commission delayed the compliance date to October 16, 2006, to allow investment companies and financial intermediaries to make contracts and enhance their systems. Subsequently, in response to numerous complaints that compliance would be costly, the Commission proposed to amend the rule to “(i) limit the types of intermediaries with which funds must negotiate information-sharing agreements, (ii) address the rule’s application when there are chains of intermediaries, and (iii) clarify the effect of a fund’s failure to obtain an agreement with any of its intermediaries.” *Mutual Fund Redemption Fees*, Investment Company Act Release No. 27255, 2006 WL 2794768 (Feb. 28, 2006). For example, the proposed amendments would clarify that if an investment company does not have an agreement with a particular intermediary, only that intermediary would be prohibited from trading. Moreover, the Commission asked for comments on whether it would be better to allow such an intermediary to effect purchases but simply prohibit it from redeeming shares within seven days of their purchase.

79. See Phyllis Diamond & Rachel McTague, *SEC Looking Closely at Role Played by Independent Directors in Fund Scandal*, 36 SEC. REG. & L. REP. 49 (2004). SEC Chair Donaldson also indicated that the SEC was reexamining the use of fund assets to facilitate distributions, the use of soft-dollars, and other matters. *Id.* The use of fund assets to facilitate distribution has since been significantly curtailed. See BINES & THEL, *supra* note 7, at §10.07[B][3].

80. 17 C.F.R. § 270.38a-1. Rule 38a-1 complements Rule 17j-1(c)(1), 17 C.F.R. § 270.17j-1(c)(1), which requires funds to adopt a code of ethics with provisions reasonably necessary to prevent certain persons from engaging in certain fraudulent, manipulative, and deceptive actions. For a discussion of Rule 17j-1, see BINES & THEL, *supra* note 7, at §11.03[A].

81. 17 C.F.R. § 275.206(4)-7.

82. See Antoinette Gartrell, *SEC Suits Against Compliance Officers Sending Wrong Message, Gallagher Says*, 47 SEC. REG. & L. REP. 1217 (2015); John Sakhleh, David S. Petron & Kevin Garvey, *As Chief Compliance Officer, Could You Be the Target of an Enforcement Action?*, 46 SEC. REG. & L. REP. 977 (2014).

Investment Company Act Rule 38a-1 requires every registered investment company (and business development company) to adopt written policies and procedures that are reasonably designed to prevent the investment company and its service providers—including investment advisers, principal underwriters, administrators, and transfer agents—from violating the federal securities laws. Moreover, the directors of a registered investment company, including a majority of disinterested directors, must approve—on the basis of a finding that the policies are reasonably designed to prevent violations—the investment company’s policies and procedures and those of each investment adviser, principal underwriter, administrator, and transfer agent.<sup>83</sup> The investment company must review the adequacy and implementation of its own policies and those of its service providers at least annually.

Rule 38a-1 also requires every investment company to designate a chief compliance officer to be responsible for the administration of the policies and procedures adopted under the rule.<sup>84</sup> The designation and compensation of the chief compliance officer must be approved by the investment company’s board, including, again, a majority of disinterested directors, and the chief compliance officer may be removed only with the approval of the board. The chief compliance officer must meet with the independent directors at least annually, and report to the board at least annually in writing on the operation of the required policies and procedures of the company and its service providers. The annual report must also address every “Material Compliance Matter” that has occurred since the last report.<sup>85</sup>

In addition to enumerating various matters that should be addressed in Rule 38a-1 policies, the SEC emphasized that its purpose was to force investment company directors to pay attention to their duties:

The consequences of failing to meet the Investment Company Act’s governance requirements are severe. Therefore, a fund’s policies and procedures should be designed to guard against, among other things, an improperly constituted board, the failure of the board to properly consider matters entrusted to it, and the failure of the board to

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83. 17 C.F.R. § 270.38a-1.

84. *Id.*

85. *See id.* § 270.38a-1(e)(2).

request and consider information required by the Investment Company Act from the fund adviser and other service providers.<sup>86</sup>

The SEC directly intervened in the governance of investment companies later in 2004 by conditioning exemptions on compliance with SEC wishes. A variety of SEC rules provide investment companies with exemptions from certain proscriptions if actions are approved by independent directors.<sup>87</sup> At the beginning of 2004, the SEC proposed to amend these exemptions to condition their availability on the investment company's having adopted a number of measures intended to secure independence from the adviser.<sup>88</sup> The proposals aroused substantial interest and controversy, both within and outside the SEC, but in September 2004 the SEC adopted the amendments, over a vigorous dissent, which argued that the Commission had inadequately considered the costs that the rule changes would impose. As adopted, the rules provided that exemptions would be available only for investment companies that satisfied the fund governance standards set forth in Rule 0-1(a)(7): at least seventy-five percent of the directors of the investment company must be independent (or two independent directors on a three-member board); the board must be chaired by an independent director; the board must perform a self-assessment at least annually; independent directors must meet separately at least quarterly; and independent directors must be able to hire their own staff.<sup>89</sup>

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86. Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, 81 SEC Docket 2775 (Dec. 17, 2003).

87. These rules include Rules 10f-3, 12b-1, 15a-4(b)(2), 17a-7, 17a-8, 17d-1(d)(7), 17e-1, 17g-1, 18f-3 and 23c-3. Cf. Task Force on Fund Director's Guidebook, *Fund Director's Guidebook*, 59 BUS. LAW. 201, 210 (2003) ("The SEC has promulgated a special set of governance standards which apply to funds that have adopted Rule 12b-1 plans, issue multiple classes of shares, or rely upon widely used SEC exemptive rules to engage in certain types of transactions with affiliates . . . . As a practical matter, the SEC governance standards apply to most funds because few funds can operate without having the ability to rely upon one or more of the exemptive rules. The rules adopted by the SEC in 2001 require that a majority of the directors be independent. Most fund complexes have adopted this practice even in the absence of any requirement.").

88. Investment Company Governance, Investment Company Act Release No. 26,323, 69 Fed. Reg. 3472 (Jan. 15, 2004).

89. Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378 (Aug. 2, 2004). The SEC had urged independent directors to retain their own counsel earlier in the year. See *Royce to Fund Directors: Make Use of Independent Counsel, CCO, Auditor*, 36 SEC. REG. & L. REP. 56 (Jan. 12, 2004).

The SEC's governance changes engendered substantial opposition on several fronts. The U.S. Chamber of Commerce sued, challenging the SEC's authority to adopt the rules.<sup>90</sup> In Congress, legislators sympathetic to the industry secured legislation requiring the SEC to submit a study to Congress justifying the independent chair rule and discussing whether funds chaired by disinterested directors perform better, have lower expenses, or have better compliance records than mutual funds chaired by interested directors, and to act on the studies' recommendations before the rule change is scheduled to be effective.<sup>91</sup>

In April 2005, the SEC published its response to Congress' demand that it justify the independent chair rules.<sup>92</sup> The Commission's report discussed the late-trading and stale pricing problems that led the Commission to act, and justified the rule changes in terms of enhanced investor confidence:

The Commission adopted the independent chair condition as a means of enhancing independent oversight of the conflicts of interest inherent in the transactions permitted by the Exemptive Rules. As the recent scandals demonstrated, active independent oversight of fund advisers and other affiliates was sorely missing in many of the leading fund complexes.

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90. See Deborah Solomon & David Rogers, *Fund Industry Nears Lobbying Win*, WALL ST. J., Nov. 17, 2004, at C21; Rachel McTague, *D.C. Circuit Denies U.S. Chamber's Request to Delay SEC Independent Fund Director Rule*, 36 SEC. REG. & L. REP. 1890 (2004).

91. See H.R. REP. NO. 108-792, at 104 (2004) ("Not later than May 1, 2005, the Securities and Exchange Commission shall submit a report to the Committee on Appropriations of the Senate that provides a justification for final rules issued by the Commission on June 30, 2004 (amending title 17, Code of Federal Regulations, Parts 239, 240, and 274), requiring that the chair of the board of directors of a mutual fund be an independent director: Provided, That such report shall analyze whether mutual funds chaired by disinterested directors perform better, have lower expenses, or have better compliance records than mutual funds chaired by interested directors: Provided further, That the Securities and Exchange Commission shall act upon the recommendations of such report not later than January 1, 2006."); see also Rachel McTague, *Oxley, Baker Object to Language on SEC Fund Rule in Appropriations Bill*, 36 SEC. REG. & L. REP. 2063 (2004); Solomon & Rogers, *supra* note 90 at C21 (supporting SEC's positions by some prominent legislators); *House, Senate Lawmakers Endorse Proposal on Independent Fund Chairman*, 36 SEC. REG. & L. REP. 515 (2004).

92. EXEMPTIVE RULE AMENDMENTS OF 2004: THE INDEPENDENT CHAIR CONDITION, SEC (2005), <http://www.sec.gov/news/studies/indchair.pdf> [<http://perma.cc/88J8-YCQF>].

The Commission did not adopt the independent chair provision as a means of enhancing fund financial performance or reducing fund expenses. The staff, including the staff of the Division of Investment Management and the Office of Economic Analysis, examined this issue, however, and found that the empirical data regarding the relationship between an independent chairman and fund performance and fees are inconclusive.<sup>93</sup>

The Commission's acknowledgment that its primary purpose had not been to enhance fund performance or reduce fund expenses highlighted an aspect of its judgment that would soon come back to haunt it. In a remarkable June 2005 decision, the United States Court of Appeals for the D.C. Circuit granted the Chamber's petition for review in part and remanded the case to the SEC to further consider its governance rules.<sup>94</sup> The court rejected the Chamber's argument that the Commission lacked authority to address the "corporate governance" of investment companies, but did conclude that the Commission had violated the Administrative Procedure Act and the Investment Company Act by failing to consider the costs imposed by the amendments and the alternatives thereto.<sup>95</sup>

When the court announced its decision, the sponsor of the rule changes, Commission Chairman William Donaldson, was set to resign from the Commission in about a week. Inasmuch as the rules had initially been adopted on a 3-2 vote, prospects for the rules might have seemed uncertain. However, the Commission promptly readopted the rules, and apparently satisfied itself that it was able quite quickly to evaluate the costs of the changes it made and find those changes superior to any alternatives.<sup>96</sup> The Chamber of Commerce challenged that decision on a number of grounds, including the Commission's failure to seek further public comment.<sup>97</sup> A few months later, the Court

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93. *Id.* at 2-3.

94. *Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005).

95. *Id.* at 136.

96. *Investment Company Governance*, Investment Company Act Release No. 26985, 2005 WL 2756705 (June 30, 2005); *see also* Michael Schroeder, *SEC Adopts Mutual Fund Rule, Risks New Court Challenge*, WALL ST. J., June 30, 2005, at C1.

97. Judith Burns, *SEC's Fund-Rule Fight Continues*, WALL ST. J., Nov. 9, 2005, at C13; Kara Scannell, *SEC Defends Review, Readoption of Mutual-Fund Rule in Appeal*, WALL ST. J., Jan. 7, 2006, at B13; John Spence & Robert Schroeder, *Independent Boards at Issue Again*, WALL ST. J., Jan. 5, 2006, at C13; *see also* Barry P. Barbash &

of Appeals vacated the readopted rule changes but stayed its mandate so that the Commission could reopen its record, and ordered the Commission to report on its progress.<sup>98</sup> The court explained that while its prior decision did not prescribe how the Commission should estimate the costs of the rule changes, the Commission had violated the Administrative Procedure Act<sup>99</sup> by readopting the rules on the basis of material not in the record of the rulemaking and without affording an opportunity for public comment. The Commission was apparently not ready to concede defeat, however, and in June 2006 it gave the court a status report and sought additional public comment on the costs of the rule changes.<sup>100</sup> Nonetheless, the Commission has not adopted the rules.

Investment advisers to statutory investment companies are subject to a number of legal restrictions, principally in regard to transactions between themselves and their companies and joint transactions with their companies.<sup>101</sup> In addition, such investment advisers are under a general statutory fiduciary duty<sup>102</sup> and a specific fiduciary duty with

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Jennifer Raymer Suellentrop, *The SEC's Mutual Fund Governance Rule: The Continuing Saga*, INV. LAW., Oct. 2005, at 1.

98. *Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. Cir. 2006).

99. Administrative Procedure Act, Pub L. No. 79-404, 60 Stat. 237 (1946).

100. Investment Company Governance, Investment Company Act Release No. 27395, 2006 WL 2794769 (June 13, 2006); *see also SEC Seeks Comment on Fund Rules, Files Status Report with D.C. Circuit*, 38 SEC. REG. & L. REP. 1053 (June 19, 2006). The Commission reopened the comment period in December 2006 to seek additional comments, particularly with respect to two papers prepared by Commission staff economists. Investment Company Act Release No. 27600, 2006 WL 3718282 (Dec. 15, 2006).

101. Investment Company Act §§ 17(a)-17(e), 15 U.S.C. §§ 80a-17(a) to 80a-17(e). *See Application of Section 17 of the Investment Company Act of 1940 to Portfolio Affiliates*, 120 U. PA. L. REV. 983 (1972); *see also* Investment Company Act § 10(f), 15 U.S.C. § 80a-10(f) (concerning an investment company's participation as a purchaser in affiliated underwritings).

102. Investment Company Act § 36(a), 15 U.S.C. § 80a-35(a), provides:

The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal



respect to compensation for services.<sup>103</sup> Also extensively regulated are other details of the relationship between the adviser and the company, such as dual employment,<sup>104</sup> terms of advisory contracts,<sup>105</sup> and other matters of administration.<sup>106</sup>

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misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in Section 1(b) [15 U.S.C. § 80a-1(b)] of this title.

103. Investment Company Act § 36(b), 15 U.S.C. § 80a-35(b) (added by Pub. L. No. 91-547, § 20, 84 Stat. 1413, 1429 (1970)).

104. Investment Company Act § 10, 15 U.S.C. § 80a-10, limits the extent to which statutory companies can choose persons as directors who are otherwise affiliated with the company (§ 10(a)), and restricts the discretion of a company not having a majority of independent directors on its board to use the services of brokers, of underwriters of the company, and of other investment bankers (§ 10(b)). Special rules also apply to persons connected with banks (§ 10(c)) and to certain open end, no-load (i.e., no underwriting commission) companies (§ 10(d)).

105. Investment Company Act § 15(a), 15 U.S.C. § 80a-15(a)-(b), makes it unlawful for any person to serve as an investment adviser to a company except pursuant to a written contract that has been approved by vote of a majority of the outstanding voting securities of the company (or except on an interim basis, see *supra* note 45). This includes a contract by another investment adviser to offer investment advice to the fund's regular investment adviser. The written contract must precisely describe all compensation to be paid. The advisory contract may not continue in effect for longer than two years, unless continuance is specifically approved at least annually ("annually" is defined in Rule 15a-2, 17 C.F.R. § 270.15a-2, by the board of directors or by a vote of the majority of the shareholders. It must provide for termination at any time without payment of penalty on sixty day's written notice to the investment adviser and for automatic termination in the event of assignment by the adviser.

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Investment Company Act § 15(c), 15 U.S.C. § 80a-15(c), requires that approval of the investment advisory contract or underwriting contract must be made by a vote of the majority of directors who are not parties to the contract or interested persons of any party to the contract. These disinterested directors have the duty to request and evaluate such information as may be reasonably necessary to evaluate the terms of the advisory contracts and the investment adviser has the duty to provide any such information. This duty on the part of the disinterested directors to inquire and the correlative duty of the adviser to inform, though implicit in the original version of the Act (see *Moses v. Burgin*, 445 F.2d 369, 376-77 (1st Cir. 1971); *Brown v. Bullock*, 194 F. Supp. 207 (S.D.N.Y. 1961)), was made express in Section 15(c) by statutory amendment in Section 8(c) of the Investment Company Act Amendments of 1970, Pub. L. No. 91-547, 84 Stat. 1419 (1970).

In 2004, the SEC amended its rules and forms to require registered management investment companies to provide greater disclosure about how their directors evaluate, approve and recommend shareholder approval of investment advisory contracts. Investment company proxy statements were previously required to discuss the material factors on which the directors based their recommendation that shareholders approve the investment advisory contract. *See* Item 22(c)(11) of Schedule 14A, 17 C.F.R. § 240.14a-101; Investment Company Act Release No. 20,614, 59 Fed. Reg. 52,689 (Oct. 13, 1994); *see also* Investment Company Act Release No. 24,816, 66 Fed. Reg. 3734 (Jan. 2, 2001) (amending requirements for disclosure in Statement of Additional Information). The 2004 amendments to Schedule 14A and to forms N-1A, 17 C.F.R. §§239.15A & 274.11A, N-2, 17 C.F.R. §§239.14 & 274.11a-1, and N-3, 17 C.F.R. §§239.17a & 274.11b, which are used for registration under the Securities Act and the Investment Company Act, require funds to include in the shareholder reports the information that is required by the fund's registration statement form, and require shareholder reports of management investment companies and insurance company managed accounts offering variable annuities to discuss, in reasonable detail, the material factors and the conclusions on which the directors based their decision. (Investment Company Act Rule 30e-1, 17 C.F.R. § 270.30e-1, correlates the information in shareholder reports with that included in registration statements. The SEC deleted as redundant the requirement that similar information be included in the Statement of Additional Information.) The reports must disclose the directors' basis for approving investment advisory contracts and recommending them to shareholders, including factors relating to the selection of the adviser and the approval of the fee. They must also indicate whether the directors relied upon comparisons of the adviser's fees and services with those under other investment advisory contracts. Moreover, the investment company's principal executive and financial officers must certify, based on their knowledge, the description of the board's evaluation process. The SEC justified the changes with the argument that expansive disclosure would encourage directors to carefully review contracts and fees and assist investors in choosing among investment companies in which to invest. *See* Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Investment Company Act. Release No. 26,486, 69 Fed. Reg. 39,798 (June 23, 2004).

## B. EMPLOYEE BENEFIT PLANS

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

In order to protect retirement and other employment benefits normally paid for by employee contributions from, or in lieu of, additional salary, Congress enacted the Employee Retirement Income Security Act of 1974 (“ERISA”).<sup>107</sup> ERISA governs private employee and benefit plans for millions of workers and is itself the subject of extensive commentary.<sup>108</sup> It imposes requirements, duties, and liabilities that are often different from, and sometimes in conflict with, law that

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106. See, e.g., Investment Company Act §§ 12, 16, 20, 15 U.S.C. §§ 80a-12, 80a-16, 80a-20. Section 12 covers a number of matters, including acquisitions and mergers, ownership of securities in insurance companies, and broker-dealers. Section 16 deals principally with the process for selection of directors, and Section 20 with proxy and voting trust matters and circular ownership. The SEC has broad exemptive power with respect to Investment Company Act regulation. Section 6(c) permits the Commission to exempt “any person, security, or transaction” from all or part of the Act if public-interest and protection-of-investors standards are satisfied. The Section 6(c) exemptive power is not ordinarily applied to the entire Act, however, and where the SEC has done so or been requested to do so, the issues involved usually relate to competition battles among the investment company industry, the insurance industry and the banking industry. See *supra* note 55. This general exemptive power in Section 6(c) is supplemented by a specific exemptive power in Section 17(b) respecting joint transactions prohibited by Section 17(a). An exemption is authorized if it is shown that the terms of the transaction are fair and the transaction is consistent with the policy of any investment company affected by the proposed transaction and with the general purposes of the Act.

107. Employee Retirement Income Security Act of 1974, Pub. L. 93-406, 88 Stat. 829 (codified as amended at § 1001-1461 (2012) and scattered sections of 26 U.S.C.). Discussions contemporaneous with enactment of the background of ERISA and the administration of the fiduciary responsibility provisions of the Act appear in Proceedings, ABA Nat’l Inst., *Fiduciary Responsibilities Under the Pension Reform Act*, 31 BUS. LAW. 1 (1975); see also William J. Chadwick & David S. Foster, *Federal Regulation of Retirement Plans: The Quest for Parity*, 4 VAND. L. REV. 641 (1975). A bibliography of articles is appended to *ERISA Fiduciary Responsibility and Prohibited Transactions*, 365-2nd T.M. (BNA).

108. For more extensive discussion of ERISA, see RONALD J. COOKE, *ERISA PRACTICE AND PROCEDURE* (2d ed. 1996); JOHN H. LANGBEIN & BRUCE A. WOLK, *PENSION AND EMPLOYEE BENEFIT LAW 62-96* (2d ed. 1995); JAYNE E. ZANGLEIN, LAWRENCE A. FROLIK & SUSAN J. STABILE, *ERISA LITIGATION* (4th ed. 2011).

otherwise governs investment management.<sup>109</sup> ERISA is a complex statute. It is, in fact, an amalgam of two separate bills—a labor bill and a tax bill—and both portions have consequences for investment managers. ERISA itself explained that the purpose of the statute was to protect plan participants and beneficiaries “by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans.”<sup>110</sup> The labor portion of ERISA, which labor lawyers typically cited to instead of the United States Code, reaches investment management through a set of provisions pertaining to fiduciary responsibility.<sup>111</sup> With respect to investment managers, the tax provisions, which are typically cited to the Internal Revenue Code, are less broad in scope, reaching primarily prohibited transactions (a defined term).<sup>112</sup>

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109. See ERISA § 514(a), 29 U.S.C. § 1144(a) (2012) (providing for preemption of state law).

110. ERISA § 2(b), 29 U.S.C. § 1001(b).

111. ERISA §§ 401-414, 29 U.S.C. §§ 1101-1114. The Department of Labor has issued a series of interpretive bulletins concerning the fiduciary responsibility provisions that are incorporated as regulations. 29 C.F.R. § 2509.75-2 (2015) (prohibited transactions); *id.* § 2509.75-3 (investment in shares of investment companies); *id.* § 2509.75-4 (indemnification of fiduciaries); *id.* § 2509.75-5 (definition of fiduciary; lines of responsibility; funding; investment manager of qualifications; bonding); *id.* § 2509.75-6 (advances on expenses to party in interest); *id.* § 2509.75-8 (definition of fiduciary; fiduciary’s right to rely on information provided by others; number of fiduciaries required; allocation and delegation of fiduciary responsibilities; performance monitoring obligations); *id.* § 2509.75-9 (independence of accountant for purpose of auditing or rendering opinion on financial information in annual report of plan); *id.* § 2509.75-10 (special reliance procedure adopted to accommodate interim qualification pending adoption of permanent ERISA regulations); *id.* § 2509.94-1 (the fiduciary standard in considering economically targeted investments); *id.* § 2509.95-1 (fiduciary standard when selecting an annuity provider); *id.* § 2510.3-21 (definition of fiduciary); see also *id.* § 2550.404a-1(b) (2015), discussed extensively in BINES & THEL, *supra* note 7, at § 8.02[B][1].

112. See I.R.C. § 4975; see also BINES & THEL, *supra* note 7, at § 11.02[B][1]. As was the case even before the enactment of ERISA, a plan that engages in imprudent investment practices can lose its tax-qualified status under Section 401(a) of the Code. See Rev. Rul. 69-494, 1969-2 C.B. 88; Rev. Rul. 69-421, Pt. 2(k)(1), 1969-2 C.B. 59, declared obsolete by Rev. Rul. 72-488, 1972-2 C.B. 649. Disqualification is not automatic even if a plan’s investments are imprudent, however. See *Shedco Inc. v. Commissioner*, T.C. Mem. 1998-295, 76 T.C.M. (CCH) 267, 1998 Tax Ct. Memo LEXIS 296, at \*46-49 (1998). Moreover, it appears clear that satisfaction of ERISA’s prudence requirements will be deemed to satisfy the prudence aspect of Section 401(a).

ERISA Section 3(21)<sup>113</sup> defines “fiduciary” broadly enough to include nearly everyone having a measurable influence in fashioning or carrying out an investment program for covered employee benefit plans.<sup>114</sup> Investment managers are also defined as a subclass of fiduciary in Section 3(38).<sup>115</sup> The principal requirement of this definition as originally adopted was that a statutory investment manager had to be a registered investment adviser under the Investment Advisers Act, a bank, or a qualified insurance company. As discussed below,<sup>116</sup> the Investment Advisers Act was amended in 1996 to provide that smaller investment advisers are generally regulated at the state level and may not register with the SEC. ERISA Section 3(38) was subsequently amended to include within the definition of “investment manager” a fiduciary exempt from registration as an investment adviser because of its small size if it is registered under state law and filed a copy of its

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*Id.* at \*38. In any event, because removal of tax-exempt status is so devastating a weapon, and because its exercise has an impact on blameless employees, it is not likely to be used except in egregious cases in which relatively few employees are involved. *But see* BNA Daily Tax Report No. 127, June 30, 1976, at G-3 (Teamsters Union pension fund reportedly in danger of losing tax-exempt status). The prudence requirement derives from the statutory requirement that a qualified plan must be for the exclusive benefit of employees and their beneficiaries, see Rev. Rul. 69-494, 1969-2 C.B. 88, and thus imprudent investments that might lead to disqualification typically involve duty-of-loyalty breaches that transgress the ERISA prohibited transaction provisions anyway. Predictably, disqualifications for imprudence seem always to involve investments in employer securities or other plan-employer transactions involving serious breaches of the duty of loyalty that would constitute prohibited transactions. *See, e.g.,* Winger’s Dept. Store, Inc. v. Commissioner, 82 T.C. 869 (1984) (loan of assets to employer); Ada Orthopedic, Inc. v. Commissioner, T.C. Memo 1997-606 (unsecured loans to participants, relatives, and friends of the trustees); Rev. Rul. 73-282, 1973-2 C.B. 123 (loans to affiliate of plan sponsor); Rev. Rul. 71-311, 1971-2 C.B. 184 (investment in employer securities); Tech. Adv. Mem. 97-13-002 (loans to sponsor’s sole stockholder).

113. ERISA § 3(21), 29 U.S.C. § 1002(21).

114. There has been a fair amount of controversy over whether particular parties were statutory fiduciaries, but courts have construed the term broadly. *See, e.g.,* Kayes v. Pacific Lumber Co., 51 F.3d 1449 (9th Cir. 1995); Olson v. E.F. Hutton & Co., 957 F.2d 622 (8th Cir. 1992); Lowen v. Tower Asset Mgmt. Inc., 829 F.2d 1290 (2d Cir. 1987); Donovan v. Mercer, 747 F.2d 304 (5th Cir. 1984). For a discussion of the judicial treatment of whether particular persons are statutory fiduciaries, see ZANGLEIN, FROLIK & STABILE, *supra* note 108, at 104-12.

115. ERISA § 3(38)(C), 29 U.S.C. § 1002(38).

116. *See* BINES & THEL, *supra* note 7, at § 2.05[B].

most recent state registration form with the Secretary of Labor when it filed that form with the state.<sup>117</sup>

The reason for specially defining investment manager in ERISA was not, however, to change the responsibilities of investment managers as fiduciaries.<sup>118</sup> Rather, the purpose was to permit plan fiduciaries and trustees to rely on investment management services without breaching common-law duties against delegation<sup>119</sup> and without incurring vicarious

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117. Section 3(38) now provides in pertinent part that an investment manager is a fiduciary who, among other things:

(B) . . . (i) is registered as an investment adviser under the Investment Advisers Act of 1940 [15 U.S.C. § 80b-1 et seq.]; (ii) is not registered as an investment adviser under such Act by reason of paragraph (1) of section 203A(a) of such Act [15 U.S.C. § 80b-3a(a)], is registered as an investment adviser under the laws of the State (referred to in such paragraph (1)) in which it maintains its principal office and place of business, and, at the time the fiduciary last filed the registration form most recently filed by the fiduciary with such State in order to maintain the fiduciary's registration under the laws of such State, also filed a copy of such form with the Secretary; (iii) is a bank, as defined in that Act [15 U.S.C. § 80b-1 et seq.]; or (iv) is an insurance company qualified to perform services described in subparagraph (A) under the laws of more than one State

. . . .

ERISA § 3(38), 29 U.S.C. § 1002(38).

118. *But cf.* 29 C.F.R. § 2510.3-21(c)(2) (2015); IRS Reg. 54.4975-9(c)(2) (investment manager that renders advice for compensation is not fiduciary with respect to assets as to which it does not have requisite influence or responsibility).

119. *See* RESTATEMENT (THIRD) OF TRUSTS § 80 (AM. LAW. INST. 2007); *see also* Brock v. Self, 632 F. Supp. 1509 (W.D. La. 1986) (holding that limitation of liability is contingent on governing document's providing for designation of others to perform fiduciary functions); 29 C.F.R. § 2509.75-8 (stating that a named fiduciary may not delegate management of assets except to a statutory investment manager); RESTATEMENT (THIRD) OF TRUSTS §§ 70, 78, 85. Section 403(a)(2) of ERISA, 29 U.S.C. § 1103(a), places in the trustees "exclusive authority and discretion to manage and control the assets of the plan, except to the extent that . . . (2) authority to manage, acquire, or dispose of assets of the plan is delegated to one or more investment managers pursuant to section 402(c)(3)." Section 402(c)(3) vests authority in the named fiduciary to appoint investment managers. Assuming reasonable care in the appointment of the investment manager, the delegation privilege is quite valuable to the named fiduciary. For example, in *Marshall v. Unicorn Group*, [1979-1981 Transfer Binder] CCH Pension Plan Guide ¶ 23,068 (S.D.N.Y. 1981), a properly appointed

liability for statutory violations by the investment manager.<sup>120</sup> The Department of Labor and the Treasury Department regulations adopted soon after the enactment of ERISA somewhat narrow the statutory definition of fiduciary,<sup>121</sup> so that a person will be treated as a fiduciary under ERISA because he provides investment advice to a plan “in only two circumstances: first, when a person had discretionary authority or control to purchase or sell securities or other property for a plan; and second, when a person renders investment advice to a plan on a regular

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investment manager prematurely redeemed a certificate of deposit, thus sacrificing the pension plan’s right to accrued interest. The trustees of the plan were held not liable. In *Dardaganis v. Grace Capital, Inc.*, 664 F. Supp. 105 (S.D.N.Y. 1987), *aff’d in part and vacated in part on other grounds*, 889 F.2d 1237 (2d Cir. 1989), a pension plan’s investment adviser was found to have breached its fiduciary duty to the plan by exceeding the equity limit established by the plan’s trustees. In rejecting the adviser’s claim that the trustees should bear responsibility for their failure adequately to enforce the investment objectives set forth in the management agreement, the court noted that the management agreement specifically required the adviser to invest “in strict conformity” with the trustees’ guidelines. *Id.* at 110. *But see* *Schetter v. Prudential-Bache Sec., Inc.*, 695 F. Supp. 1077 (E.D. Cal. 1988) (holding that a brokerage firm not duly appointed investment manager because trustees never obtained written acknowledgment from the firm that it was a fiduciary with respect to the plan). ERISA conditions the definition of “investment manager” on the manager’s having acknowledged in writing that it is fiduciary with respect to the plan. ERISA § 3(38)(C), 29 U.S.C. § 1002(38).

120. Section 405(d)(1) of ERISA, 29 U.S.C. § 1105(d)(1), relieves a trustee from liability for the acts or omissions of properly appointed statutory investment managers. *See* *Lowen v. Tower Asset Mgmt. Inc.*, 829 F.2d 1209 (2d Cir. 1987). The insulation from liability is far less than total, however. Section 405(d)(2), 29 U.S.C. § 1105(d)(2), restricts the scope of Section 405(d)(1) so as not to affect a fiduciary’s independent liability under Section 405. Thus, complicity with a statutory investment manager, for example, would deprive a fiduciary of the protection of Section 405(d)(1). *Cf.* *Trs. of HEREIU Welfare Pension Fund v. Amivest Corp.*, 733 F. Supp. 1180 (N.D. Ill. 1990).

121. 29 C.F.R. §§ 2510.3-21(c), 2510.3-21(d); I.R.S. Reg. § 54.975-9(c)(1). These provisions are discussed extensively in BINES & THEL, *supra* note 7, at § 11.02[B]. Reorganization Plan No. 4 of 1978, effective December 31, 1978, transferred the authority of the Secretary of the Treasury to issue interpretations regarding Code section 4975 to the Secretary of Labor. Although IRA’s are generally not governed by E.R.I.S.A. Title II, they are subject to the prohibited transaction rules and tax. Prohibited transaction exemptions in turn require investment advisers to IRAs to consent to being subject to E.R.S.A.-based duties. *See* EMP. BENEFITS COMM. SECTION OF LABOR AND EMP’T LAW, AM. BAR ASS’N, EMPLOYEE BENEFITS LAW Ch. 10.VIII.B.2 (3d ed. 2012 and online resource). For criticism of the Department of Labor rules, see Norman P. Stein, *I, Fiduciary: Some Reflections on the Definition of Fiduciary Under ERISA*, 6 DREXEL L. REV. 555 (2014).

basis, pursuant to an agreement or understanding that the advice will be a primary basis for the plan's investment decisions, and that the advice is individualized to the particular needs of the plan."<sup>122</sup>

The second test has proven extraordinarily important and controversial. By conditioning the fiduciary standing of an adviser without discretionary authority on advice being provided regularly, and, more importantly, pursuant to an agreement that the advice will be a primary basis for the plan's decisions, it may make it possible for broker-dealers and others to avoid fiduciary standing by the simple expedient of clearly stating that their advice is not intended to be the primary basis of the plan's investments. With the growth of defined contribution plans, brokers advising persons on their IRA accounts, especially when those persons roll substantial defined contribution plans from their former employers into personal IRA accounts, this possibility has become controversial.

In 2010, the Department of Labor proposed rulemaking to define as fiduciaries persons who render investment advice to plans for a fee.<sup>123</sup> Large parts of the investment advisory business lobbied intensely against the proposal, and found the support of numerous legislators,<sup>124</sup> and in 2012, the Department of Labor withdrew the proposal.<sup>125</sup> However the issue did not disappear, and in February 2015, President Obama endorsed stricter standards in the form of a new, as of then unpublished, Department of Labor rule.<sup>126</sup> The Department of Labor's consideration of the matter has been complicated by the SEC's

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122. See Stein, *supra* note 121, at 565.

123. Florence Olsen, *DOL Says It Will Repropose Fiduciary Rule, Citing Need to Do Further Economic Analysis*, 43 SEC. REG. & L. REP. 1951 (2011); *US Labor Department's EBSA to Re-Propose Rule on Definition of a Fiduciary*, DOL (Sept. 19, 2011), [hereinafter *Fiduciary Definition*] <http://www.dol.gov/ebsa/newsroom/2011/11-1382-NAT.html> [<http://perma.cc/622W-RBJ7>].

124. See *Definition of the Term "Fiduciary" Proposed Rule*, DOL, <http://www.dol.gov/ebsa/regs/cmt-1210-AB32.html> [<http://perma.cc/3CB6-8796>] (collecting commentary); Stein, *supra* note 121, at 569.

125. See GAO, REPORT TO CONGRESSIONAL REQUESTERS, 401(K) PLANS: LABOR AND IRS COULD IMPROVE THE ROLLOVER PROCESS FOR PARTICIPANTS 11-13 (2013), <http://www.gao.gov/assets/660/652881.pdf> [<http://perma.cc/6W92-ZGK9>].

126. See Andrew Ackerman & Karen Damato, *Obama Backs New Rules for Brokers on Retirement Accounts*, WALL ST. J., Feb. 24, 2015, at C2.



consideration of whether to impose fiduciary duties on all brokers and dealers.<sup>127</sup>

In April 2015, the Department of Labor proposed a rule to extend the definition of “fiduciary” to extend to more persons who give investment advice to plans, participants, or beneficiaries, including individual retirement account plans.<sup>128</sup> This proposal engendered a remarkable amount of opposition and controversy,<sup>129</sup> including aggressive television advertising by industry groups (acting as “Americans to Protect Family Security”) urging viewers to contact their senators and representatives in opposition.<sup>130</sup>

ERISA requires that all benefit plan assets other than insurance be held in trust.<sup>131</sup> This requirement itself works indirectly to create fiduciary responsibilities, and the trust requirement results in the application of “rules and remedies similar to those under traditional trust law to govern the conduct of fiduciaries.”<sup>132</sup> In addition to the trust requirement and aside from the prohibited-transactions provisions, the fiduciary-responsibility provisions in the labor portion impose three principal obligations that affect investment managers:

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127. See *infra* text accompanying notes 293-305; see also Joyce, *supra* note 127; Maria Lokshin, *supra* note 127.

128. See Sean Forbes, *Senators Demand Revisions to DOL Fiduciary Proposal*, SEC. L. DAILY (Aug. 7, 2015); Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice, 80 Fed. Reg. 21928 (Apr. 20, 2015) (to be codified at 29 C.F.R. 2509, 2510).

129. See, e.g., *SIFMA Pitches Best-Interest Standard as Counter to DOL Proposed Fiduciary Rule*, 47 SEC. REG. & L. REP. 1129 (June 3, 2015).

130. See *TV Attack Ads Stoke Debate Over DOL Proposal*, FINANCIAL ADVISOR IQ (Aug. 17, 2015), <http://financialadvisoriq.com/c/1178843/128453> [<http://perma.cc/GE9Q-9VSR>].

131. ERISA § 403, 29 U.S.C. § 1103.

132. H.R. REP. NO. 93-1280 (1974); see also *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 100-11 (1989) (“ERISA’s legislative history confirms that the Act’s fiduciary responsibility provisions, ‘codif[y] and mak[e] applicable to [ERISA] fiduciaries certain principles developed in the evolution of the law of trusts.’ Given this language and history, we have held that courts are to develop a ‘federal common law of rights and obligations under ERISA-regulated plans.’ In determining the appropriate standard of review for actions under [ERISA], we are guided by principles of trust law.”) (citations omitted).

(1) Delegation. The controlling instrument, which must be in writing,<sup>133</sup> can delegate investment management responsibility only through a fiduciary named in the instrument.<sup>134</sup>

(2) Fiduciary duties. An investment manager must invest “solely in the interest” of plan participants and beneficiaries,<sup>135</sup> and it must do so in accordance with a statutory standard of prudence,<sup>136</sup> including prudence in diversification of investments.<sup>137</sup>

133. ERISA § 402(a)(1), 29 U.S.C. § 1102(a)(1).

134. ERISA § 402(c)(3), 29 U.S.C. § 1102(c)(3); *see also* ERISA § 403(a)(2), 29 U.S.C. § 1103(a)(2).

135. ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1).

136. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) (“with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims”). Section 404(a)(1)(B) is discussed extensively at § 8.02[B][1]. As discussed *infra* note 91, the prudence standard is relaxed to a certain extent in employee stock ownership plans, at least to the extent prudence would otherwise require diversification.

137. ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C) (“by diversifying . . . so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so”). In interposing the word “clearly,” Congress intended to place the burden of proof on justification of nondiversification on the investment manager or such other parties as were responsible for diversification. H.R. Rep. No. 1280, at 304 (1974). Congress declined, however, to give more than general guidance with respect to diversification requirements, preferring to have the meaning of “diversification” turn on the facts of each case. For cases discussing ERISA’s diversification requirement. *See, e.g.,* Lanka v. O’Higgins, 810 F. Supp. 379 (N.D.N.Y. 1992); Marshall v. Glass/Metal Ass’n, 507 F. Supp. 378 (D. Haw. 1980); Dimond v. Ret. Plan for Emps. of Michael Baker, 582 F. Supp. 892 (W.D. Pa. 1983); Freund v. Marshall & Ilsley State Bank, 485 F. Supp. 629 (W.D. Wis. 1979). For a discussion of the meaning of diversification measured by contemporary investment theory, see BINES & THEL, *supra* note 7, at §§ 7.03[C][4], 8.04[B], and for further discussion of ERISA’s diversification provision, *see* § 8.02[B][1].

One obvious departure from meeting ordinary diversification (and, to some extent, prudence) standards is the employee stock ownership plan (“ESOP”). ERISA defines an ESOP in Sections 407(d)(6) (29 U.S.C. § 1107(d)(6), and 2003(a) (I.R.C. § 4975(e)(7)), as a qualified defined benefit plan “designed to invest primarily in employer securities.” Section 407 pertains, among other things, to holding employer securities. Section 404(a)(2) of ERISA (29 U.S.C. § 1104(a)(2)) exempts an ESOP from statutory diversification requirements, but not from statutory prudence requirements except as diversification is deemed an element of prudence. To the extent an ESOP is for the purpose of providing incentives to employees through participatory ownership, the meaning to be given statutory prudence as applied to investment in

(3) Co-fiduciary duties. As an ERISA fiduciary, an investment manager incurs liability for the acts of a co-fiduciary if the manager knowingly participates in, conceals, fails to take reasonable steps to remedy, or, by its own wrong, enables the commission of a breach of duty by the co-fiduciary.<sup>138</sup>

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employer securities may receive guidance from Section 402(b)(1) (29 U.S.C. § 1102(b)(1)), which requires a plan to provide for “a funding policy and method consistent with the objectives of the plan.” Many circuit courts adopted the so-called *Moench* presumption, holding that “an ESOP fiduciary who invests the assets in employer stock is entitled to a [rebuttable] presumption that it acted consistently with ERISA by virtue of that decision.”). See *Moench v. Robertson*, 62 F.3d 553, 569 (3d Cir. 1995), *abrogated in part by* *Fifth Third Bancorp v. Dudenhoeffer*, 134 S.Ct. 2459 (2014); *see also* *Kuper v. Iovenko*, 66 F.3d 1447 (6th Cir. 1995) (following *Moench*); Henry L. Blackiston III, *ESOPs: What They Are and How They Work*, 45 BUS. LAW. 85 (1989); Daniel Fischel & John H. Langbein, *ERISA’s Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1154 (1988); Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749 (1990); John M. Wilson, Note, *Are All ERISA Fiduciaries Created Alike?: Moench v. Robertson*, 58 U. PITT. L. REV. 255 (1996); *cf.* Matthew T. Bodie, *Aligning Incentives with Equity: Employee Stock Options and Rule 10b-5*, 88 IOWA L. REV. 539, 556 (2003) (“[C]ourts have split over whether ESOPs constitute securities, mainly due to conflicts over the application of Daniel’s ‘compulsory, noncontributory’ analysis.”). However, in *Fifth Third Bankcorp v. Dudenhoeffer*, the Supreme Court unanimously rejected the presumption of prudence. See *Fifth Third Bankcorp v. Dudenhoeffer*, 134 S.Ct. 2459 (2014).

Another aspect of prudence might be the proper valuation of employer securities. See ERISA § 407(e), 29 U.S.C. § 1107(e); *see also* 1975-50 I.R.B. 16, Rev. Rul. 69-65, 1969-1 C.B. 114; *cf.* *Canale v. Yegen*, 782 F. Supp. 963 (D.N.J. 1992). Particularly difficult issues of prudence are presented in connection with ESOP’s voting employer common stock and responding to tender offers. See, e.g., *Herman v. NationsBank Trust Co.*, 126 F.3d 1354 (11th Cir. 1997), *cert. denied*, 525 U.S. 816 (1998); *see also* Steven J. Arsenault, *Fiduciary Duties of ESOP Trustees Under ERISA in Tender Offers: The Impact of Herman v. NationsBank Trust Company and a Proposal for Reform*, 3 U. PA. J. LAB. & EMP. L. 87 (2000); Brett McDonnell, *ESOPs’ Failures: Fiduciary Duties When Managers of Employee-Owned Companies Vote to Entrench Themselves*, 2000 COLUM. BUS. L. REV. 199 (2000).

138. ERISA § 405(a), 29 U.S.C. § 1105(a). There is no cause of action for damages against nonfiduciaries who participate in fiduciary violations. See *Mertens v. Hewitt Assoc.*, 508 U.S. 248 (1993). But *see Harris Tr. & Sav. Bank v. Salomon Smith Barney Inc.*, 530 U.S. 238 (2000) (nonfiduciary party in interest liable for prohibited transaction). 29 C.F.R. §§ 2510.3-21(c)-(d)(2015) and 26 C.F.R. §§ 54.4975-9(c)-(d)(2015), interpreting the statutory term “investment advice” as it appears in Sections 3(2) and 2003(a) of ERISA, take the position that an investment manager who is a statutory fiduciary with respect to assets it manages shall not be deemed a fiduciary

The prohibited-transactions provisions bear special note. The remedies and liabilities applicable to prohibited transactions are far more extensive than those applicable to other breaches of duty under the statute.<sup>139</sup> In addition to the general criminal, legal, and equitable remedies specified in Sections 501 through 502,<sup>140</sup> and the personal liability in damages that Section 409(a) provides against fiduciaries for their breaches of duty,<sup>141</sup> an investment manager participating in a prohibited transaction is answerable for civil fine under the labor provisions,<sup>142</sup> and mandatory excise taxes under the tax provisions.<sup>143</sup>

The general principle is that, unless expressly exempted, any transaction (1) with an employee benefit plan by a fiduciary for its own account, or (2) between a plan and a party in interest (under the labor provisions) or a disqualified person (under the tax provisions) caused by a fiduciary is prohibited. Although there are linguistic differences, the definition of fiduciary with respect to investment management seems operatively the same in both parts of the statute,<sup>144</sup> and the definitions of

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with respect to other assets, the management of which is not its responsibility. But while those regulations (discussed more fully at BINES & THEL, *supra* note 7, at § 11.02[B][4]) save an investment manager from fiduciary status with respect to such other assets, they do not on their face limit the scope of Section 405(a). Thus, for example, an investment manager, aware of imprudent investing by another investment manager, may have an obligation to take reasonable steps to remedy that situation.

139. See *Mass. Mut. Life Ins. Co. v. Russell*, 473 U.S. 134 (1985) (discussing ERISA policy against self-dealing); Arthur H. Kroll & Yale D. Tauber, *Fiduciary Responsibility and Prohibited Transactions Under ERISA*, 14 REAL PROP. PROB. & TRUST J. 657 (1979). Compare *Mertens v. Hewitt Assocs.*, 508 U.S. 248, 260-62 (1993) (holding a non-fiduciary not liable for breach of duty by fiduciary), with *Harris Trust & Sav. Bank*, 530 U.S. at 241 (2000) (non-fiduciary party in interest liable for prohibited transaction).

140. ERISA § 501-502, 29 U.S.C. §§ 1131-1132; see also *LaRue v. DeWolff, Boberg & Assocs.*, 552 U.S. 248 (2008).

141. ERISA § 409(a), 29 U.S.C. § 1109(a). For a discussion of the judicial treatment of liability for breach of fiduciary duty under ERISA, see ZANGLEIN, FROLIK & STABILE, *supra* note 108, at 151-56.

142. ERISA § 502(i), 29 U.S.C. § 1132(i).

143. ERISA § 2003(a), I.R.C. §§ 4975(a), 4975(b).

144. The labor (29 C.F.R. § 2510.3-21) and tax (26 C.F.R. § 54.4975-9) regulations interpreting the term “fiduciary” with respect to investment management are identical.

party in interest (in the labor portion) and disqualified person (in the tax portion) are operatively equivalent.<sup>145</sup>

In 2010, the Department of Labor proposed rulemaking to define as fiduciaries persons who render investment advice to plans for a fee, but in 2011 withdrew the proposal and announced it would re-propose the rule.<sup>146</sup> The Department's subsequent consideration of the matter has been complicated by the SEC's consideration of whether to impose fiduciary duties on all brokers and dealers.<sup>147</sup>

In view of the serious consequences facing investment managers subject to ERISA, it is important that there be no mistake about the status of one's client. The labor and tax provisions affecting investment management activities apply to all employee benefit plans except those expressly excluded or exempted,<sup>148</sup> whether or not the covered plans meet the funding, vesting, insurance, and other requirements of ERISA. The definitions of employee welfare benefit plan in Section 3(1)<sup>149</sup> and employee pension benefit plan in Section 3(2)<sup>150</sup> include most plans offering employee fringe and retirement benefits established or

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145. ERISA § 3(14), 29 U.S.C. § 1002(14), defines "party in interest" to include "any fiduciary (including, but not limited to, any administrator, officer, trustee, or custodian), counsel, or employee of such employee benefit plan [or] a person providing services to such a plan." ERISA § 2003(a), I.R.C. § 4975(e)(2), defines "disqualified person" to include "a fiduciary [or] a person providing services to the plan." The labor and tax statutory provisions differ in an important respect. Section 406(a)(1) is violated if a fiduciary "knows or should know that the transaction constitutes a direct or indirect [prohibited transaction]." Section 4975(a)(1), which imposes an excise tax on "any disqualified person who participates in [a prohibited transaction]," has no comparable state-of-mind qualifying condition. Also, the event resulting in the prohibited transaction imposes the tax, subject to waiver (see I.R.C. C.F.R. § 54.4975-1(d)(2)); imposition of an administrative penalty is discretionary with the Secretary of Labor "if the transaction is not corrected" as prescribed by the Secretary. See ERISA § 502(i), 29 U.S.C. § 1132(i).

146. *Fiduciary Definition*, *supra* note 123.

147. See *infra* text accompanying notes 293-305; see also Joyce, *supra* note 127; Lokshin, *supra* note 127.

148. See ERISA § 4, 29 U.S.C. § 1003. Application of the fiduciary responsibility provisions does not depend on the qualification of a plan. Unfunded deferred compensation plans for select employees and plans for retired partners, however, are specifically exempted from the fiduciary responsibility provisions. ERISA § 401(a), 29 U.S.C. § 1101(a) (2012).

149. ERISA § 3(1), 29 U.S.C. § 1002(1).

150. ERISA § 3(2), 29 U.S.C. § 1002(2).

maintained by an employee organization or employer, as those terms are defined in Sections 3(4)<sup>151</sup> and 3(5).<sup>152</sup>

*2. The Uniform Management of Public Employee Retirement Systems Act*

In 1997, the National Conference of Commissioners on Uniform State Laws approved the Uniform Management of Public Employee Retirement Systems Act ("UMPERSA").<sup>153</sup> A principal purpose of UMPERSA is to establish the fiduciary obligations of those with "discretionary authority" over public retirement systems.<sup>154</sup> UMPERSA is intended to replace state laws with broad statements of manager duty that the Commissioners found to preclude appropriate investments,<sup>155</sup> and is explicitly modeled on the Restatement (Third) of Trusts' Prudent Investor Rule.<sup>156</sup>

UMPERSA also draws from ERISA. Like ERISA, it requires system assets to be held in trust,<sup>157</sup> and UMPERSA enacts exclusive-benefit and fiduciary duty standards very similar to those found in ERISA.<sup>158</sup>

C. CHARITABLE ENDOWMENT FUNDS

*1. Private Foundations: The Internal Revenue Code*

Before the Tax Reform Act of 1969,<sup>159</sup> the only federal remedy for breaches of duty by investment managers serving private foundations was to disqualify such foundations from tax-preferred status. Now,

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151. ERISA § 3(4), 29 U.S.C. § 1002(4).

152. ERISA § 3(5), 29 U.S.C. § 1002(5).

153. 7A U.L.A. 510 (1999).

154. *Id.* at 511.

155. *Id.*; see also BINES & THEL, *supra* note 7, at § 8.03[B][2].

156. See BINES & THEL, *supra* note 7, at § 8.03[B][2].

157. UNIF. MGMT. OF PUB. EMP. RET. SYS. ACT § 4 (UNIF. LAW COMM'N 1997).

158. See *id.* § 7.

159. Tax Reform Act of 1969, Pub. L. 91-172, 83 Stat. 487 (1969). See generally W. Smith & C. Chiechi, Private Foundations Before and After the Tax Reform Act of 1969 (American Enterprise Institute for Public Research, 1974).

Section 4944(a)(2)<sup>160</sup> of the Internal Revenue Code and Regulation Section 53.4944-1(a)(2)<sup>161</sup> (implementing the section) provide that foundation managers are subject to tax sanctions for making investments without exercising ordinary business care and prudence so that the purposes of the foundation are jeopardized. Investment managers who are officers, directors, or trustees of a foundation also are subject to the requirements of Section 4944(a)(2).<sup>162</sup> In addition, they are defined in Section 4946(a)(1)(B)<sup>163</sup> of the Code as disqualified persons subject to tax in the event they engage in certain self-dealing transactions with the foundation. Aside from the possibility of incurring direct personal tax liability, an investment manager may also face civil sanctions as a result of its relationship with a private foundation. The Code imposes taxes for violations on foundations as well as on foundation managers, with this important distinction: Whereas foundation managers can avoid personal liability if their involvement is not willful or due to lack of reasonable care, a foundation has no such defense. It may well be, therefore, that an investment manager whose investment policies are held to violate the requirements of the Code, such that the foundation suffers tax sanctions, will also incur state-law liability, prosecuted most likely by the state attorney general, for making imprudent investments that result in imposition of an excise tax.

There are a number of organizations excepted from the Code's private foundation classification, principally schools, churches, hospitals, and organizations receiving substantial support from governmental bodies.<sup>164</sup> Management of these organizations' investments presents less of a hazard to investment managers since there is one less regulatory authority to worry about. But the very distinction

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160. I.R.C. § 4944(a)(2) (2012). There is also a tax imposed directly on the foundation. I.R.C. § 4944(a)(1). The legislative history shows clearly that the tax on investments and on foundation managers is to be related to investment of foundation assets "in a way which jeopardizes their use for the organization's exempt purpose." S. REP. NO. 91-552, at 45 (1969). According to the Committee, investments are to be judged "in accordance with a 'prudent trustee' approach . . . ." *Id.* at 46; *see also* Summary of H.R. 13270, The Tax Reform Act of 1969, Staff Report of the Joint Comm. on Internal Revenue Taxation and the Comm. on Finance, 91st Cong., 1st Sess. 16-17 (Aug. 18, 1969).

161. 26 C.F.R. § 53.4944-1(a)(2) (2015).

162. I.R.C. § 4946(b).

163. *Id.* § 4946(a)(1)(B).

164. *Id.* § 509(a)(1).

in treatment afforded excepted organizations emphasizes the importance of properly identifying their status, especially since the statutory scheme provides that a foundation is classified as a private foundation unless exempt.<sup>165</sup> Moreover, tax liabilities aside, on the question of investment policy, the standards of prudence developed for regulated foundations are equally well suited to setting standards of prudence for charitable endowment funds investing generally. The principal reason for tax regulation of private foundations is to prevent the use of foundations as tax havens. By regulating investment purpose, therefore, Congress insists that foundation endowments be managed consistently with the donative intent assumed to be the motive of contributors. Although there is little sign that Section 4944-1(a)(2) will be applied to do so, if federal tax law with respect to “prudent” investing for foundations develops further, such development could well serve as a broader model for other managers.<sup>166</sup>

## *2. Charitable Organizations: The Uniform Prudent Management of Institutional Funds Act*

Although the enforcement problems for charitable institutions are different from those for private trusts,<sup>167</sup> the trust duties of prudence and

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165. *Id.* § 509(a).

166. *See* BINES & THEL, *supra* note 7, at § 8.02[B][2][d]; *cf.* Rev. Rul. 78-90, 1978-1 CB 380 (Jan. 1978) (low-interest loans consistent with charitable purpose).

167. Generally, the enforcement responsibility for breaches of duty to a charitable trust or corporation resides with the state attorney general. *See, e.g.*, Cal. Gov. Code § 12598(a) (“The primary responsibility for supervising charitable trusts in California, for insuring compliance with trusts and articles of incorporation, and for protection of assets held by charitable trusts and public benefit corporations, resides in the Attorney General.”); RESTATEMENT (THIRD) OF TRUSTS § 94(2) (AM. LAW. INST. 2012); UNIF. TRUST CODE § 110(d) (UNIF. TRUST COMM’N 2000) (“The [attorney general of this State] has the rights of a qualified beneficiary with respect to a charitable trust having its principal place of administration in this State.”); Bennet B. Harvey, Jr., *The Public-Spirited Defendant and Others: Liability of Directors and Officers of Not-For-Profit Corporations*, 17 J. MARSHALL L. REV. 665, 696-99 (1984); Jennifer L. White, Note, *When It’s OK to Sell the Monet: A Trustee-Fiduciary-Duty Framework for Analyzing the Deaccessioning of Art to Meet Museum Operating Expenses*, 94 MICH. L. REV. 1041 (1996). Nonetheless, persons with a special interest and settlors who have properly reserved enforcement authority may do so also. *See* Johnson v. Johnson, 515 A.2d 255 (N.J. Super. 1986) (former trustee sued unsuccessfully for investment mismanagement, and for removal; attorney general joined for removal only); UNIF.



loyalty are essentially the same.<sup>168</sup> Even so, in the investment environment after World War II, it became apparent that many of the

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TRUST CODE § 405(c) (“The settlor of a charitable trust, among others, may maintain a proceeding to enforce the trust.”); *id.* cmt. (“Contrary to Restatement (Second) of Trusts § 391 (1959), subsection (c) grants a settlor standing to maintain an action to enforce a charitable trust. The grant of standing to the settlor does not negate the right of the state attorney general or persons with special interests to enforce either the trust or their interests.”); SCOTT, FRATCHER & ASCHER, *supra* note 7, at § 37.3.10; *cf.* James v. Gerber Prods. Co., 483 F.2d 944 (6th Cir. 1974) (beneficiary of testamentary trust has standing under Rule 10b-5 to sue purchaser of securities sold from trust). Third parties dealing with a charitable organization retain their right to sue for breach of duty to them, even where the breach occurs in carrying out the charitable organization’s charitable purpose. *See, e.g.,* Stern v. Lucy Webb Hayes Nat’l Training Sch. for Deaconesses and Missionaries, 381 F. Supp. 1003 (D.D.C. 1974).

168. According to the comments of Restatement (Third) of Trusts, P.I.R., § 389 cmt. (AM. LAW. INST. 1992), “[i]n making decisions and taking actions with respect to the investment of trust funds, the trustee of a charitable trust is under a duty similar to that of the trustee of a private trust. However, “social considerations may be taken into account in investing the funds of charitable trusts to the extent the charitable purposes would justify an expenditure of trust funds for the social issue or cause in question or to the extent the investment decision can be justified on grounds of advancing, financially or operationally, a charitable activity conducted by the trust.” RESTATEMENT (THIRD) OF TRUSTS § 90, cmt. c (AM. LAW. INST. 2007). RESTATEMENT (THIRD) OF TRUSTS, P.I.R., § 379 cmt. stated:

The trustee of a charitable trust, like the trustee of a private trust, must comply with valid terms of the trust, except as the doctrine of *cy pres* is applied or deviation is authorized, and is subject to normal fiduciary duties: to administer the trust; to administer it solely in the interest of effectuating the charitable purposes; to act with impartiality with respect to different charitable purposes and different interests in the trust; to delegate as a prudent investor would delegate; to keep and render clear and accurate accounts with respect to the administration of the trust; to furnish complete and accurate information as to the nature and amount of the trust property; to exercise such care and skill in administering the trust as a manager of ordinary prudence would exercise; to take reasonable steps to assume and maintain control of the trust property; to use reasonable care and skill to preserve the trust property; to take reasonable steps to realize on claims that are a part of the trust property; to defend actions that may result in a loss to the trust estate, unless it is reasonable not to make such defense; to keep trust property separate from the trustee’s individual property; to act properly in making deposits of trust funds in a bank; to use

restrictions on the administration of private trusts were harming charitable trusts. In particular, trustees of charitable trusts desired clear authority to delegate investment responsibility to professional investment managers and to participate in a wider range of investment opportunities, as well as more power to disregard the distinction between principal and income in order to meet current expenses.<sup>169</sup> With the publication of two influential reports on these matters concerning college endowment funds as a catalyst,<sup>170</sup> the National Conference of Commissioners on Uniform State Laws undertook to fashion a statute that would be responsive to the investment needs of charitable institutions. In 1972, the Conference approved the Uniform Management of Institutional Funds Act ("UMIFA"),<sup>171</sup> which authorized the prudent expenditure of capital appreciation "for the uses and purposes for which an endowment fund is established,"<sup>172</sup> the making of certain kinds of investments "without restriction to investments a fiduciary may make,"<sup>173</sup> and the delegation of investment authority and

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reasonable care and skill to make the trust property productive; and to incur expenses only on a reasonable basis. (citations omitted.)

169. If the terms of a charitable trust call for both the expenditure of income and preservation of corpus, they require the trustee to respond to both present and future objectives. See RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. i.

170. See CARY & BRIGHT, ENDOWMENT FUNDS, *supra* note 14; ADVISORY COMMITTEE ON ENDOWMENT MANAGEMENT, MANAGING EDUCATIONAL ENDOWMENTS: REPORT TO THE FORD FOUNDATION (1969); see also J. PETER WILLIAMSON, PERFORMANCE MEASUREMENT AND INVESTMENT OBJECTIVES FOR EDUCATIONAL ENDOWMENT FUNDS (1972); William L. Cary & Craig B. Bright, *The "Income" of Endowment Funds*, 69 COLUM. L. REV. 396 (1969).

171. 7A U.L.A. 475 (1999). For a discussion on the influence of the federal rules on private foundations, see BINES & THEL, *supra* note 7, at § 2.04[C][1]. On the language of UMIFA, see RESTATEMENT (THIRD) OF TRUSTS § 90 reporter's notes. The UMIFA standard of care is discussed in BINES & THEL, *supra* note 7, at § 8.02[C].

172. UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT § 2. On the wisdom of using principal for current expenses, see *The Harvard-Yale Game*, 8 INSTITUTIONAL INVESTOR 46 (Sept. 1972); *Let's Not Strangle the Golden Goose: An Open Letter to Harvard's President from Paul Cabot*, *id.* at 50; see also Shakin, *Down to Its Last \$2 Billion: Ford Foundation Is Tightening the Purse-Strings*, BARRON'S, June 2, 1975, at 11.

173. UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT § 4.

payment of compensation to “independent investment advisors, investment counsel or managers, banks, or trust companies . . . .”<sup>174</sup>

Broadly speaking, trustees of charitable trusts are subject to the same duties of prudence and loyalty as are other trustees.<sup>175</sup> UMIFA, however, restated the standard of care for members of a “governing board.”<sup>176</sup> Under UMIFA, governing board members are subject to a standard of “ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision.”<sup>177</sup> The Commissioners described this standard as “generally comparable to that of a director of a business corporation rather than that of a private trustee,” and they explained their purpose as follows:

Fear of liability of a private trustee may have a debilitating effect upon members of a governing board, who are often uncompensated public-spirited citizens. They are managers of nonprofit corporations guiding a unique and perhaps very large institution. The proper standard of responsibility is more analogous to that of a director of a business corporation than that of a professional private trustee. The Act establishes a standard of business care and prudence in the context of the operation of a nonprofit institution.<sup>178</sup>

The extent to which UMIFA departs from the prudent-investor rule depends on the manner in which UMIFA is construed in states that adopted it.<sup>179</sup> It is clear that a material distinction was intended. Indeed, even after the UMIFA was promulgated, some states, including Massachusetts, continued to favor a standard closely aligned, in language at least, with *Harvard College*. For example, long after that promulgation, Massachusetts law continued to provide that:

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174. *Id.* § 5.

175. See BINES & THEL, *supra* note 7, at § 2.04[C][2].

176. UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT § 1(4) (defining the governing board as “the body responsible for management” of a charitable institution or its funds).

177. *Id.* § 6.

178. HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS AND PROCEEDINGS OF THE ANNUAL CONFERENCE MEETING IN ITS EIGHTY-FIRST YEAR 190 (1972).

179. See 5 SCOTT, FRATCHER & ASCHER, *supra* note 7, at § 37.3.8 n. 15 (adopting states). At the time UMIFA was approved, many states had a far more restrictive view of a trustee’s investment discretion than contemplated by *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446, 461 (1830), much less the rule as adopted in RESTATEMENT (THIRD) OF TRUSTS § 90. See 5 SCOTT, FRATCHER & ASCHER, *supra* note 7, at § 37.3.8.

No member of the governing board shall be liable for any action taken or omitted with respect to such appropriation or accumulation or with respect to the investment of institutional funds, including endowment funds, under the authority granted in this chapter, if such member shall have discharged the duties of his position in good faith and with that degree of diligence, care and skill which prudent men would ordinarily exercise under similar circumstances in a like position.<sup>180</sup>

In 2006, the Conference of Commissioners on Uniform State Laws modified UMIFA, and renamed it the Uniform Prudent Management of Institutional Funds Act (“UPMIFA”).<sup>181</sup> UPMIFA’s prudence standard no longer uses the “ordinary business care” language, but instead rings closer rings to *Harvard College*. Section 3(b) of UPMIFA provides in relevant part that, “each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.”<sup>182</sup> The comments noted the departure from the “ordinary business care and prudence” language of the UMIFA, but also stated that the new standard “is consistent with the business judgment standard under corporate law, *as applied to charitable institutions*.”<sup>183</sup>

This was apparently enough for Massachusetts, which in 2009 amended its Uniform Prudent Management of Institutional Funds Act: “In addition to complying with the duty of loyalty imposed by law other than this chapter, each person responsible for managing and investing an

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180. MASS. GEN. LAWS ANN. ch. 180A § 8 (amended 2009); *see also* CAL. PROB. CODE § 18506(a) (repealed 2008) (“When investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing property, appropriating appreciation, and delegating investment management for the benefit of an institution, the members of the governing board shall act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of like character and with like aims to accomplish the purposes of the institution. In the course of administering the fund pursuant to this standard, individual investments shall be considered as part of an overall investment strategy.”).

181. UNIF. PRUDENT MGMT. OF INSTITUTIONAL FUNDS ACT (2006).

182. *Id.* § 3(b).

183. *Id.* § 3 cmt. (emphasis in original); *see also* Susan N. Gary, *Charities, Endowments, and Donor Intent: The Uniform Prudent Management of Institutional Funds Act*, 41 GA. L. REV. 1277 (2007).

institutional fund shall manage and invest the fund in good faith and with the care that an ordinarily prudent person in a like position would exercise under similar circumstances.”<sup>184</sup>

#### D. HOLDERS OF DEBT SECURITIES: THE TRUST INDENTURE ACT OF 1939

The purpose of the Trust Indenture Act of 1939<sup>185</sup> is to provide, through independent trustees, protection for holders of debt securities, which, because of the size of the issue and the number of security holders, must be issued under indentures and administered through a central supervising authority.<sup>186</sup> In normal circumstances, the work of an indenture trustee involves administrative duties far more than investment management. Nonetheless, issuers occasionally seek to alter the security underlying their obligations, and the process of deciding whether to approve or disapprove can require investment analysis of high quality from an indenture trustee.<sup>187</sup> Furthermore, should it be necessary for an indenture trustee to avail itself of its creditor’s remedies, issues involving more active investment management may arise. In all events, Section 315(c) of the Trust Indenture Act<sup>188</sup> imposes on the trustee a statutory duty of prudence in carrying out all its responsibilities after default. Additionally, the theoretical independence of the indenture trustee frequently is unsupported by the facts, since indenture trustees usually have commercial relations with the debtor and, indeed, may obtain office by virtue of those relations. With middling effectiveness, the Trust Indenture Act also tries to deal with the conflicts of interest that occur when the indenture trustee is not truly independent.

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184. MASS. GEN. LAWS ANN. ch. 180A § 2 (West 2015) (following UPMIFA, but adding the word “that”); *see also* CAL. PROB. CODE § 18503(b) (West 2015).

185. *See* Trust Indenture Act of 1969, Pub. L. No. 76-253, 53 Stat. 1149 (codified as amended at 15 U.S.C. §§ 77aaa—77bbb (2012)).

186. *See* 4 LOSS, SELIGMAN & PAREDES, *supra* note 52, at ch. 4.

187. *See, e.g.*, Royce De R. Barondes, *An Economic Analysis of the Potential for Coercion in Consent Solicitations for Bonds*, 63 FORDHAM L. REV. 749 (1994); William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 172 (1989); Marcel Kahan, *Rethinking Corporate Bonds: The Trade-off Between Individual and Collective Rights*, 77 N.Y.U. L. REV. 1040 (2002).

188. Trust Indenture Act § 315(c), 15 U.S.C. § 77ooo(c).

## E. CROWDFUNDING

The Jumpstart Our Business Startups Act (the “JOBS Act”),<sup>189</sup> enacted in 2012, was designed to reduce the regulatory burden of the securities laws on businesses raising investment funds. Among other changes, it was intended to facilitate “crowdfunding,” by which ventures may use the internet to seek relatively small investments from large numbers of investors. The JOBS Act added Section 4(a)(6) to the Securities Act,<sup>190</sup> which provides an exemption from registration under the Securities Act for small crowdfunding transactions provided, among other things, that the aggregate amount sold to any single issuer is limited to:

(i) the greater of \$2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than \$100,000; and

(ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of \$100,000, if either the annual income or net worth of the investor is equal to or more than \$100,000.<sup>191</sup>

The exempted transactions must be conducted through a broker or a “funding portal” that complies with the requirements of new Section 4A of the Securities Act.<sup>192</sup> The SEC’s proposed implementation of the crowdfunding provisions of the JOBS Act was criticized, and it is not clear how the crowdfunding market will evolve, if it does.<sup>193</sup> However, the statute contemplates that brokers and funding portals will play a central role in crowdfunding. Among other things, they will screen

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189. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (codified as amended in scattered sections of 15 U.S.C.).

190. JOBS Act § 4(a)(6), 15 U.S.C. § 77d(a)(6).

191. JOBS Act § 4(a)(6), 15 U.S.C. § 77d(a)(6).

192. 15 U.S.C. § 77d-1.

193. See, e.g., Brian Korn, *The Trouble with Crowdfunding*, FORBES (April 14, 2013, 2:59 PM), <http://www.forbes.com/sites/deborahljacobs/2013/04/17/the-trouble-with-crowdfunding> [<http://perma.cc/9NU6-X2AM>]; see also Ruth Simon & Angus Loten, *Frustration Rises over Crowdfunding Rules*, WALL ST. J. (April 30, 2014), <http://www.wsj.com/articles/SB10001424052702304163604579532251627028512> [<http://perma.cc/KS6L-NJU2>].

investors to assure that they do not over-invest. In October 2015, the SEC adopted a regulatory framework for crowdfunding under the JOBS Act, and much of the very long adopting release focused on the qualifications and obligations of fund portals and broker intermediaries.<sup>194</sup>

#### F. MUNICIPAL ADVISERS

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”)<sup>195</sup> amended Section 15B of the Exchange Act to require “municipal advisers” to register with the SEC.<sup>196</sup> Municipal advisers are persons who are not municipal entities, or employees who give advice to or on behalf of municipal entities with respect to municipal financial products, or the issuance of municipal securities, or solicit municipal entities.<sup>197</sup> This broad definition encompasses “financial advisors, guaranteed investment contract brokers, third-party marketers, placement agents, solicitors, finders, and swap advisors” that advise municipalities.<sup>198</sup> The focus of the regulatory scheme relates largely to the issuance of securities by municipalities, but the definition of “municipal financial product”<sup>199</sup> includes “investment strategies,” which in turn includes plans or programs for the investment of proceeds of municipal securities.<sup>200</sup>

In November 2013, the SEC adopted Rules 15Ba1-1 through 15Ba-8,<sup>201</sup> which establish a registration regime for municipal advisers and require them to keep records.<sup>202</sup> The rules were to become effective in January 2014, but the Commission temporarily stayed the rules and

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194. Securities Act Release No. 9974 (Oct. 30, 2015); *see also* Securities Act Release No. 9470, (CCH) FED. SEC. L. REP. ¶ 80,470 (Oct. 23, 2013) (proposing release).

195. Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 15 U.S.C.).

196. 15 U.S.C. § 78o-4(a)(1).

197. Securities Exchange Act § 15B(e)(4)(A), 15 U.S.C. § 78o-4(e)(4)(A).

198. Exchange Act Release. Release No. 70462 at 35 (Sept. 20, 2013).

199. 15 U.S.C. § 78o-4(e)(5).

200. Securities Exchange Act § 15B(e)(2), 15 U.S.C. § 78o-4(e)(2).

201. 17 C.F.R. §§ 240.15Ba1-1—240.15Ba-8 (2015).

202. Registration of Municipal Advisors, Securities Exchange Act Release No. 34-70462 (September 20, 2013), 78 Fed. Reg. 67467 (Nov. 12, 2013).

related forms until July 1, 2014, to allow market participants adapting their policies and procedures to comply with the rules.<sup>203</sup>

#### IV. REGULATION BY TYPE OF MANAGER

The primary sources of professional investment management services are the trust departments of banks, insurance companies (which manage variable annuity and variable life insurance products through separate accounts registered as investment companies), investment advisers and counselors, and brokerage firms. Although some cross-regulation occurs, separate regulatory systems control most of these organizations. Moreover, they are subject not only to different sets of rules, but also to regulation by different administrative authorities.

##### A. BANK TRUST DEPARTMENTS: REGULATION BY THE FEDERAL RESERVE AND THE COMPTROLLER OF THE CURRENCY

Because bank trust departments receive their authority to act from, and are regulated by, both state and federal authorities,<sup>204</sup> their investment management duties and obligations may differ depending on the jurisdiction exercising regulatory authority. Since federal law governing national banks is broader than state law in coverage and is representative of relevant state law in design, federal law is the model used in this Article. The trust law obligations of state banks are generally a matter of state trust law.<sup>205</sup>

The Federal Reserve Act conferred authority on the Federal Reserve Board to grant trust powers to national banks, a power now held

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203. Registration of Municipal Advisors; Temporary Stay of Final Rule, Securities and Exchange Act Release No. 34-71288, (Jan. 13, 2014).

204. See 5 SCOTT, FRATCHER & ASCHER, *supra* note 7, at § 11.1.6.2; see also *Lewis v. BT Inv. Managers, Inc.*, 447 U.S. 27 (2000) (holding unconstitutional state statute that prohibited out-of-state banks from owning or controlling in-state provider of investment advisory services).

205. See FEIN, *supra* note 46, at § 12.03; see also 5 SCOTT, FRATCHER & ASCHER, *supra* note 7, § at 11.1.6.2. For nonmember state banks required to become insured by the FDIC, the FDIC inspects trust activities, formerly in conformity with national bank inspection requirements under Regulation 9 (12 C.F.R. pt. 9 (2015)), but now subject to the standards set by the FDIC, except for 12 C.F.R. § 9.18 (“Collective Investment Funds”). See FDIC Trust Examination Manual § 1.B (2001).



by the Comptroller of the Currency.<sup>206</sup> Initial rudimentary controls over the trust activities of national banks appeared as early as 1933 in the Glass-Steagall Act<sup>207</sup> (substantial portions of the Glass-Steagall Act were repealed in 1999).<sup>208</sup> At present, the most significant federal regulations are those of the Comptroller of the Currency, who was authorized in 1962 to grant fiduciary powers to national banks by special permit, so long as those trust activities do not violate local law.<sup>209</sup> A number of traditional restrictions, such as a prohibition of commingling trust accounts and general funds, were also enacted at that time.

The enabling statute itself contemplates that the trust powers of national banks will mirror those of local state banks.<sup>210</sup> Generally, a

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206. 12 U.S.C. § 92a(a) (2012). The Federal Reserve Act has been amended so frequently that no useful catalogue of its codification is possible save a statement that, as amended, it is generally dispersed throughout Title 12 of the United States Code.

207. Banking Act of 1933 (Glass-Steagall Act), ch. 89, 48 Stat. 162, *repealed in part by* Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 101(a), 113 Stat. 1338, 1341 (1999). The Glass-Steagall Act was designed primarily to “reduce the risk that inventory losses in speculative securities might jeopardize the stability of banks and the banking system,” Gerald T. Dunne, *Glass-Steagall Act—A History of Its Legislative Origins and Regulatory Construction*, 92 BANKING L. J. 38, 41-42 (1975), and was directed mainly at banks dealing in securities for their own accounts. Banks traditionally acted as trustees and managing agents for individual accounts, and this activity did not violate the Glass-Steagall Act’s separation of investment and commercial banking. *See* *Invest. Co. Inst. v. Camp*, 401 U.S. 617 (1971). Thus, ordinary bank trust activities did not implicate the Glass-Steagall Act. *See* FEIN, *supra* note 46, at § 12.04[E]. Nevertheless, the legislative history of the Act did contain some indication of concern with the activities of trust departments, *see*, for example, 77 CONG. REC. 3491-3493 (1933) (remarks of Rep. McFadden), and many provisions of the statute could have application in that area. *See, e.g.*, *Invest Co. Inst.*, 401 U.S. at 617 (prohibiting collective agency accounts). The Glass-Steagall Act, its post-enactment history and its partial repeal by the Gramm-Leach-Bliley Act are extensively discussed in FEIN, *supra* note 46, ch. 1, 4.

208. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 101(a), 113 Stat. 1338, 1341 (1999).

209. 12 U.S.C. § 92a(a).

210. *See id.* (The “Comptroller of the Currency shall be authorized and empowered to grant by special permit to national banks applying therefor, when not in contravention of State or local law, the right to act as trustee, executor, administrator, registrar of stocks and bonds, guardian of estates, assignee, receiver, committee of estates of lunatics, or in any other fiduciary capacity in which State banks, trust companies, or other corporations which come into competition with national banks are permitted to act under the laws of the State in which the national bank is located.”); *see*

national bank may not exercise fiduciary powers without first obtaining approval from the Office of the Comptroller.<sup>211</sup> Part 9 of the Comptroller's regulations governs the fiduciary activities of national banks.<sup>212</sup> Although its various rules are largely directed at trust administration from the view of preventing unsound activities that might expose a bank to liability, Part 9 does deal with the manner in which those assets are managed, particularly with respect to collective investment funds.<sup>213</sup> As a supplement to the regulations, the Comptroller publishes general guidelines and issues opinions on specific matters, including a series of relevant handbooks.<sup>214</sup>

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also OCC, *Annual Reviews of Fiduciary Accounts Pursuant to 12 C.F.R. § 9.6(c)* (Mar. 27, 2008), <http://occ.gov/news-issuances/bulletins/2008/bulletin-2008-10.html> [<http://perma.cc/3VCG-DCN7>]; Office of the Comptroller of the Currency, *Fiduciary Activities of National Banks*, 66 Fed. Reg. 34,792 (July 2, 2001) (stating that "[t]he Contravention Clause in section 92a(a) requires that a national bank look to the laws of the state in which it acts, or proposes to act, in a fiduciary capacity to determine what fiduciary capacities are permissible."). The Comptroller's rules require national banks to "invest funds of a fiduciary account in a manner consistent with applicable law," 9 C.F.R. § 9.11, and define "applicable law" to mean "the law of a state or other jurisdiction governing a national bank's fiduciary relationships, any applicable Federal law governing those relationships, the terms of the instrument governing a fiduciary relationship, or any court order pertaining to the relationship." 9 C.F.R. § 9.2(b).

211. 12 C.F.R. § 9.3, § 5.26; *see also id.* § 9.2(g) (defining "fiduciary powers"). Once a national bank has obtained the Comptroller's permission to exercise fiduciary powers, it generally need not obtain prior approval to engage in other fiduciary activities or to exercise those powers in another state, but instead need only give notice. *See id.* § 9.3(b); *see also* Office of the Comptroller of the Currency, *Fiduciary Activities of National Banks*, 66 Fed. Reg. 34,792 (July 2, 2001). The Comptroller may also charter national banks that limit themselves to the operation of trust companies. *See* 12 U.S.C. § 27(a).

212. 12 C.F.R. pt. 9; *see also* BINES & THEL, *supra* note 7, at § 8.02[B][2][a].

213. *See, e.g.,* 12 C.F.R. § 9.11 (investment of fiduciary funds); *id.* § 9.18 (collective investment funds); *see also id.* § 9.4 (administration of trust activities); *id.* § 9.5 (written procedures); *id.* § 9.6 (review of accounts); *id.* § 9.8 (recordkeeping); *id.* § 9.9 (audits of fiduciary activities); *id.* § 9.10 (funds awaiting investment or distribution); *id.* § 9.12 (conflicts of interest); *id.* § 9.13 (custody of assets); *id.* § 9.15 (compensation).

214. *See, e.g.,* Office of the Comptroller, *Comptroller's Handbook: Asset Management: Collective Investment Funds* (May 2014); Office of the Comptroller, *Comptroller's Handbook: Asset Management: Retirement Plan Products and Services* (Feb. 2014); Office of the Comptroller, *Comptroller's Handbook: Asset Management: Unique and Hard-to-Value Assets* (Aug. 2012); Office of the Comptroller,

In addition to traditional trust services, banks increasingly offered investment advisory services and brokerage services to institutional and retail customers even under the strictures of the Glass-Steagall Act. By 1989, for example, the Federal Reserve Board ruled that the parent of a national bank could provide investment advisory and brokerage services to institutional and retail customers through a subsidiary.<sup>215</sup> With the partial repeal of Glass-Steagall, banks and their affiliates have even greater authority to offer advisory, brokerage, fiduciary and mutual fund services, albeit sometimes under supervision of the SEC.

As banks expanded their investment management and other activities relating to the securities markets, the SEC sought regulatory authority over bank securities activities, including those of trust departments.<sup>216</sup> The Gramm-Leach-Bliley Act extended the SEC's authority over certain bank activities, under the guise of functional regulation, but traditional bank trust activities remain outside Commission control.<sup>217</sup> Gramm-Leach-Bliley also repealed the long-standing exclusion of banks from the definition of "broker" in the Exchange Act.<sup>218</sup> Banks that meet the statutory definition (i.e., any person engaged in the business of effecting transactions in securities for the account of others) still are not brokers if they confine their activities to trust activities (and certain others).<sup>219</sup> Specifically, Section 3(a)(4)(B)(ii) provides that a bank shall not be considered a broker where the bank effects transactions in a trustee capacity, or effects

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Comptroller's Handbook: Asset Management Operations and Controls (Jan. 2011); Office of the Comptroller, Comptroller's Handbook: Asset Management (Dec. 2000); Office of the Comptroller, Comptroller's Handbook: Conflicts of Interest (Jan. 2015/June 2000); Comptroller's Handbook: Investment Management Services (Aug. 2001); Office of the Comptroller, Comptroller's Handbook: Personal Fiduciary Activities (Feb. 2015). These publications are available on the Office of the Comptroller's web site. See OCC, <http://www.occ.treas.gov/handbook/amgt.htm> [<http://perma.cc/5AGX-EGX2>]; see also OCC, THE DIRECTOR'S BOOK 61-64 (2010) <http://www.occ.treas.gov/director.pdf> [<http://perma.cc/CB62-2N6Q>] (director responsibility for administering trust activities),

215. PNC Financial Corp. [1989-1990 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 87,614 (Mar. 14, 1989); see also FEIN, *supra* note 46, at §§ 1.03, 1.04, 1.05 (chronicling regulatory and judicial relief for banks).

216. See FEIN, *supra* note 46, at § 3.01[C](1)B].

217. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

218. Gramm-Leach-Bliley Act § 201; see also Securities Exchange Act § 3(a)(4), 15 U.S.C. § 78c(a)(4) (defining "broker").

219. 15 U.S.C. § 78c(a)(4)(B).

transactions in a fiduciary capacity in its trust department or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards, and—

(I) is chiefly compensated for such transactions, consistent with fiduciary principles and standards, on the basis of an administration or annual fee (payable on a monthly, quarterly, or other basis), a percentage of assets under management, or a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers, or any combination of such fees; and

(II) does not publicly solicit brokerage business, other than by advertising that it effects transactions in securities in conjunction with advertising its other trust activities.<sup>220</sup>

In addition to subjecting banks to “fiduciary principles and standards,” this statutory exclusion is conditioned on the banks’ directing trades in publicly traded securities to a registered broker or dealer for execution.<sup>221</sup>

Gramm-Leach-Bliley also changed the way that banks are treated under the Exchange Act’s definition of “dealer.”<sup>222</sup> Banks are no longer excluded in total from the definition, but a bank is not a dealer merely because it “buys or sells securities for investment purposes . . . for accounts for which the bank acts as a trustee or fiduciary.”<sup>223</sup> In sum, and speaking broadly, banks are now subject to SEC regulation if they are brokers and dealers, but traditional trust activities do not make banks brokers or dealers.

In May 2001, the SEC adopted “interim final rules” to implement the new exclusions for banks, but extended the general exception from broker-dealer registration until October 1, 2001.<sup>224</sup> Banks and bank

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220. *Id.* § 78c(a)(4)(B)(ii); *see also id.* § 78c(a)(4)(D) (defining “fiduciary capacity”).

221. *Id.* § 78c(a)(4)(C).

222. Gramm-Leach-Bliley Act § 202; *see also* 15 U.S.C. § 78c(a)(5) (defining “dealer”).

223. Securities Exchange Act § 3(a)(5)(C)(ii), 15 U.S.C. § 78c(a)(5)(C)(ii).

224. SEC, Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities

regulators alike criticized the rules intensely, and in response, the Commission extended the exemption from registration and proposed further changes in the rules.<sup>225</sup> The Commission finally adopted final rules in February 2003, which deal primarily with the exclusion for banks dealing with asset-backed securities.<sup>226</sup>

In 2004, the SEC proposed a new Regulation B, which would permit banks, thrifts and credit unions to affect a variety of securities transactions without coming within the definition of “broker” within the Exchange Act.<sup>227</sup> After proposing Regulation B, the SEC further extended the temporary exemption of banks, savings associations, and savings banks from the definition of “broker” to give itself time to consider comments to Regulation B and particularly harsh criticism from bank regulators.<sup>228</sup> Subsequently, the Financial Services

Exchange Act of 1934, Exchange Act Release No. 44291, 66 Fed. Reg. 27,760 (May 18, 2001).

225. SEC, Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exchange Act Release No. 46745, 67 Fed. Reg. 67,496 (Nov. 5, 2002).

226. SEC, Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exchange Act Release No. 47364, 68 Fed. Reg. 8686, (Feb. 24, 2003). *But see id.* at 8695 n.83 (stating “[w]e note, however, that in giving meaning to the term ‘fiduciary’ in Section 3(a)(5)(C)(ii), we look to the legislative history. The legislative history states that [Exchange Act Section 3(a)(5)] ‘“excepts a bank from the definition of ‘dealer’ when it buys and sells securities for investment purposes for the bank or for accounts for which the bank acts as trustee or fiduciary. This mirrors existing law distinguishing between investors and dealers, and is limited to the portfolio trading of the bank and accounts for which it makes investment decisions.”’”) (citing H.R. REP. NO. 106-74, pt. 3, at 170-171 (1999)).

227. Exchange Act Release No. 49,879, 69 Fed. Reg. 39,682 (June 30, 2004); *see also* Timothy R. McTaggart, *Thrift Exception under the Investment Advisers act: The Thrifts Quests for Parity with the Banks*, INV. LAW., Mar. 2005, at 10; *SEC Proposes Rule for Bank Brokers, Sees Ongoing Dialogue with Bank Regulators*, 36 SEC. REG. & L. REP. 1021 (2004).

228. Order Extending Temporary Exemption of Banks, Savings Associations, and Savings Banks From the Definition of “Broker” under Section 3(a)(4) of the Securities Exchange Act of 1934, Exchange Act Release No. 50,618, 69 Fed. Reg. 64,607 (Nov. 5, 2004). Bank regulators harshly criticized proposed Regulation B. *Regulators Criticize SEC Bank Proposals*, WALL ST. J., Oct. 11, 2004, at C3. The Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency filed a critical comment letter with the SEC on Oct. 8, 2004. BD. OF GOVERNORS OF THE FED. RESERVE SYS., FDIC, OFFICE OF THE COMPTROLLER OF THE

Regulatory Relief Act of 2006 directed the Federal Reserve Board and the SEC to adopt a single set of rules to implement the Exchange Act's bank exception.<sup>229</sup> At the end of 2006, the SEC and the Federal Reserve Board jointly proposed rules that would make clear that the exception extends to banks involved in a relatively wide variety of securities-related activities or referring customers to registered broker-dealers.<sup>230</sup> At the same time, the SEC withdrew proposed Regulation B.<sup>231</sup>

In 2007, the SEC and the Federal Reserve Board jointly adopted final rules, designated Regulation R, that except banks from the definition of "broker" when they engage in certain third-party networking arrangements and trust and fiduciary, sweep, custody, and safekeeping activities.<sup>232</sup> The agencies also indicated that they would thenceforth act jointly in issuing interpretations and no-action letters concerning the new rules.

#### B. INVESTMENT ADVISERS: THE INVESTMENT ADVISERS ACT OF 1940

The Investment Advisers Act of 1940 (the "Investment Advisers Act" or "Advisers Act"),<sup>233</sup> originally designed as little more than a

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CURRENCY, COMMENT LETTER ISSUED ON THE SEC'S PROPOSED BROKER RULES FOR BANKS (2004), <http://www.occ.gov/static/news-issuances/news-releases/2004/nr-ia-2004-93.pdf> [<http://perma.cc/T7VY-U5BB>].

229. Financial Services Regulatory Relief Act of 2006, Pub. L. No. 109-351 §101, 120 Stat. 1966 (codified as amended at 15 U.S.C. §78c(a)(4)(F) (2012)).

230. Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks, Exchange Act Release No. 54945, 2006 SEC LEXIS 2942 (Dec. 18, 2006). The Regulatory Relief Act also amended the definition of "bank" in Exchange Act §3(a)(6) (codified as amended at 15 U.S.C. §78c(a)(6)) to include federal savings associations and other savings associations insured by the FDIC, and the proposed rules would apply to their status as broker as well.

231. Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks, Exchange Act Release No. 54945, 2006 SEC LEXIS 2942 (Dec. 18, 2006).

232. 17 C.F.R. § 247.100 to 247.781 (2015); *see* Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks, Exchange Act Release No. 56,501, 72 Fed. Reg. 56,514, 2007 SEC Lexis 2169 (Oct. 3, 2007); *see also* Exchange Act Release No. 56,501A, 73 Fed. Reg. 20,779 (Apr. 17, 2008) (technical amendments); David F. Freeman, Jr., *SEC and Federal Reserve Finalize Regulation R, Bank Broker and Dealer Exemptions*, INV. LAW. Nov. 2007, at 1.

233. 15 U.S.C. §§ 80b-1 *et seq.* In addition to the Investment Advisers Act, state Blue Sky laws also regulate investment advisers.

census-type licensing law,<sup>234</sup> has become a statute with substantive regulatory power over investment managers. The provisions of the Advisers Act extend, according to the statutory definition of “investment adviser” in Section 202(a)(11),<sup>235</sup> to every person in the business of offering investment advice to others for a fee, unless a statutory or regulatory exclusion is available.

With certain important exceptions, statutory investment advisers must register with the SEC.<sup>236</sup> The Advisers Act was amended in 1996 in a manner designed to split the registration of investment advisers between the states and the SEC.<sup>237</sup> As a result, an investment adviser that was not an adviser to a registered investment company could not register with the SEC if it had less than \$25 million under management and was regulated (or required to be regulated) as an investment adviser in the state of its principal office.<sup>238</sup>

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234. In 1940, David Schenker, the Chief Counsel of the SEC Investment Trust Study, described the purposes of Title II of Section 3580, the SEC’s proposal for regulating investment companies and investment advisers, in the following terms:

Now, I cannot impress too strongly upon the Senators the fact that our title 2 does not attempt to say who can be an investment counselor, and does not even remotely presume to undertake to pass upon their qualifications. All we say is that in order to get some idea of who is in this business and what is his background, you cannot use the mails to perform your investment counsel business unless you are registered with us.

*Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. Pt. 1, at 50 (1940). It should be noted however, that the title also contains antifraud and other prohibitory provisions directed at practices of advisers. *See e.g.*, Investment Advisers Act § 206, 15 U.S.C. § 80b-6 (1970). These received some attention in debate: “[t]he bill makes fraudulent practices by investment advisers unlawful and requires investment advisers . . . to register with the Commission which is empowered to deny registration to individuals convicted . . . for securities frauds.” 86 CONG. REC. 9809 (1940) (remarks of Rep. Cole).

235. 15 U.S.C. § 80b-2(a)(11).

236. *Id.* § 80b-3.

237. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416, 3437 (codified as amended at 15 U.S.C. § 80b-20 (2014)); *see* Stevens & Tyler, *supra* note 61.

238. Investment Advisers Act § 203A, 15 U.S.C. § 80b-3a; *see* Rule 203A-1, 17 C.F.R. § 275.203A-1 (increasing the \$25 million threshold); *see also* Rule 203A-2, 17 C.F.R. § 275.203A-2 (exemption from prohibition for certain small investment advisers)

In 2010, the Dodd-Frank Act pushed more small advisers into state regulation, increasing the threshold for federal regulation to \$100 million unless the adviser would have to register with 15 or more states or would not be subject to examination by the securities commissioner of its home state if it registered therein.<sup>239</sup> The SEC adopted regulations implementing the change in 2011.<sup>240</sup> A mid-sized adviser must register with the Commission unless it is registered with the securities commissioner in the state in which it maintains its principal place of business (or it would not be subject to examination as an investment adviser by the commissioner if it registered in that state).<sup>241</sup> The commission adopted a new rule, Advisers Act Rule 203A-5,<sup>242</sup> which provided for the withdrawal of mid-sized advisers from SEC registration and for the transition from federal to state regulation.

An investment adviser registers with the SEC by filing a Form ADV.<sup>243</sup> Over time, Form ADV has come to play a central role in the regulation of investment managers who are subject to the Advisers Act, and indeed is the primary regulatory tool to the extent that the Commission has relied upon disclosure as a means of regulation. The SEC's "brochure rule" requires investment advisers registered under the Act (or required to be registered) to "furnish each advisory client and prospective advisory client with a written disclosure statement which may be either a copy of Part II of its form ADV . . . or a written document containing at least the information . . . required by Part II of Form ADV."<sup>244</sup> The Advisers Act authorizes the SEC to require investment advisers to make extensive disclosure about their business

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239. Investment Advisers Act § 203A(a), 15 U.S.C. § 80b-3a(a) (as amended by Dodd-Frank Act § 410). Section 928 of the Dodd-Frank Act, entitled "Clarification that Section 205 of the Investment Advisers Act of 1940 Does Not Apply to State-registered Advisers," amended Investment Advisers Act § 205(a), 15 U.S.C. § 80b-5(a), to exempt state-only registered advisers from the restrictions on gain-based compensation.

240. See Rules Implementing Amendments to the Investment Advisers Act of 1940, Securities and Exchange Commission Release Act Release No. 3221 (June 22, 2011).

241. See Investment Advisers Act § 203A(a)(2), 15 U.S.C. § 80b-3a(a)(2). The Commission also amended Rule 203A-2(a), 17 C.F.R. § 275.203A-2(a), so that pension consultants advising plan assets of less than \$200 million will generally be registered and regulated by states.

242. 17 C.F.R. § 275.203A-5.

243. See Investment Advisers Act § 203(c)(1), 15 U.S.C. § 80b-3(c)(1); 17 C.F.R. § 275.203-1 (filing requirement); see also 17 C.F.R. § 275.203-1.

244. Rule 204-3, 17 C.F.R. § 275.204-3.



practices in their registration forms, and Part II of Form ADV requires just such disclosure, which is of course subject to rigorous antifraud provisions. Advisers must disclose the advisory services and fees they offer, their investment expertise, methods, information sources and strategies and execution procedures, among other things. For practical and political reasons, the Commission has frequently attempted to accomplish its substantive goals by tinkering with the disclosure requirements of the Form.<sup>245</sup>

Beyond registration and disclosure, the Advisers Act provides for substantive regulation of various activities of investment advisers. For example, Section 205(a) regulates adviser performance fees and the assignment of investment advisory contracts.<sup>246</sup> As noted above, Section 206 is a broad antifraud provision.<sup>247</sup>

At the same time the SEC adopted Investment Company Act Rule 38a-1, which requires every registered investment company to appoint a chief compliance officer and to institute written policies and procedures to prevent violations of the federal securities laws,<sup>248</sup> the SEC adopted Advisers Act Rule 206(4)-7,<sup>249</sup> which makes it unlawful for a registered investment adviser to provide investment advice unless it has implemented written policies and procedures reasonably designed to prevent it and its supervised persons from violating the Advisers Act.

Like Rule 38a-1, Rule 206(4)-7 does not set out the policies and procedures required. It is clear, however, that the SEC understands the rule to demand thorough and effective policies. As the SEC explained:

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245. Compare SEC, Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3221 (June 22, 2011) (adopting extensive changes to Form ADV to accomplish shift from federal to state registration for mid-sized investment advisers and the disclosure of information for advisers exempt from registration), with SEC, Investment Advisers Act Rel No. 3060, 75 Fed. Reg. 49,234 (July 28, 2010) (requiring plain English disclosure in brochures in Form ADV); and SEC, Disclosure by Investment Advisers Regarding Wrap Fee Programs, Investment Advisers Act Rel No. 1411, 59 Fed. Reg. 21,657 (April 19, 1994). *But see also* BINES & THEL, *supra* note 7, at §10.03[B][2] (proposals to require disclosure of brokerage direction practices).

246. 15 U.S.C. § 80b-5(a). The regulation of performance fees is discussed in BINES & THEL, *supra* note 7, at § 5.03[B][3].

247. 15 U.S.C. § 80b-6; *see also* BINES & THEL, *supra* note 7, at § 8.02[B][2][b].

248. *See supra* text accompanying note 80.

249. 17 C.F.R. §275.206(4)-7; *see also* SEC, Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, 68 Fed. Reg. 74,714 (Dec. 24, 2003) (adopting release).

Rule 206(4)-7 does not enumerate specific elements that advisers must include in their policies and procedures. Commenters [on the proposed rule] agreed with our assessment that funds and advisers are too varied in their operations for the rules to impose a single set of universally applicable required elements. Each adviser should adopt policies and procedures that take into consideration the nature of that firm's operations. The policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred.<sup>250</sup>

On the model of Rule 38a-1, its companion, the Investment Advisers Act rule, Rule 206(4)-7, also requires registered advisers to have a chief compliance officer and to review their policies and procedures annually to determine their adequacy and effectiveness.

The SEC also adopted Rule 204A-1, which requires investment advisers registered or required to be registered under the Advisers Act to maintain and enforce codes of ethics. The rule requires that the codes contain certain minimum standards, particularly with respect to securities trading by employees, but contemplates variation among firms.<sup>251</sup> Any supervised person working as a registered investment adviser who violates the code is required to report that violation to the adviser's chief compliance officer. Later in the year, the Investment Counsel Association of America published a report entitled "Best Practices for Investment Adviser Codes of Ethics," which is based on earlier Association codes and a review of the practices and policies of various investments advisers and managers.<sup>252</sup>

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250. SEC, Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, 68 Fed. Reg. 74,715-16 (Dec. 24, 2003).

251. 17 C.F.R. §275.204A-1; *see also* SEC, Investment Adviser Codes of Ethics, Investment Advisers Act Release No. 2256, Investment Company Act Release No. 26,492, 69 Fed. Reg. 41,696 (July 9, 2004). The personal trading provisions of the rule are modeled on Investment Company Act § 17j-. *See* Investment Company Act Release No. 26,492, 69 Fed. Reg. at 41,698. Rule 17j-1 is discussed in BINES & THEL, *supra* note 7, at §11.03[A].

252. *Best Practices for Investment Adviser Codes of Ethics*, ICAA, [http://investmentadviser.org/eweb/docs/Publications\\_News/PublicDocs\\_UsefulWebsite/s/PubDoc/IAA\\_Best\\_Practices\\_for\\_Code\\_of\\_Ethics.pdf](http://investmentadviser.org/eweb/docs/Publications_News/PublicDocs_UsefulWebsite/s/PubDoc/IAA_Best_Practices_for_Code_of_Ethics.pdf) [http://perma.cc/3DUX-7RBD].

Regulation under the Advisers Act often raises difficult questions, but the focus here is on the initial question of whether an investment manager is an investment adviser within the meaning of the Act. In considering the scope of the statute, it is important to bear in mind that the statutory definition of investment adviser excludes a number of people or entities which would otherwise seem to fit the definition,<sup>253</sup>

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253. See BINES & THEL, *supra* note 7, at ch. 5 (“The Reach of the Investment Advisers Act of 1940”). Section 202(a)(11), 15 U.S.C. § 80b-2(a)(11) provides:

“Investment adviser” means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956, which is not an investment company, except that the term “investment adviser” includes any bank or bank holding company to the extent that such bank or bank holding company serves or acts as an investment adviser to a registered investment company, but if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, shall be deemed to be the investment adviser; (B) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession; (C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor; (D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation; (E) any person whose advice, analyses, or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury, pursuant to section 3(a)(12) of the Securities Exchange Act of 1934 [15 U.S.C. § 78c(a)(12)], as exempted securities for the purposes of that Act; or (F) such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order.

and that various statutory advisers are exempt from the registration requirement.<sup>254</sup>

### *I. Investment Counsel*

Section 208(c)<sup>255</sup> of the statute reserves the title “investment counsel” to investment advisers satisfying two conditions: (1) that their principal business be serving as statutory investment advisers; and (2) that a substantial part of their business consist of rendering investment supervisory services for clients. The purpose of Section 208(c) was to protect the emerging industry of non-trustee investment management and to encourage development of professional standards.<sup>256</sup> The content of the investment supervisory services required for entitlement to use of the name “investment counsel” is unclear, however. As defined in Section 202(a)(13), “investment supervisory services” requires that investment advice be given continuously on the basis of individual needs.<sup>257</sup> But there has been little regulatory effort to interpret Section 202(a)(13) in context except in a 1973 report of an advisory committee to the SEC.<sup>258</sup>

Persons rendering financial advice operate under various names and designations.<sup>259</sup> The Dodd-Frank Act directed the Comptroller General

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254. Investment Advisers Act §§ 203(b), 203(a), 15 U.S.C. §§ 80b-3(b), 80b-3A(a).

255. 15 U.S.C. § 80b-8(c). This provision was amended in 1960 to eliminate the requirement that a person be engaged primarily in rendering investment supervisory services, Congress relying instead on the operative term “substantial part.” Pub. L. No. 86-750, 74 Stat. 885, 887 (1960).

256. See, e.g., Report on H.R. 10065, House Comm. on Interstate and Foreign Commerce, H.R. REP. NO. 2639, 76th Cong., 3d Sess. 27-28 (June 18, 1940); see also 7 LOSS, SELIGMAN & PAREDES, *supra* note 52, at § 8-C-4(e).

257. 15 U.S.C. § 80b-2(a)(13).

258. SEC, REPORT OF THE ADVISORY COMMITTEE ON INVESTMENT MANAGEMENT SERVICES FOR INDIVIDUAL INVESTORS, SMALL ACCOUNT INVESTMENT MANAGEMENT SERVICES 27-32 (1973). The statutory definition in Section 202(a)(13) has been the subject of litigation, however. See *Anderson Co. v. John P. Chase, Inc.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,009 (S.D.N.Y. 1975); see also In re Clements, Investment Advisers Act Release No. 177, 1964 SEC LEXIS 397, 42 SEC 373 (Oct. 19, 1964).

259. See ANGELA A. HUNG ET AL., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS (2008); *Bill Introduced to Protect Elderly from Scamming ‘Senior’ Specialists*, 41 SEC. REG. & L. REP. 867 (2009).

of the United States to study and report to Congress on “the effectiveness of State and Federal regulations to protect investors and other consumers from individuals who hold themselves out as financial planners through the use of misleading titles, designations, or marketing materials.”<sup>260</sup> The Act directed the Comptroller to consider a number of issues, particularly the possibility that various titles and designations may mislead investors:

In conducting the study . . . the Comptroller General shall consider—

(1) the role of financial planners in providing advice regarding the management of financial resources, including investment planning, income tax planning, education planning, retirement planning, estate planning, and risk management;

(2) whether current regulations at the State and Federal level provide adequate ethical and professional standards for financial planners;

(3) the possible risk posed to investors and other consumers by individuals who hold themselves out as financial planners or as otherwise providing financial planning services in connection with the sale of financial products, including insurance and securities;

(4) the possible risk posed to investors and other consumers by individuals who otherwise use titles, designations, or marketing materials in a misleading way in connection with the delivery of financial advice;

(6) the ability of investors and other consumers to understand licensing requirements and standards of care that apply to individuals who hold themselves out as financial planners or as otherwise providing financial planning services;

(7) the possible benefits to investors and other consumers of regulation and professional oversight of financial planners; and

(8) any other consideration that the Comptroller General deems necessary or appropriate to effectively execute the study required . . .<sup>261</sup>

In formulating recommendations in the report on the study, the Comptroller was required to consider:

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260. Dodd-Frank Act § 919C(a)(1).

261. *Id.* § 919C(b) (section 919C(b) skips subsection (5)).

[T]he appropriate structure for regulation of financial planners and individuals providing financial planning services . . . and . . . the appropriate scope of the regulations needed to protect investors and other consumers, including but not limited to the need to establish competency standards, practice standards, ethical guidelines, disciplinary authority, and transparency to investors and other consumers.<sup>262</sup>

In 2011, the Government Accountability Office (“GAO”), which is part of the Comptroller’s authority, delivered the mandated report to the congressional committee specified in the Act.<sup>263</sup> Though it noted the absence of regulatory schemes directed at financial planners, the GAO reported that most services provided by financial planners are regulated. The GAO expressed concern that, to consumers, the sources of regulatory oversight may be confusing, and there is a risk that consumers are unfamiliar with standards of care applicable to different services. The GAO also commented on the titles and designations relied on by financial planners as an additional source of consumer information. Given that neither regulators nor industry representatives recommended additional regulation, the GAO proposed no federal regulatory action for the present.

## 2. Broker-Dealers

Most of the advisory activities of broker-dealers are regulated under the Exchange Act, especially the antifraud provisions in Sections 10(b)<sup>264</sup> and 15(c)(1).<sup>265</sup> Nevertheless, were it not for a statutory exclusion in Section 202(a)(11)(C) of the Investment Advisers Act, broker-dealers would also almost unavoidably fall within the statutory definition of investment adviser. That subsection excludes from the definition of investment adviser “any broker or dealer whose performance of [investment advisory] services is solely incidental to the

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262. *Id.* § 919C(c).

263. GAO Report to Congressional Addressees, Regulatory Coverage Generally Exists for Financial Planners, but Consumer Protection Issues Remain, GAO-11-235 (Jan. 18, 2011). The Committees are the Senate Committee on Banking, Housing and Foreign Affairs, the Senate Special Committee on Banking and the House Committee on Financial Services. *See* Dodd-Frank Act § 919C(d)(1).

264. Securities Exchange Act § 10(b), 15 U.S.C. § 78j(b).

265. Securities Exchange Act § 15(c)(1), 15 U.S.C. § 78o(c)(1).

conduct of his business as a broker or dealer and who receives no special compensation therefor . . . .”<sup>266</sup> To be sure, a number of broker-dealers do not rely on the statutory exclusion to avoid registration because they or their advisory affiliates charge management fees for providing investment advice; and hence, are probably receiving “special compensation therefor.”<sup>267</sup>

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266. Investment Advisers Act § 202(a)(11)(C), 15 U.S.C. § 80b-2(11)(C). It seems that broker-dealers were not intended to be excluded from the definition of investment adviser as the Investment Company and Investment Advisers Acts were originally contemplated by the drafters. The proposed legislation submitted by the SEC defined “investment adviser” for purposes of both titles as follows:

“Investment adviser” means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include (A) a bank; (B) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession; (C) the publisher of any bona fide newspaper or newsmagazine of general circulation; or (D) such other persons, not within the intent of this paragraph, as the Commission may designate by rules and regulations or order.

S. 3580, 76th Cong., 3d Sess. § 45(a)(16) (3d Sess. 1940). Moreover, broker-dealers were expressly excluded from the application of Title I, the investment company portion. *Id.* § 3(a)(2)). This indicated that they were not intended to be excluded from Title II, the investment adviser portion. *See also Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 181 (3d Sess. 1940) (statement of David Schenker, Chief Counsel, Securities and Exchange Commission).

267. The hearings on Senate Doc. S. 3580 show that broker-dealers receiving advisory fees were intended to be included. 76th Cong., 3d Sess. at 711 (statement of Douglas T. Johnston, President, Johnston & Lagerquist, Inc and Vice President, Investment Counsel Association of America). More importantly, the hearings on the draft of the bill, which became the Investment Company and Investment Advisers Acts of 1940, confirm that the Committee believed that the exclusion of broker-dealers in Investment Advisers Act § 202(a)(11)(C), 15 U.S.C. § 80b-2a(11)(C), would not be available to broker-dealers receiving a fee for their investment advisory activities. *See Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the H. Comm. on Interstate and Foreign Commerce*, 76th Cong. 87 (3d Sess. 1940) (statement of James White, Representing Souder, Stevens & Clark, Boston, Mass.).

Section 202(a)(11)(C) sets up two conditions to be satisfied for broker-dealers to be excluded from the statutory definition of investment adviser:

- (1) investment advice is provided only as an incident of the broker-dealer function; and
- (2) no special compensation is received for the advice.

Furthermore, both conditions must be satisfied for the exclusion to operate because Section 202(a)(11)(C) lists them conjunctively.<sup>268</sup>

The legislative history of the Section 202(a)(11)(C) exclusion is thin.<sup>269</sup> Shortly after the Advisers Act was adopted, the SEC issued

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268. The relevant portion of Investment Advisers Act § 202(a)(11)(C) reads:

“Investment adviser” means any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities . . . but does not include . . . (C) any broker or dealer whose performance of such service is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor . . . .

*See also* *Kassover v. UBS AG*, 619 F. Supp. 2d 28, 33 (S.D.N.Y. 2008) (dismissing complaint because investors failed to allege that UBS was paid special compensation or that advice was not incidental to brokerage).

269. The meaning of the exclusionary language is unclear, since the meaning of “investment adviser” is discussed in the legislative history of the Act only in its broadest sense by repetition of the definition provided in the Act. It is clear that the definition was meant to encompass a wider spectrum of “advisers” than members of the profession of investment counselors:

Investment advisers are persons who for compensation engage in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing or selling securities or who, for compensation and as part of a regular business, promulgate analyses or reports concerning securities.

H.R. Rep. No. 2639, 76th Cong., 3d Sess. 27 (3d Sess. 1939-40) (similar language appears in S. Rep. No. 1775, 76th Cong., 3d Sess. 20 (1940)).

David Schenker, Chief Counsel of the SEC Investment Trust Study, stated that investment advisers are “that broad category ranging from people who are engaged in the profession of furnishing disinterested, impartial advice to a certain economic



Investment Advisers Act Release No. 2,<sup>270</sup> taking the position that a commission surcharge based on advice to customers constitutes special compensation. But that release is of little help in evaluating arrangements in which the broker-dealer is ostensibly paid only standard brokerage fees for executing transactions,<sup>271</sup> but obtains something else of value, such as more business for client referrals.

As methods of marketing and pricing brokerage services change over time, broker-dealers must be alert to the possibility that new practices may make them investment advisers subject to the Advisers Act. This is especially true with respect to accounts in which clients pay their brokers a fixed dollar amount or a percentage of assets held on account for all investment advice, securities transactions, and related services. These fee-based accounts may simplify arrangements with clients and increase broker-dealer profits, and may also reduce the incentive of brokers to churn accounts, albeit perhaps at the price of giving them an incentive not to trade at all.<sup>272</sup>

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stratum of our population to the other extreme, individuals engaged in running tipster organizations, or sending through the mails stock market letters.” *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the House Comm. on Banking and Currency*, 76th Cong., 3d Sess. Pt. 1, at 47 (3d Sess. 1940). Apparently, the only direct interpretation of the exclusion at issue was made by Douglas T. Johnston, vice-president of the Investment Counsel Association of America, who said that the definition would still include “certain . . . brokerage houses which maintain investment advisory departments and make charges for services rendered . . . .” *Id.* pt. 2, at 711. Thus, the only theme that appears widely in the legislative history is that the statute is meant to apply to those who render investment advice for compensation in the ordinary course of their business or as an independent aspect thereof. For a discussion of current problems in distinguishing between broker-dealers and investment advisers, see Thomas M. Selman, Joseph Price & Lawrence N. Kosciulek, *Regulating Mutual Fund Distribution: Is the Traditional Definition of ‘Broker-Dealer’ Obsolete?*, INV. LAW., Apr. 1998, at 9.

270. Participation in Transactions by Broker-Dealers, Release No. IA-2, Fed. Sec. L. Rep. (CCH) ¶ 56156, 11 Fed. Reg. 10996 (Oct. 28, 1940), 4 Fed. Sec. L. Rep. (CCH) ¶ 56,156 (Oct. 28, 1940).

271. The release dealt only with the addition of an “overriding commission” or “service charge” over and above the regular commission that a broker-dealer would receive from executing the transaction. *See id.*

272. The Investment Counsel Association of America has argued that fee-based brokerage accounts may be inappropriate for some clients, especially those who do not trade frequently. *See Rachel McTague, Broker-Dealer, Adviser Groups Disagree on SEC Exemption for Fee-Based Accounts*, 36 SEC. REG. & L. REP. 1714 (2004) [hereinafter *Broker-Dealer, Adviser Groups Disagree*]; *see also* Rachel McTague, *SEC*

Broker-dealers that offer these fee-based programs may be outside the exclusion from the definition of investment adviser because investment advice might seem to be more than an incident to the broker-dealer function, or because the fee amounts to special compensation for advice.<sup>273</sup> Broker-dealers that were also registered as investment advisers could avoid some issues by treating only their relationships with wrap-fee clients as investment advisory relationships. In 1994, the SEC amended its rules to provide specific disclosure requirements for registered investment advisers, including broker-dealers registered as investment advisers that offered wrap-fee programs.<sup>274</sup> Registered investment advisers offering wrap-fee programs were required to provide clients a separate wrap-fee program brochure setting forth the wrap fee, whether the fee is negotiable, any other fees that might be payable, and the services provided. The brochure must also disclose that the costs of the wrap-fee program might differ from the cost of purchasing the covered services separately.

In 1999, the SEC proposed, and in 2005 re-proposed, a rule to provide that broker-dealers that allowed clients to pay for securities transactions, advice and other services by fee of a fixed amount or a percentage of assets would not be deemed investment advisers.<sup>275</sup> Under the proposed rule, a broker-dealer providing investment advice to clients would be excluded from the definition of “investment adviser,” no

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*Looks into Possibility of Abuses Related to Use of Fee-Based Accounts*, 36 SEC. REG. & L. REP. 1819 (2004).

273. The SEC has long been inclined to limit an exemption from the Investment Advisers Act for broker-dealers, but declined to adopt a permanent rule change. *See* Certain Broker-Dealers Deemed Not to Be Investment Advisers, Investment Advisers Act Release No. 2340, 2004 WL 38804, at \*2-3 (proposed (Jan. 6, 2005)); Investment Advisers Act Release Nos. 34-42099, Release No. 1845, 64 Fed. Reg. 61,226, 61,228-29 (proposed 227 (Nov. 10, 1999)); *see also* Certain Broker-Dealers Deemed Not to Be Investment Advisers, Investment Advisers Act Release No. 2339, 84 SEC Docket 2204, 2005 WL 38803, at \*2-3 (Jan. 6, 2005) (temporary rule); *cf.* 17 C.F.R. § 206(3)(1) (2015), discussed at BINES & THEL, *supra* note 7, at § 11.02[D][2][b] (acting as principal or broker for another). Serious initiatives to treat broker-dealers providing investment advice as fiduciaries have been proposed by both the Department of Labor and the SEC. *See infra* text accompanying notes 301-06.

274. Disclosure by Investment Advisers Regarding Wrap Fee Programs, Investment Company Act. Rel No. 1411, 59 Fed. Reg. 21,657 (Apr. 19, 1994) (effective Oct. 1, 1994).

275. *See supra* text accompanying notes 293-305.

matter how compensated, if the advice was provided solely incidental to brokerage services, the account was non-discretionary, and the broker-dealer informed the client that the accounts were brokerage accounts. When it proposed the rule, the SEC also announced that until it took final action, the SEC would act as if the rule were in effect.<sup>276</sup>

The proposed rule engendered a great deal of comment and opposition, and the Financial Planning Association brought an action challenging the SEC's authority to adopt the rule and suggesting that, by honoring the rule without adopting it, the SEC was violating administrative law.<sup>277</sup> In response to these developments, the SEC reopened the comment period for the proposed rule in August 2004.<sup>278</sup> The SEC subsequently asked the court to postpone consideration of the Association's challenge, indicating that it would take final action on the rule by the end of 2004.<sup>279</sup>

In January 2005, the SEC re-proposed Rule 202(a)(11)-1 and sought comment on its overall approach to the regulation of broker-dealers as advisers. Under the re-proposed rule, broker-dealers would be excepted from the definition of "investment adviser" if they provided non-discretionary advice solely incidental to brokerage services, even if compensated on an asset-based or fixed fee. The Commission also proposed to announce an interpretive position clarifying when advisory services such as financial planning are solely incidental to brokerage, so that the rendering of such services would not bring a broker-dealer into

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276. *Id.*

277. *Fin. Planning Ass'n v. SEC*, 482 F.3d 481, 483-84 (D.C. Cir. 2007); *see also Financial Planning Group Asks SEC to Withdraw Proposal Regarding Brokers*, 36 SEC. REG. & L. REP. 1167 (2004); Rachel McTague, *SEC Reopens Comment Period on Proposed Exemptive Rule for Brokers*, 36 SEC. REG. & L. REP. 1517 (2004); Rachel McTague, *Financial Planners Sue SEC over Exemptive Rule for Brokers*, 36 SEC. REG. & L. REP. 1344 (2004). The Financial Planning Association also ran advertisements asking readers to write to the SEC about the rule proposal. *See, e.g.*, WALL ST. J., Sept. 10, 2004, at C3.

278. *See Certain Broker-Dealers Deemed not to be Investment Advisers*, Investment Advisers Act Release No. 2278, 69 Fed. Reg. 51620, 83 SEC Docket 1745 (Aug. 18, 2004).

279. *See Investment Advisers: SEC Seeks Delay of FPA Challenge to Proposal for Broker-Dealer Exemption*, 36 SEC. REG. & L. REP. 1566 (2004); *see also Broker-Dealer, Adviser Groups Disagree*, *supra* note 272. In any event, the SEC did not even re-propose the rule until 2005.

the definition of adviser.<sup>280</sup> In April 2005, the Commission adopted Rule 202(a)(11)-1, explaining:

Under the rule, a broker-dealer providing advice that is solely incidental to its brokerage services is excepted from the Advisers Act if it charges an asset-based or fixed fee (rather than a commission, mark-up, or mark-down) for its services, provided it makes certain disclosures about the nature of its services. The rule states that exercising investment discretion is not “solely incidental to” (a) the business of a broker or dealer within the meaning of the Advisers Act or (b) brokerage services within the meaning of the rule. The rule also states that a broker or dealer provides investment advice that is not solely incidental to the conduct of its business as a broker or dealer or to its brokerage services if the broker or dealer charges a separate fee or separately contracts for advisory services. In addition, the rule states that when a broker-dealer provides advice as part of a financial plan or in connection with providing planning services, a broker-dealer provides advice that is not solely incidental if it: (i) holds itself out to the public as a financial planner or as providing financial planning services; or (ii) delivers to its customer a financial plan; or (iii) represents to the customer that the advice is provided as part of a financial plan or financial planning services. Finally, under the rule, broker-dealers are not subject to the Advisers Act solely because they offer full-service brokerage and discount brokerage services (including electronic brokerage) for reduced commission rates.<sup>281</sup>

The Financial Planning Association challenged the adopted rule in court.<sup>282</sup> At the same time, firms that had welcomed the rule, full-service firms in particular, were concerned about implementing the requirement that they or their personnel register as advisers if they provide financial

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280. See Certain Broker-Dealers Deemed not to be Investment Advisers, Investment Company Act Release No. 2340, 70 Fed. Reg. 2716 (proposed Jan. 6, 2005) (to be codified at 17 C.F.R. pt. 275).

281. Certain Broker-Dealers Deemed not to be Investment Advisers, Investment Company Act Release No. 2376, 17 C.F.R. § 275.202(a)(11)-1 (2005); see also Eric Arnold & Kevin Zambrowicz, *Final SEC Rule Addressing Broker-Dealer Exclusion from Definition of Investment Adviser*, INV. LAW., June 2005, at 15; Jane A. Kanter & Michael L. Sherman, *Broker-Dealer Developments: Better Late than Never? SEC Adopts Broker-Dealer Exemptive Rule*, INV. LAW., Apr. 2005, at 18.

282. See *Fin. Planning Ass'n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007); Phyllis Diamond, *Investment Advisers: FPA Challenges Substance of SEC Exemptive Rule for Brokers*, 37 SEC. REG. & L. REP. 770 (2005).

planning services or handle discretionary accounts. In response, the Commission delayed the compliance date of the new rule until the end of January 2006.<sup>283</sup>

On March 30, 2007, in *Financial Planning Association v. SEC*,<sup>284</sup> the Court of Appeals for the District of Columbia Circuit vacated Rule 202(a)(11)-1, holding that the Commission had exceeded its statutory authority. The court reasoned that inasmuch as the Advisers Act directly addresses the status of broker-dealers, the exemption provided by the rule was not consistent with the intent of the statute, as required by Section 202(a)(11) of the Act.<sup>285</sup> Following a stay of the court's mandate, fee-based accounts had to be converted to either advisory accounts or traditional brokerage accounts by October 1, 2007.<sup>286</sup>

In September 2007, the SEC proposed a new rule, also to be designated Rule 202(a)(11)-1, which would, according to the Commission, reinstate interpretive positions that the court had invalidated along with the old rule. The proposed rule would have clarified that investment advice is not "solely incidental" to the broker-dealer business if the broker exercises investment discretion or charges a separate fee for the advice. It would also "clarify" that a broker-dealer does not receive special compensation solely because it charges a lower

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283. Certain Broker-Dealers Deemed Not To Be Investment Advisers, Extension of Compliance Date, Investment Company Act Release No. 2426, 70 Fed. Reg. 54629 (Sept. 12, 2005). In December 2005, the Division of Investment Management published a letter of interpretative guidance on the new rule, focusing particularly on the holding-out and financial planning elements. See Securities Industry Association, SEC No-Action Letter, 2005 WL 3526529 (Dec. 16, 2005). Thereafter, industry associations representing various interested parties continued to petition the Commission for and against further delay in implementation. See *Broker-Dealers: Advisers Group Calls on SEC to Enforce Broker-Dealer Exception*, 38 SEC. REG. & L. REP. 163 (2006). The Court of Appeals for the D.C. Circuit heard oral argument on the Financial Planning Association's challenge to the rule in October 2006. See *Broker-Dealers: FPA, SEC Argue in D.C. Cir. over Power of SEC to Create New IAA Exemption for BDs*, 38 SEC. REG. & L. REP. 1728 (2006).

284. *Fin. Planning Ass'n*, 482 F.3d at 483.

285. Investment Advisers Act § 202(a)(11).

286. See Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Investment Advisers Act Release No. 2653, 75 Fed. Reg. 55022 (Sept. 24, 2007); see also Jane J. Kim & Eleanor Laise, *SEC Decision Forces Investors to Make Choice*, WALL ST. J., May 17, 2007, at D1; BINES & THEL, *supra* note 7, at §11.02[D][2][b] (discussing SEC response to the decision). See generally Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 395 (2010).

commission for discount brokerage services than it charges for full-service brokerage.<sup>287</sup>

Controversy over the propriety of permitting broker-dealers to offer fee-based accounts without registering under the Advisers Act led the SEC to ask the Rand Corporation to analyze how investors view investment advisers and brokers.<sup>288</sup> Early in 2008, Rand concluded that investors generally do not understand that each is subject to a distinct regulatory regime.<sup>289</sup>

Congress addressed the question of whether broker-dealers and investment advisers should operate under the same fiduciary standards in the Dodd-Frank Act, but it did not resolve the issue. Although the House bill would have put broker-dealers and investment advisers under a uniform fiduciary duty, the enacted statute<sup>290</sup> left the matter for subsequent determination, to be focused upon “retail customers,” meaning natural persons who receive personalized investment advice about securities from broker-dealers or investment advisers, and use that advice primarily for personal, family, or household purposes.<sup>291</sup> The Dodd-Frank Act directed the SEC to study and report to Congress on the efficacy of existing standards of care for broker-dealers and investment advisers and associated persons, and whether there are gaps, shortcomings, or overlaps that should be addressed by rule or statute.<sup>292</sup>

The Dodd-Frank Act also permitted the Commission to commence rulemaking to address the standard of care for broker-dealers and investment advisers and associated persons for providing personalized investment advice to retail customers and such other customers as the

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287. See Interpretive Rule Under the Advisers Act Affecting Broker-Dealers, Investment Advisers Act Release No. 2652, 72 Fed. Reg. 55126 (Sept. 24, 2007).

288. See *Securities and Exchange Commission: SEC Taps Rand Corp. for Study on Roles of BDs, Investment Advisers*, 38 SEC. REG. & L. REP. 1643 (2006).

289. See *Financial Services: SEC Report Finds Lines Between Brokerages, Advisers Blur in Investors' Eyes*, 40 SEC. REG. & L. REP. 6 (2008).

290. Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 15 U.S.C.).

291. See Dodd-Frank Act § 913(a) (defining retail customer); see also Investment Advisers Act § 211(g)(2) (defining retail customer). The term “retail customer” is defined in the Dodd-Frank Act and the amended Advisers Act, but it is not defined in the amended Exchange Act, although it is used there.

292. See Dodd-Frank Act § 913(b)(d). The Act sets out a number of considerations the Commission should consider in conducting the study. *Id.* § 913(c).

Commission provides.<sup>293</sup> Toward that end, the Act amended Section 15 of the Exchange Act to provide that the Commission may by rule subject broker-dealers providing personalized investment advice about securities to the same standards of conduct applicable to investment advisers under the Investment Advisers Act.<sup>294</sup> It also amended Section 211 of the Investment Advisers Act to provide that the Commission may require that broker-dealers and investment advisers when providing personalized investment advice must act in the best interest of the customer, and must disclose any material conflict of interest.<sup>295</sup> However, the grant of rulemaking authority specifically provides that the receipt by a broker-dealer of commissions or other standard compensation shall not, in and of itself, be considered a violation of any such standard, and further provides that nothing in the amended statutory section shall require a broker-dealer to have a continuing duty of care or loyalty to its customer after providing personalized investment advice.<sup>296</sup>

The Dodd-Frank Act also attempted to improve the SEC's focus on investor protection. In June 2009, the Commission formed an Investor Advisory Committee.<sup>297</sup> The Dodd-Frank Act added a new Section 39 to

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293. *Id.* § 913(f).

294. *See* Securities Exchange Act § 15(k)-(m).

295. *See* Investment Advisers Act § 211(g)-(i) (amended by Dodd-Frank Act § 913(g)); *see also* S. Rep. No. 111-178, at 166:

The section also requires the SEC to issue a report . . . that considers public input. If this study identifies any gaps or overlap in the legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, and investment advisers, the SEC shall commence a rulemaking within two years to address such regulatory gaps and overlap that can be addressed by rule, using its existing authority under the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940.”). The SEC may promulgate rules governing the conduct of broker-dealers and investment advisers providing advice to retail customers and other customers as it by rule provides, “except the Commission shall not ascribe a meaning to the term ‘customer’ that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser.

296. *See* Securities Exchange Act § 15(k)(1), codified by Dodd-Frank Act § 913(g); *see also* Investment Advisers Act § 211(g)(1), codified by Dodd-Frank Act § 913(g).

297. S. REP. NO. 111-176, at 104 (2010).

the Exchange Act that statutorily established the Committee, and charged it with advising and consulting with the Commission on regulatory priorities, the regulation of securities products, trading strategies, fee structures and the effectiveness of disclosure, and initiatives to protect investors and promote investor confidence.<sup>298</sup> The Act also created the Office of the Investor Advocate within the SEC, which will make policy recommendations to the Commission and assist investors in resolving conflicts with financial firms, and amended the Exchange Act to establish firmly the Commission's authority to gather information and conduct investor testing programs for the purpose of developing new rules and programs.<sup>299</sup>

In January 2011, the staff of the SEC published its Study on Investment Advisers and Broker-Dealers as required by Section 913 of the Dodd-Frank Act.<sup>300</sup> The study found that retail investors did not understand the obligations of investment advisers and broker-dealers, and the staff concluded that the Commission should adopt rules implementing a uniform fiduciary standard for broker-dealers and investment advisers providing personalized investment advice to retail investors:

Despite the extensive regulation of both investment advisers and broker-dealers, retail customers do not understand and are confused by the roles played by investment advisers and broker-dealers, and more importantly, the standards of care applicable to investment advisers and broker-dealers when providing personalized investment advice and recommendations about securities. Retail customers should not have to parse through legal distinctions to determine whether the advice they receive was provided in accordance with their expectations. Instead, retail customers should be protected uniformly when receiving personalized investment advice or recommendations about securities regardless of whether they choose to work with an investment adviser or a broker-dealer. At the same

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298. See Securities Exchange Act § 39, amended by Dodd-Frank Act § 911. Section 39 also establishes qualifications and terms for Committee members.

299. See Securities Exchange Act § 19(e), amended by Dodd-Frank Act § 912.

300. See SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS (2011), <http://www.sec.gov/news/studies/2011/913studyfinal.pdf> [<http://perma.cc/T2MM-CSSQ>]; see also Maria Lokshin, *SEC Stalled on Uniform Fiduciary Standard for Broker-Dealers, Advisers, Sources Say*, 44 SEC. REG. & L. REP. 1811 (2012); Maria Lokshin, *Republicans Urge SEC Not to Take Up Rulemaking on Uniform Fiduciary Standard*, 43 SEC. REG. & L. REP. 1877 (2011).



time, it is necessary that such protection allows retail customers to continue to have access to the various fee structures, account options, and types of advice that investment advisers and broker-dealers provide.

Therefore, this Study recommends that the Commission exercise its rulemaking authority to adopt and implement, with appropriate guidance, the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. In addition, the study recommends that when broker-dealers and investment advisers are performing the same or substantially similar functions, the Commission should consider whether to harmonize the regulatory protections applicable to such functions. Such harmonization should take into account the best elements of each regime and provide meaningful investor protection.<sup>301</sup>

In particular, the study recommended that the Commission should ensure that:

[T]he standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.<sup>302</sup>

It also recommended further initiatives with respect to principal trading between broker-dealers and customers, investor education, uniform and minimal professional standards, and harmonization of the regulation of advertising, supervision, licensing, books and records, and the use of finders and solicitors.

Recently, the Department of Labor proposed to treat brokers and others providing investment advice to employee benefit plans, including IRAs, as ERISA fiduciaries.<sup>303</sup> The Department also proposed an exemption, labeled the “Best Interest Contract Exemption,” for qualifying “common compensation, such as commissions and revenue

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301. See SEC, *supra* note 300, at 165-66; see also Yin Wilczek, *GOP Lawmakers Urge SEC Not to Move on Fiduciary Duty*, 43 SEC. REG. & L. REP. 575 (2011).

302. See SEC, *supra* note 300, at vi; see also Martha Kessler, *Galvin Urges Fiduciary Standard for Broker-Dealers*, 45 SEC. REG. & L. REP. 1272 (2013).

303. Proposed Definition of the Term Fiduciary; Conflict of Interest Rule—Retirement Investment Advice, 80 Fed. Reg. 21928 (April 20, 2015).

sharing” affecting “retail accounts.”<sup>304</sup> In parallel, the SEC’s Investment Advisory Committee recommended that broker-dealers providing investment advice to retail customers “be governed by a fiduciary duty,” and that extending such a duty to other investors be considered.<sup>305</sup>

### 3. Other Statutory Investment Advisers

Section 202(a)(11) was designed with two types of investment advisers principally in mind: investment counselors, and purveyors of limited circulation market letters. Instead of restricting the statutory definition to those types of investment advisers; however, Congress structured Section 202(a)(11) for broad coverage subject to specific exclusions. Given the breadth of the definition, particularly difficult questions can arise with respect to those not expressly excluded, as, for example, financial planners and consultants, or the general partner of an investment limited partnership.<sup>306</sup> Moreover, the outlines of the exclusions are not entirely clear, either. Indeed, one of the Supreme Court’s most important decisions under the Advisers Act involved the construction of an exclusion.<sup>307</sup>

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304. Proposed Best Interest Contract Exemption, 80 Fed. Reg. 21960 (April 20, 2015).

305. SEC, RECOMMENDATION OF THE INVESTOR ADVISORY COMMITTEE BROKER-DEALER FIDUCIARY DUTY, <http://www.sec.gov/spotlight/investor-advisory-committee-2012/fiduciary-duty-recommendation-2013.pdf> [<http://perma.cc/PSF2-STVM>].

306. See SEC, 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, Investment Advisers Act Release No. 1092, 1987 SEC LEXIS 3487 (Oct. 8, 1987); see also 7 LOSS, SELIGMAN & PAREDES, *supra* note 52, at § 8-C-2; Gregory Zuckerman & Michael Schroeder, *Hedge Funds May Face Crackdown*, WALL ST. J., Jan. 30, 2003, at C1, C7 (noting that less than 20% of hedge fund managers are registered with the SEC as investment advisers). Such persons may be exempt from the registration requirement even if they are statutory advisers. See Investment Advisers Act § 203(b); Marcia MacHarg, Kenneth J. Berman & Rachel H. Graham, *Forever Unregulated? A Primer for Private Fund Sponsors*, 15 INSIGHTS No. 10, at 9 (Oct. 2001). Some hedge fund managers apparently registered as investment advisers voluntarily, on the theory that doing so signaled a willingness to comply with higher-standards of regulation. See Loch Adamson, *Fixed on Success*, INST. INV., Dec. 14, 2005, at 875.

307. See *Lowe v. SEC*, 472 U.S. 181, 185 (1985) (holding newsletters providing impersonal investment advice are not statutory investment advisers).

In addition to broker-dealers, exclusions apply to banks and bank holding companies; professionals such as lawyers, accountants, and teachers; publishers of newspapers of general circulation; investment advisers dealing only in securities of the United States; and those investment advisers determined by the SEC not to require regulation under the Act. The exclusions must be read with some care, however. For example, the exclusion applying to banks and bank holding companies does not apply to their affiliates. Moreover, a bank is not excluded from the definition to the extent it is an adviser to a registered investment company, although in that case, if the advice is provided through a separately identifiable department or division, that entity—the department and not the bank—is the investment adviser.<sup>308</sup>

Until the Advisers Act was amended in 2006, federal savings associations, federal savings banks, and state savings associations were not banks for purposes of the Advisers Act,<sup>309</sup> and accordingly could not take advantage of the exclusion of banks from the definition of “investment adviser.” In 2004, the SEC proposed to allow thrift institutions an exemption from the Act.<sup>310</sup> The SEC reasoned that the failure to exclude thrift institutions from the Advisers Act did not reflect a congressional judgment that thrifts should be subject to the Advisers Act, but was simply the result of the fact that at the time the Advisers Act was enacted, thrifts could not provide investment advisory services.<sup>311</sup> Since then, however, thrifts had gained the power to offer trust services and act as investment advisers, subject to regulation by the Office of Thrift Supervision that is similar to the corresponding regulation of banks. On the theory that thrift regulation provides the same protection to thrift clients that bank regulation provides to bank clients, the SEC proposed to exempt from the Advisers Act thrift-provided investment advisory services where the thrift acts solely in the capacity of trustee, executor, administrator, or guardian for customer accounts created for a fiduciary purpose, or as trustee of collective trust

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308. See Investment Advisers Act § 202(a)(11)(A).

309. See *id.* § 202(a)(2).

310. Proposed Rule, Certain Thrift Institutions Deemed Not to be Investment Advisers, Investment Advisers Act Release No. 2232, <http://www.sec.gov/rules/proposed/34-49639.htm> [<http://perma.cc/8C7X-A9D7>].

311. See Certain Thrift Institutions Deemed Not to Be Investment Advisers, Investment Advisers Act Release No. 2232, 69 Fed. Reg. 25,788 (May 7, 2004).

funds excluded from the definition of “investment company.”<sup>312</sup> Subsequently, the issue was mooted when the Financial Services Regulatory Relief Act of 2006 amended the definition of the word “bank” in the Advisers Act (and the Exchange Act) to include savings associations, thus extending the statutory exclusion to savings associations.<sup>313</sup>

As noted above, managers of hedge funds initially took different approaches on whether to register as investment advisers. Early in 2003, the SEC organized a roundtable on hedge funds, to discuss:

[T]he structure, operation and compliance activities of hedge funds, including the role of hedge fund service providers; the marketing of hedge funds; investor protection concerns, including disclosure issues, valuation issues and potential conflicts of interest; current regulation of hedge funds and their managers,...whether additional regulation [was] necessary; and if additional regulation [was] warranted, what form it might take.<sup>314</sup>

A few months later, the SEC published a staff report that concluded, among other things, that “the Commission should consider requiring hedge fund advisers to register as investment advisers under the Advisers Act, taking into account whether the benefits outweigh the burdens of registration.”<sup>315</sup> The proposal and regulation promulgated under the Investment Advisers Act, attracted public attention in July 2004, when, by a vote of three to two, the SEC proposed Rule 203(b)(3)-2 to require advisers to certain hedge funds with 15 or more

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312. The proposal was criticized for being both too wide and too narrow. See Rachel McTague, *Exception for Thrift Advisory Services Ill-Conceived or Not Enough*, *Critics Say*, 36 SEC. REG. & L. REP. 1311 (2004).

313. See Financial Services Regulatory Relief Act of 2006, Pub. L. No. 109-351 §401(a)(1), 120 Stat. 1966 (2006), Exchange Act §3(a)(6), 15 U.S.C. §78c(a)(6); cf. Exchange Act Release No. 54947 (Dec. 18, 2006) (proposing to withdraw Exchange Act Rule 15a-9, 17 C.F.R. §240.15a-9, exempting savings associations from definition of “broker” and “dealer” because Financial Services Regulatory Relief Act made it unnecessary).

314. See SEC, Roundtable Discussions Relating to Hedge Funds, Investment Advisers Act Release No. 2117 (Mar. 26, 2003).

315. See SEC, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS (Sept. 29, 2003), <http://www.sec.gov/news/studies/hedgefunds0903.pdf> [<http://perma.cc/JKC4-UAC9>].

investors to register as investment advisers under the Advisers Act.<sup>316</sup> The SEC cited three factors that caused the majority to be concerned with hedge fund advisers: (1) the growth in the number and size of hedge funds; (2) incidents of hedge fund advisers engaging in fraudulent activity, including exaggerated performance claims, payment of inappropriate commissions, and misappropriation of investor assets; and (3) the retailization of hedge funds, with smaller investors, pensioners, and other market participants directly or indirectly investing in hedge funds.<sup>317</sup> The rule proposed that each owner of a private fund (that is, a fund that would have to register as an investment company but for the exemptions provided by Sections 3(c)(1) and 3(c)(7) of the Investment Company Act) that permits owners to redeem part of their investments within two years of purchase and that offers interests based on the expertise of the adviser be counted as a separate client for purposes of deciding whether the adviser has to register. The redemption provision of the definition of private funds was designed to exclude private equity funds from the registration requirement. The dissenters questioned the majority's premises, and encouraged those to be affected to submit comments to the SEC. The response was heavy, but the SEC, with the same division, adopted Rule 203(b)(3)-2, requiring advisers to most hedge funds to register by Feb. 1, 2006.<sup>318</sup> The effect of the rule was not only to require registration, but also to require the newly registered advisers to adopt compliance provisions and subject them to SEC examination and other provisions of the Advisers Act.<sup>319</sup>

An advisory firm and the hedge fund it managed challenged the new rule before the Court of Appeals for the District of Columbia

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316. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266 (Jul. 20, 2004). Not surprisingly, the Investment Company Institute supported the move. See Rachel McTague, *ICI's Stevens Urges SEC to Act on Hedge Fund Adviser Registration*, 36 SEC. REG. & L. REP. 1108 (2004).

317. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266 (Jul. 20, 2004).

318. See Rules Implementing Amendments to the Investment Advisers Act of 1940, 17 C.F.R. §275.203(b)(3)-2. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004); see also Deborah Solomon, *Back Off! Businesses Go Toe-to-Toe with SEC*, WALL ST. J., Oct. 27, 2004, at C5.

319. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004).

Circuit,<sup>320</sup> which vacated the rule in *Goldstein v. SEC*.<sup>321</sup> Although the court noted the substantive criticism of the rule made by the dissenting commissioners, its opinion focused on the language of the Advisers Act, particularly on the word “client” in Section 203(b)(3), which, at the time, exempted advisers which had fewer than 15 clients during the course of the preceding 12 months. The Commission took the position that each investor in a hedge fund was a client of the fund’s adviser. The court rejected this position as unreasonable or even arbitrary. On the basis of a far-ranging discussion of the use of the word “client” in the securities laws and in commerce generally, the court concluded that a hedge fund adviser’s only client is the fund, and not those who invest in the fund. Accordingly, the court concluded, the Commission could not deprive a hedge fund adviser of the exemption of Section 203(b)(3). Although the court narrowed the reach of the registration requirements of the Advisers Act, it took some pains to indicate that hedge fund advisers are still subject to its antifraud provisions. In particular, the court seemed to approve of the Second Circuit’s opinion in *Abrahamson*

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320. *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006); see Judith Burns, *Court Questions SEC Regulation for Hedge Funds*, WALL ST. J. (Dec. 10, 2005), <http://www.wsj.com/articles/SB113418388100019212> [<http://perma.cc/4HD3-CRD2>] (discussing oral argument); Gregory Zuckerman, *Hedge-Fund Hero? Maverick Attacks SEC Restrictions*, WALL ST. J. (Jan. 28, 2006), <http://www.wsj.com/articles/SB113841092073358903> [<http://perma.cc/47DD-KDEN>]. About 800 hedge-fund advisers eventually registered with the SEC. See *800 Fund Advisers Register*, N.Y. TIMES (Feb. 2, 2006), [http://www.nytimes.com/2006/02/02/business/02hedge.html?\\_r=0](http://www.nytimes.com/2006/02/02/business/02hedge.html?_r=0) [<http://perma.cc/L6CN-K95V>]. Some advisers reportedly changed lock-up provisions of the funds they managed so that the managers would not have to register as advisers. See Gregory Zuckerman & Ian McDonald, *Hedge Funds Avoid SEC Registration Rule*, WALL ST. J. (Nov. 10, 2005), <http://www.wsj.com/articles/SB113158878465793171> [<http://perma.cc/3N7BQ-NBU8>]; Kara Scannell, *Hundreds of Hedge-Fund Advisers Register with SEC*, WALL ST. J. (Jan. 28, 2006), <http://www.wsj.com/articles/SB113841043852658892> [<http://perma.cc/XEG5-UAJF>] (suggesting that advisers to one-quarter of hedge funds will avoid registration with two-year lockups); *Royce Cautions Investors About Extension of Redemption Periods*, 37 SEC. REG. & L. REP. 306 (2005). On December 8, 2005, the SEC’s Division of Investment Management gave the Subcommittee on Private Investment Entities of the ABA’s Section of Business Law extensive advice on the two-year redemption period exclusion from registration. See ABA Subcomm. on Priv. Inv. Entities, SEC No-Action Letter (Dec. 8, 2005), <http://www.sec.gov/divisions/investment/noaction/aba120805.htm> [<http://perma.cc/JC7N-BFVS>].

321. *Goldstein*, 451 F.3d 873.

*v. Fleschner*,<sup>322</sup> which held that limited partners in a hedge fund may challenge the fund's adviser for fraud under Section 206 of the Advisers Act.

The SEC seemed somewhat more willing to accommodate itself to judicial restriction of hedge fund regulation than it was with respect to the D.C. Circuit's rejection of the independent director rules for mutual funds, discussed above.<sup>323</sup> At the end of 2006, however, the Commission unanimously proposed explicitly to prohibit advisers of pooled investment vehicles—including hedge funds—from misleading or defrauding investors and prospective investors, and to make it more difficult for investors to qualify to invest in such vehicles.<sup>324</sup>

With respect to fraud, the Commission explained that *Goldstein* created uncertainty with respect to whether Sections 206(1) and (2) of the Advisers Act apply to the advisers of investment pools. Accordingly, the Commission proposed to use its rulemaking power under Section 206(4) of the Act to adopt Rule 206(4)-8, which would apply to advisers not required to register under the Advisers Act. In 2007, the Commission adopted Rule 206(4)-8 as proposed.<sup>325</sup>

When the Commission proposed Rule 206(4)-8, it also proposed to restrict investor access to hedge funds by creating a sub-category of "accredited investor" for purposes of Regulation D under the Securities Act,<sup>326</sup> to be called "accredited natural persons," made up of investors owning at least \$2,500,000 of certain types of investments. Under the

322. *Abrahamson v. Fletcher*, 568 F.2d 862 (2d Cir. 1977).

323. Thus, for example, the Commission's Chairman joined the conclusion of the President's Working Group on Financial Markets in concluding that new direct regulation of hedge funds is unnecessary. See Rachel McTague, *U.S. Regulators Agree on Key Principles to Improve Oversight of Hedge Fund Industry*, 39 SEC. REG. & L. REP. 281 (2007). In December 2006, the incoming Democratic Chairman of the House Financial Services Committee stated that he would not reintroduce legislation to reverse the result of *Goldstein*. See *SOX, Hedge Fund, Options Hearings in Frank's Sights for House Panel Next Year*, 38 SEC. REG. & L. REP. 2048 (2006).

324. See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Sec. Act Release No. 8766 (Dec. 27, 2006).

325. 17 C.F.R. § 275.206(4)-8 (2007). See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Investment Advisers Act Release No. 2628, Fed. Sec. L. Rep. (CCH), 72 Fed. Reg. 44756 (Aug. 3, 2007) (effective Sept. 10, 2007). In *SEC v. Rabinovich & Assocs.*, No. 07 Civ. 10547(GEL), 2008 WL 4937360 (S.D.N.Y. Nov. 18, 2008), the SEC obtained a permanent injunction in a Rule 206(4)-8 enforcement proceeding involving boiler-room sales of investment partnership interests.

326. 17 C.F.R. § 230.501(a) (2015).

rules proposed by the Commission, issuers of securities that would be investment companies except for Section 3(c)(1) of the Investment Company Act would be limited to such investors in Regulation D offerings. The Commission subsequently determined to propose more extensive amendments and accordingly deferred consideration of the proposed change to the definition of “accredited investor.”<sup>327</sup>

The Dodd-Frank Act addressed the definition of accredited investor for purposes of the Securities Act by directing the SEC to adjust the net worth threshold to exclude the primary residence of the investor, and to review the standard periodically. At the end of 2011, the SEC revised its rules to exclude the positive equity that a natural person has in his or her primary residence when determining whether the investor holds sufficient assets to be an accredited investor.<sup>328</sup>

Although hedge funds and other private investment entities were not generally held responsible for the financial crisis that began in 2007, they were subjected to regulation in the Dodd-Frank Act, which undid much of what hedge fund managers had previously accomplished in the D.C. Circuit.<sup>329</sup>

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327. See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44756.

328. See Dodd-Frank Act § 413(a); see also Net Worth Standard for Accredited Investors, Securities Act Release No. 9287, Fed. Sec. L. Rep. (CCH) (Dec. 21, 2011) (amending Securities Act Rules 215 & 501, 17 C.F.R. §§ 230.215, 230.501); Net Worth Standard for Accredited Investors, Securities Act Release No. 9177, Fed. Sec. L. Rep. (CCH) (Jan. 15, 2011) (proposing amendment to definition of accredited investor).

329. Title IV of the Dodd-Frank Act, entitled “Regulation of Advisers to Hedge Funds and Others,” is given the short title of the Private Fund Investment Advisers Registration Act of 2010. See Dodd-Frank Act § 401; S. REP. NO. 111-176, at 10938109;

Title IV requires advisers to large hedge funds to register with the Securities and Exchange Commission, in order to close a significant gap in financial regulation. Because hedge funds are currently unregulated, no precise data regarding the size and scope of hedge fund activities are available, but the common estimate is that the funds had at least \$2 trillion in capital before the crisis. Their impact on the financial system can be magnified by extensive use of leverage—their trades can move markets. While hedge funds are generally not thought to have caused the current financial crisis, information regarding their size, strategies, and positions could be crucial to regulatory attempts to deal with a future crisis. The case of



The Dodd-Frank Act removed the provision of the Advisers Act that had previously exempted from registration advisers with fewer than fifteen clients who did not hold themselves out to the public as investment advisers,<sup>330</sup> which consequently subjected many hedge fund managers to the registration requirement. The burden was ameliorated for some advisers by a new exemption from registration for advisers who advised solely venture capital funds, and by a provision directing the SEC to provide an exemption from registration for any adviser advising solely private funds that has assets under management in the United States of less than \$150 million (although the SEC may require such advisers to maintain records and make reports).<sup>331</sup>

The Dodd-Frank Act also increased the burden on registered advisers. Registered investment advisers are required to maintain a variety of records, subject to SEC inspection.<sup>332</sup> The SEC was also given authority to regulate client assets over which a registered adviser has custody,<sup>333</sup> and the Comptroller General was directed to study the cost associated with custody regulation.<sup>334</sup>

In November 2010, the SEC proposed rules to implement and supplement the Dodd-Frank Act's repeal of the private adviser exemption.<sup>335</sup> At the same time, the Commission proposed limited exemptions for advisers to certain types of funds, as required by the Dodd-Frank Act, as well as requirements that advisers to private funds provide information to the SEC. Thus it proposed rules implementing the Dodd-Frank Act's exemption from Investment Advisers Act registration for advisers to venture capital funds and advisers managing

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Long-Term Capital Management, a hedge fund that was rescued through Federal Reserve intervention in 1998 because of concerns that it was 'too-interconnected-to-fail,' shows that the activities of even a single hedge fund may have systemic consequences. Hedge fund registration was part of the Treasury's Department's regulatory reform proposal, and has been endorsed by many witnesses before the Committee . . . .

330. See Dodd-Frank Act § 403.

331. See 15 U.S.C. § 80b-3(l) to (m).

332. See *id.* § 80b-4.

333. See Dodd-Frank Act § 411.

334. *Id.* § 412.

335. Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3110, Fed. Sec. L. Rep. (CCH) (Nov. 19, 2010).

less than \$150 million in private fund assets.<sup>336</sup> The Commission adopted rule revisions in June 2011.<sup>337</sup>

As amended by the Dodd-Frank Act, Section 203(l)<sup>338</sup> of the Advisers Act provides that an adviser that advises only venture capital funds is exempt from registration under the Act. Section 203(l) directed the SEC to define the term “venture capital fund” for purposes of the exemption, and Advisers Act Rule 203(l)-1(a) does so.<sup>339</sup> Broadly speaking, a venture capital fund is a private fund<sup>340</sup> that holds primarily qualifying assets of qualifying portfolio companies, does not incur leverage except for limited defined purposes, does not offer investors redemption or similar liquidity rights, represents itself to investors as pursuing a venture capital strategy and has not elected to be treated as a business development company.<sup>341</sup>

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336. See Exemptions for Advisers to Venture Capital Funds, Investment Advisers Act Release No. 3111, Fed. Sec. L. Rep. (CCH) (Nov. 19, 2010).

337. See Rules Implementing Amendments to the Investment Advisers Act of 1940, Inv. Advisers Act Release Inv. No. 3221, Fed. Sec. L. Rep. (CCH) (June 22, 2011); Exemptions for Advisers to Venture Capital Funds, Investment Advisers Act Release No. 3222, Fed. Sec. L. Rep. (CCH) (June 22, 2011).

338. Investment Advisers Act § 203(l).

339. *Id.* § 203(l)-1(a).l)-1.

340. See *id.* § 202(a)(29) (defining a private fund as a fund that would be an investment company but for Sections 3(c)(1) or 3(c)(7) of the Investment Company Act).

341. Advisers who act as investment advisers solely to venture capital funds are also exempt from registration, although they will be subject to SEC record-keeping and reporting requirements. See *id.* § 203(b)(1), as amended by Dodd-Frank Act § 407. Section 407 of Dodd-Frank added Section 203(l) to the Advisers Act, which exempts from registration investment advisers advising a statutorily uncapped number of “venture capital funds.” Congress left to the SEC the responsibility for defining venture capital funds, and directed the SEC to act within a year. It also delegated authority to the SEC to require reporting by exempt venture capital fund advisers. As required by Section 407, the SEC proposed Advisers Act Rule 203(l)-1 as part of a release addressing rules to implement statutory exemptions for advisers to venture capital funds, advisers to private funds under \$150 million and foreign private advisers. See Investment Advisers Act Release No. 3111, 99 SEC Docket 3370, 2010 WL 4686054 (Nov. 19, 2010) (the “Proposing Release”). The adopting release is Investment Advisers Act Release No. 3222, 101 SEC Docket 1649, 2011 WL 2482894 (Jun. 22, 2011) (the “Adopting Release”). The Proposing Release had a prospective feature and a retrospective feature. Looking forward, the Proposing Release would exempt advisers to venture capital funds formed after December 31, 2011 that satisfy the criteria established in the regulatory definition. Looking back, self-identified venture capital

At the same time that it eliminated the exemption for advisers to private funds, the Dodd-Frank Act added Section 203(m) to the Advisers Act, which directed the SEC to provide an exemption from registration for private fund advisers with less than \$150 million of assets under management.<sup>342</sup> Advisers Act Rule 203(m)-1<sup>343</sup> exempts from registration under the Advisers Act any investment adviser whose principal office and place of business is in the United States that acts solely as an investment adviser to qualifying private funds and manages private fund assets of less than \$150 million.<sup>344</sup> An adviser with its

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funds, formed prior to that date, would be grandfathered. In response to comments urging flexibility in structuring portfolio investments, the SEC slightly modified the approach taken in the Proposing Release in order to permit greater discretion for advisers to “venture capital funds” to include some investments, up to twenty percent in value, that are not “qualifying investments.” Otherwise, Rule 203(l)-1 offered little flexibility to straight venture equity investing, for the most part limiting eligibility to equity-only portfolio investments. As a consequence, advisers to funds committing to later-round venture investing will have to register (or be otherwise exempt) if, as a matter of policy, they desire to allocate risk by engineering a fund’s or its portfolio companies’ capital structure. Advisers who act as investment advisers solely to venture capital funds are also exempt from registration, although they will be subject to SEC record-keeping and reporting requirements.

Further, portfolio companies must satisfy their own regulatory definition. Rule 203(l)-1 requires at least eighty percent of a venture fund’s capital contributions, including uncommitted capital, to be invested in a qualifying investment issued by a “qualifying portfolio company.” See Investment Advisers Act Rule 203(l)-1(c)(4). For purposes of satisfying the regulatory definition, a “qualifying investment” must be a directly issued-and-purchased equity security and a “qualifying portfolio company” cannot be “foreign traded” or in a control relationship with a company that is, nor can it issue debt any of the proceeds of which are distributed to the fund’s investors. In addition, a qualified portfolio company cannot be an investment company, a private fund, a money-market fund or a commodity pool. Existing venture capital funds have a broad, but not carte-blanche, exemption. Exempt venture capital funds still are subject to the reporting obligations imposed by Dodd-Frank. In a trap for the unwary, in contrast to the foreign private-adviser exemption, advisers to U.S. venture capital funds lose the exemption if they advise foreign funds that would not be exempt, if domestic, under the qualification provisions of Rule 203(l)1.

342. 15 U.S.C. § 80b-3(m).

343. 17 C.F.R. § 275.203(m)-1; see also *German Financial Services Firm Subsidiary Need Not Register Under IAA, Staff Confirms*, 44 SEC. REG. & L. REP. 1132 (Jun. 4, 2012).

344. The Dodd-Frank Act directed the SEC to provide a registration exemption for any adviser that acts solely as an adviser to private funds and has assets under management in the United States of less than \$150 million, although they will also be subject to SEC record-keeping and reporting requirements. See Investment Advisers

principal office and place of business outside the United States is exempt from registration if it has no client in the United States except for qualifying private funds, and its assets managed at a place of business in the United States are solely attributable to private fund assets which have a total value of less than \$150 million.<sup>345</sup>

At the same time the Commission adopted the venture capital and private fund advisers exemptions from registration, it adopted Advisers Act Rule 204-4<sup>346</sup> requiring the exempted advisers to file informational

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Act § 203(b)(m), as amended by Dodd-Frank Act § 408. The Dodd-Frank Act gave family offices even more generous treatment, excluding them from the definition of investment adviser rather than merely exempting them from registration, *see* Investment Advisers Act § 202(a)(11)(G), as amended by Dodd-Frank Act § 409, although some family offices are brought back within the antifraud provisions of the Advisers Act, *see* Dodd-Frank Act § 409(c). When the SEC proposed rules to define the term “family offices” for purposes of the exclusion, it discussed its history of regulation of family offices and family-run offices and explained that it attempted to define the term in a manner consistent with its previous administrative policy toward exemption. *See* Family Offices, Investment Advisers Act Release No. 3098, 99 SEC Docket 2015, 2010 WL 3994796 (Oct. 12, 2010); *see also* Family Offices, Investment Advisers Act Release No. 3220, 101 SEC Docket 1449, 2011 WL 2482889 (Jun. 22, 2011) (adopting Investment Advisers Act Rule 202(a)(11)(G)-1, 17 C.F.R. § 275.202(a)(11)(G)-1, defining “family offices”); *see also* SEC Division of Investment Management, Guidance Update No. 2014-13, *Key Employee Trusts Under the Family Office Rule* (Dec. 2014), <http://www.sec.gov/investment/im-guidance-2014-13.pdf> [<http://perma.cc/HP6D-P3FP>].

345. Foreign private advisers are exempt from registration if they have no place of business in the United States, fewer than 15 clients in the United States in advised private funds, and aggregate assets attributable to United States investors of less than \$25 million or such higher amount as the SEC provides by rule, and do not hold themselves out to the public in the United States as investment advisers and do not act as investment adviser to a registered investment company or a business development company. *See* Investment Advisers Act § 202(a)(30), as amended by Dodd-Frank Act § 402 (defining “foreign private adviser”); Investment Advisers Act § 203(b)(3), as amended by Dodd-Frank Act § 403 (providing exemption from registration for foreign private adviser); *see also* Investment Advisers Act § 202(a)(29), as amended by Dodd-Frank Act § 402 (defining “private fund” to mean any issuer that would be an investment company but for the exclusions of Section 3(c)(1) or 3(c)(7) of the Investment Company Act, 15 U.S.C. §§ 80a-3(c)(1), 80a-3(c)(7)); BINES & THEL, *supra* note 7, § at2.06[D][3].

346. Investment Advisers Act Rule 204-4, 17 C.F.R. § 275.204-4; *see also* Investment Advisers Act Rule 204-1, 17 C.F.R. § 275.204-1 (updating amendments to Form ADV).

reports with the SEC on Form ADV. The Commission amended Form ADV to require disclosure, among other things, of information about advised funds and the adviser's affiliates. Most of the information on these reports is available to the public.

In 2012, the JOBS Act was enacted.<sup>347</sup> The JOBS Act was intended to reduce the regulatory burden on businesses seeking capital, and made substantial changes to the registration process for public sales of securities, among other things. One change of potentially substantial significance for hedge funds and other investment managers is the change the statute required for offerings under SEC Rule 506 of Regulation D,<sup>348</sup> which permits an issuer to sell securities to accredited investors without requiring extensive disclosure. Until enactment of the JOBS Act, the most burdensome limitation of Rule 506 was the prohibition of general solicitation,<sup>349</sup> which the SEC has interpreted to require that the issuer communicate only with potential investors with which it or its broker-dealer intermediaries had a preexisting relationship. The JOBS Act required the SEC to eliminate the prohibition of general solicitations for Rule 506 offerings.<sup>350</sup> In July 2013, the SEC amended Rule 506 to eliminate the prohibition against general solicitation and general advertising in some Rule 506 offerings.<sup>351</sup> General solicitation is not prohibited in a Rule 506 offering so long as all purchasers are accredited investors and the issuer takes reasonable steps to assure that all purchasers are accredited investors.<sup>352</sup> The SEC also amended Form D to require that issuers relying on this provision so state. At the same time, the Commission proposed further amendments to Regulation D and Form D, which would have required issuers to file a Form D before engaging in a general solicitation, and to file general solicitation materials with the Commission, and would have disqualified issuers from relying on Rule 506 if they did not comply

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347. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (Apr. 5, 2012) (codified in scattered sections of 15 U.S.C.).

348. 17 C.F.R. § 230.506.

349. 17 C.F.R. § 230.502(c).

350. See JOBS Act § 201(a)(1), 126 Stat. at 313-15.

351. See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act of 1933 Release No. 9415, 2013 WL 3817300 (Jul. 10, 2013).

352. See, e.g., *SIFMA Offers Firms Guidance for Verifying 'Accredited Investor' Status*, 46 SEC. REG. & L. REP. 1264 (2014).

with the Form D filing requirements.<sup>353</sup> These proposals generated substantial criticism and controversy, and in September 2013 the Commission extended the comment period.<sup>354</sup>

### CONCLUSION

The three principles that govern investment management law—the duty of care, the duty of loyalty, and the public duty—remain the common conduct postulates underlying investment management law. In the fullness of time, however, the means for promoting and measuring fiduciary conduct have changed remarkably. Whereas the particulars of enforcement of fiduciary conduct and remedying breaches were once mainly the product of common-law developments and scholarly commentary, statutory controls and regulatory oversight in separately defined spheres of activity now dominate. Compliance seems both to govern the boundaries of investment responsibility for investment fiduciaries, and to protect against after-the-fact challenges. To be sure, professionally indefensible investment management and classic self-dealing will likely transgress both statutory and regulatory requirements, on the one hand, and common-law precedent, on the other. Yet, satisfaction of legislative and administrative requirements, coupled with defined contractual undertakings, are so much the focus of attention that often it is lost how dependent statutory and regulatory requirements are on the common-law history. The review we engaged in above will, we hope, promote broader recognition that planning and structuring legal responsibilities and risks associated with new or evolving investment management practices depends on engineering that crosses jurisdictional lines.

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353. See Amendments to Regulation D, Form D, and Rule 156, Securities Act of 1933 Release No. 9416, 2013 WL 4413723 (Jul. 10, 2013); *see also* Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings, Securities Act of 1933 Release No. 9414, 2013 WL 3817311 (Jul. 10, 2013).

354. See Re-opening of Comment Period for Amendments to Regulation D, Form D, and Rule 156, Securities Act of 1933 Release No. 9458 (Sept. 27, 2013).