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Abstract

Parts I and II discuss the regulation of advisers and brokers in the United States through first a historical and then a functional prism. Part III illustrates these two approaches by looking at one particular rule regulating investment advisers — the performance fee rule — which challenges the assumptions I am making about the regulation of advisers and brokers. Part IV discusses recent regulatory initiatives at the SEC in light of these two approaches.

II. LOOKING BEYOND NATIONAL BOUNDARIES

MODELS OF SECURITIES REGULATION IN THE UNITED STATES

*Arthur B. Laby**

INTRODUCTION

There are two general approaches to securities regulation in the United States: the first is to require disclosure of information about securities and about market participants; the second is to prohibit particular types of conduct by those market participants. The U.S. Securities and Exchange Commission ("SEC" or "Commission") regulates most public companies, for example, by requiring disclosure of material information in annual and quarterly reports and other disclosure documents.[1] The SEC does not pass judgment on whether a particular company would make a good investment.[2] The SEC regulates stockbrokers, on the other hand, by placing many substantive prohibitions on their activities.[3] Tender offers are regulated primarily through

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1. *See, e.g.*, Securities Exchange Act § 13(a), 15 U.S.C.A. § 78m(a) (1997 & Supp. 1998) (requiring issuers to disclose "such information and documents . . . as the Commission shall require to keep reasonably current," annual, and quarterly reports as prescribed by Commission).

2. Merit based regulation of public companies was debated and rejected in the 1930s in favor of disclosure. *See* James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959).

3. *See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 690 (1995) ("The 1934 Act contains a number of provisions, in the nature of substantive regulation, that are designed to protect customers' funds and securities in the hands of broker-dealers.").

disclosure,[4] while certain types of transactions with affiliates are banned, even if the transactions are fully disclosed.[5]

These two approaches—disclosure and substantive prohibitions—also can be demonstrated through the difference in the regulation of two types of market professionals: investment advisers (or "advisers"), who are regulated primarily through disclosure, and broker-dealers (or "brokers"), who are subject to substantive prohibitions on their activities. This Essay shall focus on the regulation of advisers and brokers as a sort of case study to explore why we find ourselves with these different regimes.

Parts I and II discuss the regulation of advisers and brokers in the United States through first a historical and then a functional prism. Part III illustrates these two approaches by looking at one particular rule regulating investment advisers—the performance fee rule—which challenges the assumptions I am making about the regulation of advisers and brokers. Part IV discusses recent regulatory initiatives at the SEC in light of these two approaches.

I. *INVESTMENT ADVISER AND BROKER-DEALER REGULATION*

Investment advisers in the United States are generally subject to broad duties of disclosure, not detailed substantive rules prohibiting conduct. Under the Investment Advisers Act of 1940[6] ("Advisers Act"), advisory firms are required to make detailed disclosures about their business, and the people who work there to the SEC and to their clients. When a firm seeks to register as an adviser with the SEC, the firm submits a SEC Form ADV,[7] which contains detailed questions about the firm's history, operations, services, and fees, as well as questions about the firm's employees and affiliates, including their disciplinary his-

4. *See* e.g. Securities Exchange Act § 13(e), 15 U.S.C.A. §§ 78m(e) (1997 & Supp. 1998) and SEC Rule 13e-4, 17 C.F.R. 240.13e-4 (1999).

5. *See, e.g.,* Investment Company Act §§ 17(a), 17(b), 15 U.S.C.A. §§ 80a-17(a), 80a-17(b) (1997 & Supp. 1998) (prohibiting certain transactions between investment company and specified persons who are affiliated persons of investment company).

6. Investment Advisers Act § 203, 15 U.S.C.A. § 80b-3 (1997 & Supp. 1998). Investment advisers register with the Commission on Form ADV, a uniform form used by the SEC and state securities regulators. *See* Investment Advisers Act Rule 203-1, 17 C.F.R. § 275.203-1 (1999).

7. *See* SEC Form ADV, 17 C.F.R. § 279.1 (1999).

tory. The SEC reviews certain aspects of the application, and most become effective within forty-five days.

In addition to SEC-required disclosure on Form ADV, the Advisers Act contains a broad antifraud provision that has been interpreted to require extensive duties of disclosure. The statute makes it illegal to "employ any device, scheme, or artifice to defraud any client or prospective client" or "to engage in any transaction, practice, or course of business which operates as a fraud or deceit . . ."[8] In drafting this provision, Congress was concerned about the conflicts of interest inherent in the advisory relationship, and sought to address them through disclosure.[9] In the leading case interpreting this provision, the U.S. Supreme Court wrote:

> The Investment Advisers Act of 1940 thus reflects a congressional recognition "of the delicate fiduciary nature of an investment advisory relationship," as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser–consciously or unconsciously–to render advice which was not disinterested.[10]

The Supreme Court later repeated that the antifraud provisions of the Advisers Act establish "federal fiduciary standards" and "enforceable fiduciary obligations" for investment advisers.[11] Although the antifraud rules place certain prohibitions on advisers' conduct, these prohibitions are generally addressed by disclosure. SEC rules, for example, prohibit cash payments for the solicitation of advisory clients unless certain conditions are met and the arrangements are fully disclosed.[12] Similarly, advisers are prohibited from selling securities to clients out of the advisers' own accounts unless fully disclosed in writing beforehand and the client consents.[13]

Specific substantive rules prohibiting conduct by advisers are few and far between. Advisers must keep certain books and records,[14] and are generally prohibited from charging perform-

8. Investment Advisers Act § 206, 15 U.S.C.A. § 80b-6 (1997 & Supp. 1998).

9. *See* S. Rep. No. 1775, at 22 (1940); SEC v. Capital Gains Research Bureau, 375 U.S. 180, 191 (1963).

10. *Capital Gains*, 375 U.S. at 191-92.

11. Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979).

12. Investment Advisers Act Rule 206(4)-3, 17 C.F.R. § 275.206(4)-3 (1999).

13. Investment Advisers Act § 206(3), 15 U.S.C.A. § 80b-6(3) (1997 & Supp. 1998).

14. Investment Advisers Act Rule 204-2, 17 C.F.R. § 275.204-2 (1999).

ance fees or incentive fees—fees that are based on the performance of their investment recommendations.[15] The SEC, however, does not require advisers to meet minimum qualifications, satisfy substantive requirements, or be licensed by a self-regulatory organization, such as the National Association of Securities Dealers (or "NASD").

Regulation of broker-dealers is a different kettle of fish. Under the Securities Exchange Act of 1934 (or "Exchange Act"),[16] brokers are required to register with the SEC, but that's just the beginning. The Exchange Act, and the rules under this act, subject brokers to a panoply of substantive rules that go far beyond disclosure. Broker-dealers are subject to licensing by the NASD, the organization that regulates broker-dealers through its own rules—which are approved by the SEC.[17] Brokers also have detailed financial responsibility requirements—like the net capital rule, which requires them to have liquid assets on hand to meet their obligations to investors and creditors.[18] Brokers also are subject to detailed credit regulations, and the Exchange Act authorizes the Federal Reserve Board to set credit—or margin—restrictions on the amount of money brokers can lend to clients.[19]

II. *WHY THE DIFFERENCE?*

How do we explain the difference in the approach to the regulation of these market participants? After all, we could imagine a system where we place many more substantive restrictions on advisers, and many countries, like France and Spain, *do* place both minimum qualification and capital requirements on investment advisers.[20] Alternatively, we could liberalize many of

15. Investment Advisers Act § 205(a)(1), 15 U.S.C.A. § 80b-5(a)(1) (1997 & Supp. 1998).

16. Securities Exchange Act § 15, 15 U.S.C.A. § 78o (1997 & Supp. 1998). Broker-dealers register with the Commission on Form BD, which has been adopted by the SEC, and virtually all of the states for use by these states and the self-regulatory organizations.

17. *Id.* § 15(b)(8), 15 U.S.C.A. § 78o(b)(8) (1997 & Supp. 1998).

18. Securities Exchange Act Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (1999).

19. The Securities Exchange Act of 1934 authorizes the Federal Reserve Board to set rules on credit that can be maintained on non-exempt securities and makes it illegal for any broker-dealer to extend credit in violation of the Board's rules. *See* Securities Exchange Act § 7, 15 U.S.C.A. § 78g (1997 & Supp. 1998).

20. *See* MARCIA L. MACHARG & ROBERTA R.W. KAMEDA, INTERNATIONAL SURVEY OF INVESTMENT ADVISER REGULATION 143-44 (France), 267-68 (Spain) (1994).

the restrictions the SEC currently places on brokers by requiring only disclosure of balance sheet information that would reflect the firm's net capital, but not regulate it. Why do we end up where we are today?

There are at least two ways to explain the difference. The first reason is historical: regulation is a response to discrete historical events.[21] The second reason is functional: regulation responds flexibly to the particular function that a person or firm performs, regardless of who is performing the function.[22]

A. *A Historical Reason*

In a discussion on the broad outlines of regulation, Chief Judge Richard A. Posner remarked that we should try to understand the politics of regulation—how and why did it come about—as "crisis calls for change."[23] Crisis describes the tumultuous decade of the 1930s when Congress considered broker-dealer and investment adviser legislation for the first time. A look at the politics of regulation in the 1930s explains much of the legislation governing brokers and subsequently advisers.

In the early part of the decade, when the Exchange Act was enacted, the securities industry, like much of the country, was in dire straits. The nation was calling for Wall Street to be held accountable for the market crash, and President Franklin D. Roosevelt and the Democrats were successful in the 1932 elections by promising a New Deal for all Americans. The Securities Act of 1933—the first federal securities law—which required public companies to register their securities offerings and disclose information, was passed as part of President Roosevelt's

21. Similarly, the interest group model explains legislation as a response to interest groups, or coalitions of interest groups, jockeying for support of particular legislation at a given point in time. *See* Jonathan R. Macey, *Promoting Public Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 227 (1986) (stating that laws are viewed as commodities bought by particular interest groups that outbid or outmaneuver competing interest groups).

22. A theory of functional regulation has gained currency in the debate over financial services reform. *See, e.g.*, Melanie L. Fein, *Functional Regulation: A Concept for Glass-Steagall Reform?*, 2 STAN. J.L. BUS. & FIN. 89 (1995).

23. Chief Judge Richard A. Posner, Deregulation—Its Impact on Competition Law in the United States, Remarks at the Weimar Symposium, The Competition Law of Deregulation (Oct. 16, 1998). *Editors Note*: Also see Judge Posner's piece in this Book of the FORDHAM INTERNATIONAL LAW JOURNAL.

first hundred days in office.[24]

From January 1933 until June 1934, Congress held seventeen months of hearings on the cause of the Great Depression. The hearings were called the Pecora hearings, named after Ferdinand Pecora, counsel to the Senate Committee on Banking and Currency that conducted them. These hearings were apparently followed with the same intensity as the House and Senate Watergate Hearings and the recent impeachment proceedings of President Clinton. During the Pecora Hearings, leading bankers and financiers were vilified and blamed for much of the nation's economic woes. Pecora later wrote that the public was "deeply aroused by the spectacle of cynical disregard of fiduciary duty on the part of many of its most respected leaders . . ."[25]

At the same time, Congress was considering stock exchange regulation, including the regulation of broker-dealers. Opponents of regulation blamed the Securities Act of 1933 for the lack of financing available in 1933 and 1934, and argued that a law regulating the stock market would make matters worse. The argument, however, did not prevail. Although the legislative fight was intense, Roosevelt became actively involved and, with New Deal fervor still running strong, Congress passed the law. The Exchange Act was considered a victory for the Roosevelt administration by establishing the regulation of stock exchanges and providing for the SEC as a permanent watchdog over the markets.[26]

Investment adviser regulation was not enacted until six years later. By 1939 and 1940, the first wave of reform had passed over the country and did not include advisers. The intervening six years were critical for shaping the legislation that would eventually be enacted.

What took Congress so long to pass adviser legislation? First, it took time for the SEC to conduct a study and send its report back to Congress. The genesis of the Advisers Act, and the Investment Company Act of the same year, was a small paragraph tucked into the Public Utility Holding Company Act of 1935. This provision required the Commission to study invest-

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24. *See, e.g.*, DIANA B. HENRIQUES, FIDELITY'S WORLD 79-102 (1995); JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 1-72 (1995).

25. FERDINAND PECORA, WALL STREET UNDER OATH 283 (1939).

26. *See* SELIGMAN, *supra* note 24, at 95-100; *see also* PECORA, *supra* note 25, at 287-91.

ment companies and investment trusts, and report its findings to Congress by January 1937. The time it took the SEC to conduct the study increased because of the growth of the industry, the changing nature of services offered, and the discovery of continuing abuses. The SEC did not deliver the study until 1939—two years late.[27]

Time also was lengthened by the lobbying efforts of an industry that was slowly getting back up on its feet.[28] Although the Great Depression was still a bitter reality for most of the country, by 1935 the stock market had started to recover, and some of the larger advisers joined forces to form a trade association to lobby against the impending legislation. In the summer of 1937, the New York Herald Tribune reported "[t]hat Federal regulation is impending is conceded on all sides, though no definite statement to that effect has come from Washington. The ramifications of the 'industry' are manifold, and its problems unusually difficult of solution."[29] Nine days later, the Investment Counsel Association of America ("ICAA") was formed. According to the Tribune, the certainty of legislation was a "driving force."[30]

The nascent ICAA had its hands full. When Senate hearings on the investment adviser portion of the bill began in earnest in April 1940, the ICAA and others conducted a well-orchestrated campaign against the bill both on and off the Senate floor.[31] The legislative history of the Advisers Act is filled with arguments that the ICAA advanced against federal regulation. It argued that advisers should be regulated by the states, not the SEC; that the profession was not yet mature enough to be regulated; and that fraud was present in other professions that were not subject to federal regulation—why pick on advisers?[32]

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27. *Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Subcomm. of the Comm. on Banking and Currency*, 76th Cong. 51-53 (1940) (statement of David S. Schenker, Chief Counsel, Securities and Exchange Commission) [hereinafter Schenker Statement].

28. HENRIQUES, *supra* note 24, at 83-84.

29. Luttrel Maclin, *Code is Planned for Investment Counsel Trade—Impending U.S. Control Spurs Effort To Form a National Organization*, N.Y. HERALD TRIBUNE, July 18, 1937, IV.8, *cited in* DWIGHT ROGERS, A BRIEF HISTORY OF THE INVESTMENT COUNSEL ASSOCIATION OF AMERICA 19-20 (1982).

30. ROGERS, *supra* note 29, at 19-20; Maclin, *supra* note 29.

31. *Id.* at 33-34.

32. *Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Subcomm. of the Comm. on Banking and Currency*, 76th Cong. 745-47 (1940) (statement of Rudolf P. Berle, General Counsel, Investment Counsel Association of America).

The lobbying efforts of the ICAA met with success. The initial bill contained a provision, for example, that allowed the SEC to set the terms of advisory agreements "regularly used" with clients. The industry argued that this provision was silly: there was no such thing as a contract that was "regularly used"—and subsequent drafts of the bill omitted the offensive passage.[33] Provisions that would allow the Commission to require advisers to file certain reports, keep certain books and records, and open their books to SEC examiners, did not appear until 1960, while brokers have been subject to these requirements since the enactment of the Exchange Act in 1934.[34]

Not only were the advisers able to block provisions they disliked, but they also were able to add some they wanted. The Advisers Act included the prohibition performance fees, already mentioned above, in part because the ICAA lobbied for it. The ICAA was intent on protecting the reputation of its members, and one writer at the time remarked, "[t]he objective of the association now being discussed is to separate the sheep from the goats."[35] Performance fees, like contingency fees for lawyers, were viewed as inappropriate for businessmen. If advisers wanted to keep their reputations intact, then they could not afford to have the lesser members of their profession charging performance fees.[36]

The Advisers Act, more so than the Exchange Act, was a product of political compromise.[37] By June 1940, the ICAA was able to tell Congress that "all of [its] objections have been satisfactorily adjusted." An ICAA representative went on: "The Investment Counsel Association of America unqualifiedly endorses the present bill . . . we urgently hope passage of the bill may be expedited at this session of Congress . . ."[38] The political circum-

33. *Id.* at 744. The language was introduced in S. 3580, but deleted in the first reprint. A new bill, S. 4108, was introduced without the language.

34. LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3376 (3d ed. 1991); ROGERS, *supra* note 29, at 48.

35. Maclin, *supra* note 29, at 78.

36. S. REP. NO. 1775, at 21 (1940) (stating that not only must public be protected from frauds and misrepresentations of unscrupulous tipsters and touts, but bona fide investment counsel must also be safeguarded against stigma of activities of these individuals).

37. *See* SELIGMAN, *supra* note 24, at 214, 222.

38. *Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before the Subcomm. of the Comm. on Interstate and Foreign Commerce*, 76th Cong. 92 (1940) (statement of Dwight Rose, Investment Counsel Association of America).

stances of their legislative birth, therefore, were responsible, at least to some degree, for the difference in approach to adviser and broker regulation.

B. *A Functional Reason*

The second reason for the difference in broker and adviser regulation is functional. We learn a lot by looking carefully at the role brokers and advisers play in the economy and the function the two pieces of legislation were designed to have—what was Congress really trying to accomplish? The Advisers Act, when first enacted, was primarily designed to determine the number of advisers that were engaged in the business—it was like a census—and then to disclose information about those advisers to the public.[39] A stated purpose of the law was to ensure that investors had "adequate information as to the activities, practices, ability, training, and integrity of investment advisers . . ."[40] Twenty years later, in the leading case interpreting the Advisers Act, the Supreme Court stated that the purpose of the Act was "to substitute a philosophy of disclosure for the philosophy of *caveat emptor* . . ."[41]

There was no attempt to try to regulate the kind of advice advisers would provide or to standardize their qualifications. As David Schenker, the SEC's Chief Counsel for the Investment Trust Study, noted at the time, "I cannot impress too strongly upon the Senators the fact that our Title II does not attempt to say who can be an investment counselor, who can't be an investment counselor, and does not even remotely presume to undertake to pass upon their qualifications."[42]

Another purpose of the Advisers Act was to federalize the state law, or common law, of fiduciary duties for advisers that had developed over time. A Declaration of Policy, in an early draft of the legislation, stated that investors are adversely affected when advisers "relieve themselves of their fiduciary obliga-

39. Schenker Statement, *supra* note 27, at 48, 50.

40. *Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Subcomm. of the Comm. on Banking and Currency*, 76th Cong. 30 (1940) (Title II—Investment Advisers, Findings of the Congress, § 202 Declaration of Policy).

41. SEC v. Capital Gains Research Bureau, 375 U.S. 180, 198 (1963).

42. Schenker Statement, *supra* note 27, at 50.

tions to their clients."[43] As mentioned, the Supreme Court has since recognized that the Advisers Act creates federal fiduciary standards.[44]

The legislative history of broker-dealer legislation reflects a different purpose. Broker-dealer legislation was not meant to take a census of brokers, to require client disclosure, or to federalize common law. Rather the legislation was meant in large part to help restore health to the ailing economy of the 1930s.[45] The net capital rule for brokers, for example, is a liquidity rule—customers open an account with their broker with the expectation that they will be able to liquidate their holdings even if markets fall and many investors are trying to liquidate at the same time. As one court stated, "[t]he rule operates to assure confidence and safety to the investing public."[46] Advisers do not have the same concerns. Although an adviser might advise a client to take risks, the adviser does not have the same trading and credit relationships with other market participants that brokers have. As a result, advisers do not have the same sort of exposure to market events that brokers do, and do not require the same types of rules.

That is also true for credit regulations imposed on brokers by the Exchange Act. Congress wrote credit regulations into the Exchange Act explicitly *not* to guard the small investor against making a bad decision to borrow and invest too much money with his broker. Rather, Congress passed credit regulations to ensure that credit would be directed away from stock market speculation and toward more desirable ends.[47]

Stock exchanges at the time were accused of "sucking funds" from every corner of the country, and speculation was described as resulting from inadequate control of the national credit system that made speculation of funds easy—"funds which the national welfare much more requires in local commerce, industry, and agriculture."[48] The legislative history to the Ex-

43. *Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Subcomm. of the Comm. on Banking and Currency*, 76th Cong. 30 (1940).

44. Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979).

45. H.R. REP. NO. 1383, at 4-6 (1934).

46. *See, e.g.*, Blaise d'Antoni & Assoc., Inc. v. SEC, 289 F.2d 276, 277 (5th Cir. 1961).

47. H.R. REP. NO. 1383, at 8 (1934).

48. *Id.* at 6.

change Act sums it up: "This legislation is not an attempt to reach out and correct the morals of the citizens of any one State; it is an attempt to deal with the very vital economic problems going to the root of the functioning of our national credit system."[49] Unlike brokers, advisers do not generally loan money to their clients to buy on margin, and therefore do not need the same types of credit regulations imposed on them.

III. *PERFORMANCE FEES*

Whether viewed from a historical or functional perspective, adviser regulation is primarily disclosure-based regulation—its purpose is to provide information to the SEC and to investors, and to promote advisers' fiduciary duties to investors. Broker-dealer regulation is primarily substantive regulation on the activities of brokers—its purpose is to ensure macroeconomic stability. But what about the performance fee rule imposed on investment advisers mentioned above? This restriction is substantive and not disclosure-based. The Advisers Act provides, as it provided when enacted in 1940, that advisory contracts may not provide for compensation to the adviser "on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client."[50] To explain this anomaly, we have to look at the reasons the provision was enacted, and determine if they depart from the reasons mentioned above for regulating advisers.

The reasons for the provision have changed over time. The original reasons were more akin to the reasons for the prohibitions on brokers than the reasons for originally adopting adviser regulation. Recent changes to the rules the Commission adopted under the provision, however, reflect the approach seen for other adviser regulation.

As discussed above, the prohibition on performance fees was enacted, in part, as a result of pressure from the ICAA. It can also be explained through a functional approach. Congress's concern with performance fees was similar to Congress's concerns generally with broker-dealers: speculation and excessive risk-taking. Congress recognized that performance fee arrangements can function as an incentive for advisers to recom-

49. *Id.*
50. Investment Advisers Act § 205, 15 U.S.C.A. § 80b-5 (1997 & Supp. 1998).

mend that clients take excessive risks, since the potential gain to the adviser is very large, while the potential harm to the adviser is minimal.[51] The Senate Report on the bill stated that investment advisers "can enter profit-sharing contracts which are nothing more than 'heads I win, tails you lose' arrangements."[52] What could be done about these risky arrangements?

Congress was looking for ways to limit excessive speculation in the wake of the stock market crash. Here was an area where Congress had a ready means to adjust the incentives of advisers to limit speculation and risk-taking, and the lawmakers seized it. Moreover, the restriction on performance fees had the support of the investment adviser industry, so although this rule was a substantive restriction on the activity of advisers, it is not one that Congress had to fight for. Thus, the performance fee rule resulted from a mix of historical and functional influences; but the functional influence was the attempt to limit risk-taking, the same goal that animated the restrictions placed on brokers in the Exchange Act. From this perspective, the performance fee rule under the Advisers Act looks a little like broker-dealer regulation in investment adviser clothing.

The performance fee rule was revised three times. In 1970, Congress made an exception to the performance fee rule for certain advisory contracts relating to assets of over US$1 million.[53] In 1985, the Commission adopted a rule that allowed an adviser to charge performance fees if the adviser included certain terms in the performance fee agreement and made certain disclosures, but only if clients had a high net worth.[54] In 1998, the Commission liberalized the rule even further, this time eliminating all of the contractual and disclosure requirements while increasing, to account for inflation, the amount required to qualify as a high net worth client.[55]

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51. H.R. REP. No. 2639, at 29 (1940).

52. S. REP. No. 1775, at 22 (1940).

53. *See* Investment Advisers Act § 205(b)(2)(B), 15 U.S.C.A. § 80b-5(b)(2)(B) (1997 & Supp. 1998) (permitting "fulcrum" fees, which increase and decrease with investment performance, for contracts for assets over US$1 million).

54. Exemption to Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Investment Advisers Act Release No. 996 [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,939, at 87,889 (Nov. 14, 1985) [hereinafter Investment Advisers Act Release No. 996].

55. Exemption to Allow Investment Advisers to Charge Fees Based Upon a Share

Changes to the rule over the years reflect a shift toward the disclosure approach that has characterized other adviser regulation. Congress enacted the performance fee provision in 1940 to discourage advisers from engaging in speculative trading—not only because of the harm to investors, but also because of the general harm to the economy. The General Statement in the Senate Report discussing the performance fee rule points to the increasing widespread activities of advisers and "their potential influence on security markets . . ."[56] Over the years, however, concerns about limiting speculation that had so exercised the Congress in the wake of the Great Depression became out-of-date. The main concern that animated Congress and the SEC with respect to Advisers Act rules was protection of the client through disclosure and ensuring that advisers were meeting their fiduciary duties. In time, these same concerns were reflected in changes to the performance fee provisions.

In 1970, Congress provided the exception mentioned above for contracts over US$1 million,[57] and more importantly, gave the SEC broad statutory authority to grant exemptions from all provisions of the Advisers Act.[58] At the time, Congress pointed to the performance fee rule as one of the areas where exemptions would be appropriate.[59] By 1985, the SEC concluded that it was appropriate to permit clients who were "financially experienced" and "able to bear the risks" to enter into performance fee arrangements.[60]

The notion that the protections afforded by the Advisers Act are not necessary when the investors are wealthy makes sense in the context of the general purpose of the Advisers Act. After all, since wealthy investors, or their agents, have the ability to bargain effectively with their adviser, they are presumably less likely than other investors to benefit from required contractual terms and mandatory disclosures. In the 1985 rule amendments, the SEC required that the performance fee contract represent an

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of Capital Gains Upon or Capital Appreciation of a Client's Account, Investment Advisers Act Release No. 1731 [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,037, at 80,667 (July 15, 1998) [hereinafter Investment Advisers Act Release No. 1731].

56. S. REP. No. 1775, at 21 (1940).

57. Investment Advisers Act § 205(b)(2)(B), 15 U.S.C.A. § 80b-5(b)(2)(B) (1997 & Supp. 1998).

58. *Id.* § 206A, 15 U.S.C.A. § 80b-6a (1997 & Supp. 1998).

59. S. REP. No. 91-184, at 46 (1969); H.R. REP. No. 91-1382, at 42 (1970).

60. Investment Advisers Act Release No. 996, *supra* note 54, ¶ 87,902.

arm's length agreement. The SEC stated that, in its view, "an arm's length arrangement between the parties is one whose terms correspond to those which independent parties of equal bargaining position would arrive at after negotiation and without overreaching by either party."[61]

The Commission also reiterated the fiduciary duties of advisers entering into performance fee arrangements, regardless of the client's wealth. The Commission, in its explanation of the rule amendments, stated that the changes "should not be read as narrowing, in any manner, the disclosure obligations of investment advisers," and the Commission reminded advisers of their duty of "utmost good faith and fair disclosure of all material facts . . . ."[62]

In 1992, the SEC's Division of Investment Management issued a report recommending that Congress pass legislation clarifying the SEC's authority to provide exemptions from the performance fee rule for contracts with persons whom the Commission determined did not need the protections of the Advisers Act. The SEC staff wrote that "where a client appreciates the risk of performance fees and is in a position to protect itself from overreaching by the adviser, the determination of whether such fees provide value is best left to the client."[63] The staff was also concerned about the effects on competition for U.S. advisers that were unable to enter into these contracts with international clients "even where these arrangements are legal and customary in a client's country of residence . . . ."[64] Congress listened. Four years later, Congress amended the performance fee provision to eliminate, among other things, the restrictions with regard to contracts with non-U.S. residents, and authorized the Commission to exempt contracts with persons the SEC determines do not need the protections of the statute.[65]

In 1998, the SEC used its new authority and eliminated altogether the required contractual provisions in performance fee

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61. *Id.* ¶ 87,904.

62. *Id.*

63. Division of Investment Management, U.S. Securities and Exchange Commission, Protecting Investors: A Half-Century of Investment Company Regulation 245 (1992).

64. *Id.*

65. *See* Investment Advisers Act § 205(3), 15 U.S.C.A. § 80b-5(e) (1997 & Supp. 1998).

contracts for sophisticated clients.[66] Again, the Commission emphasized that "the elimination of the contractual and disclosure provisions . . . does not alter the obligation of an adviser, as a fiduciary, to deal fairly with its clients and to make full and fair disclosure of its compensation arrangements."[67] The Commission was comfortable, at least with respect to sophisticated investors, to get out of the business of specifying certain provisions of advisory contracts and to rely instead on the adviser's fiduciary duties.

The amendments to the performance fee prohibition over the past thirty years also reflect changes in the thinking of market participants since the 1930s and 1940s. While the ICAA supported the prohibition in the 1930s, the industry supported *liberalizing* the prohibition in 1998. In the notice and comment period for the SEC's most recent rule change, the Commission received twenty-two comment letters. The commenters supported liberalizing the rule; many even urged the Commission to further expand the types of clients eligible to enter into such arrangements.[68] The ICAA, now composed of 225 of the larger advisory firms, supported the proposal, writing that restrictions on performance fees "have hindered flexibility" in creating performance fee arrangements. "These sophisticated clients should be able to negotiate the terms of such contracts as they see fit."[69]

IV. *RECENT DEVELOPMENTS IN INVESTMENT ADVISER AND BROKER REGULATION*

Several recent regulatory initiatives at the SEC reflect the two approaches to regulation—disclosure for advisers and substantive rules for brokers. The first of these initiatives is the SEC's approach to addressing the Year 2000 (or "Y2K") computer problem with respect to both advisers and brokers. The second is the effort the Commission has taken to use disclosure over the Internet as a regulatory tool. The third is rulemaking the Commission has proposed to address a practice known as

66. Investment Advisers Act Release No. 1731, *supra* note 55.

67. *Id.* at 80, 669-70.

68. *Id.* ¶ 80,669.

69. Letter from Karen L. Barr, General Counsel, ICAA, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Jan. 15, 1998) (available in SEC Public File No. S7-29-97).

"pay to play"—where firms make political contributions to obtain business with state and local governments.

A. *The Year 2000 Problem*

The Year 2000 problem is by now old news. The SEC, however, was reminding market participants, such as advisers and brokers, as well as public companies, for several years to encourage them to take steps to avoid the Y2K computer problem. The steps the Commission has taken to address the Y2K problem, however, differed sharply for advisers, where the emphasis was on disclosure, and for brokers, where the SEC adopted more substantive regulation.

For investment advisers, the SEC was concerned mainly about whether clients were receiving sufficient disclosure of risks associated with their advisers' Y2K preparedness. Early in 1998, the Commission staff issued a Legal Bulletin addressing the Y2K problem. The Legal Bulletin stated:

> If the failure to address the Year 2000 issue could materially affect the advisory services provided to clients, an adviser that will not be able to or is uncertain about its ability to address Year 2000 issues has an obligation to disclose such information to its clients and prospective clients. This disclosure must be made in a timely manner so that the clients and prospective clients may take steps to protect their interests.[70]

The SEC also required SEC-registered advisers to file special reports with the Commission on a new form, Form ADV-Y2K, about their readiness for the Y2K computer problem.[71] The SEC, however, stopped short of placing any substantive requirements on advisers as to their readiness for the millennium bug. In fact, commenters on the SEC's rule proposal requiring these reports expressed concern that some of the questions "appeared to prescribe steps that *all* advisers must take" to prepare for the Y2K problem. In response, the SEC revised the wording of some of the questions and stated that "the Advisers Act *requires* no par-

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70. Division of Corporation Finance and Division of Investment Management, U.S. Securities and Exchange Commission, Staff Legal Bulletin No. 5 (CF/IM) (Jan. 5, 1998) <http://www.sec.gov/rules/othern/slbcf5.htm> (on file with the *Fordham International Law Journal*).

71. Investment Adviser Year 2000 Reports, Investment Advisers Act Release No. 1769 [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,049, at 80,809 (Oct. 1, 1998) [hereinafter Investment Advisers Act Release No. 1769].

ticular steps to be taken by an adviser" to prepare for the Y2K problem.[72] Also, in responding to questions about whether the form placed any new substantive requirements on advisers, the staff stated that "Form ADV-Y2K is only a report; and the only new obligation the Commission has created on an investment adviser is to respond to all of the questions in the form truthfully and to file the form in a timely manner."[73]

The SEC's approach to brokers' Y2K preparedness is different, reflecting the continuing concern that brokers can affect the securities markets in ways that advisers likely cannot—the same difference that animated the distinctions between adviser and broker regulation that arose in the 1930s. Brokers, like investment advisers, were required to disclose their readiness for the Y2K problem on a form, Form BD-Y2K.[74] The SEC recognized, however, that the failure of a broker-dealer firm, due to its function in the markets, may present systemic risks in ways that the failure of an advisory firm does not. According to the SEC, it is important for all broker-dealers to be Y2K compliant because the problems of any non-compliant broker-dealer "could have detrimental and potentially widespread consequences on other market participants."[75]

The Commission, as a result, adopted what it called a "proactive" approach that goes far beyond disclosure.[76] Under SEC rules, brokers are required to meet certain operational capability requirements. The new rules set forth specific criteria on what it means to be Y2K ready and provide that if a broker is not ready by August 31, 1999, or has not certified that any material problems will be fixed by November 15, 1999, it must make that information public and cease doing business.[77] Thus, the SEC responded to the Y2K problem very differently with respect to advisers and brokers. Advisers were admonished to make ap-

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72. *Id.* ¶ 80,812.

73. Division of Investment Management, U.S. Securities and Exchange Commission, *FAQs About Investment Advisers and the Year 2000 Problem, Question 24* (Nov. 12, 1998) <http://www.sec.gov/rules/othern/faqs2000.htm> (on file with the *Fordham International Law Journal*).

74. Securities Exchange Act Rule 17a-5(e)(5), 17 C.F.R. § 240.17a-5(e)(5) (1999).

75. Year 2000 Operational Capability Requirements for Registered Broker-Dealers and Transfer Agents, Exchange Act Release No. 41661 [Current] Fed. Sec. L. Rep. (CCH) (adopted July 27, 1999).

76. *Id.*

77. *Id.*

propriate disclosures, while brokers may suffer the ultimate regulatory sanction: to cease doing business.

B. *Use of Disclosure over the Internet as a Regulatory Tool*

If disclosure is to be the primary regulatory tool governing investment advisers, then the Internet provides a valuable new medium to disseminate information. Securities regulators around the world have recognized that the Internet can be a valuable regulatory tool. In a recent report, the International Organization of Securities Commissions wrote, "[s]ecurities regulators, like securities markets and market participants, also realize the benefits of the Internet and [are] using it in innovative ways. They are not only responding to the regulatory issues . . . but also are making use of the Internet to enhance their own regulatory effectiveness."[78]

This practice is exactly what the Commission appears to be doing in the area of investment advisers. Although most public issuers in the United States must file their disclosure documents on the SEC's EDGAR system, which is made available on the Commission's web site, investment advisers do not make their filings on EDGAR, and until recently, their filings were obtainable only through contacting the SEC for copies. When the SEC adopted the rule requiring Y2K disclosure forms for investment advisers, however, it was intent on making the forms available on the Commission's website. In the SEC's release adopting the rule requiring the filings, the SEC stated, "[s]hortly after the Commission receives the forms, we will make data from the forms available on the Commission's web site."[79] The Y2K forms, both for advisers and brokers, are available on the SEC's web site.[80] As a result, anyone with access to the Internet can read a simulated version of the Y2K forms filed by advisers and brokers.

This trend is likely to continue. As noted above, advisers register with the SEC on a registration form, Form ADV, which is mailed to the SEC and maintained in a public file. In 1996, Congress required the SEC to "establish and maintain" an electronic

78. *See* Technical Committee, International Organization of Securities Commissions, *Securities Activity on the Internet,* Part III (Sept. 1998) <http://www.iosco.org/docs-public/1998-internet_security.html> (on file with the *Fordham International Law Journal*).

79. Investment Advisers Act Release No. 1769, *supra* note 71, ¶ 80,811.

80. The web site address is <http://www.sec.gov/news/y2k/y2kreps.htm>.

process to respond to questions about the disciplinary history of investment advisers,[81] and permitted the SEC to require SEC-registered advisers to file forms through any entity designated by the SEC.[82] The Commission is planning an electronic registration system through which advisers will satisfy both state and SEC filing requirements by making a single electronic filing, and a database containing information from the filings would be placed on the Internet.[83] Thus, once the electronic registration system is complete, disclosure about investment advisers, including their disciplinary histories, will be readily available, much like Y2K information is available now.

C. *Pay To Play*

In certain circumstances, no amount of disclosure can stop a harm from occurring. In those circumstances, even in the adviser area, the SEC will likely consider substantive rules that effectively prohibit particular conduct. The most recent example in the investment adviser area is a proposed limitation on providing advisory services when an advisory firm makes political contributions to obtain government contracts—a practice known as "pay to play."

Long before pay to play was identified as a problem in the investment adviser area, it was considered a problem in the municipal securities markets.[84] Broker-dealers seeking to underwrite municipal bond offerings made political contributions to officials who could award underwriting contracts. The Commission studied the problem and determined that pay to play harms the municipal markets: it increases the costs of underwritings, undermines their integrity, and damages investor confidence.[85] In 1994, the Municipal Securities Rulemaking Board passed Rule

81. *See* Investment Adviser Supervision Coordination Act § 306, Pub. L. No. 290, 110 Stat. 3416 (1996).

82. Investment Advisers Act § 203A(d), 15 U.S.C.A. § 30b-3a(d).

83. U.S. Securities and Exchange Commission Press Release, *SEC Staff Recommends that NASDR Operate an Electronic Investment Adviser Registration System* (98-120) (Oct. 30, 1998) <http://www.sec.gov/news/press/98-120.txt> (on file with the *Fordham International Law Journal*).

84. *See, e.g., Murky Depths (Municipal Finance)*, ECONOMIST, Nov. 4, 1995, at 83 (stating that minicipal bond market is "more rife with corruption than even its fiercest critics have claimed").

85. *See* DIVISION OF MARKET REGULATION, U.S. SECURITIES AND EXCHANGE COMMISSION, STAFF REPORT ON THE MUNICIPAL SECURITIES MARKETS 9-11 (1993).

G-37 banning the practice for broker-dealers, and the SEC approved this rule shortly thereafter.[86]

Rule G-37 is harsh medicine. It prohibits brokers from engaging in the municipal securities business with a government client for two years after making a political contribution to an official of the government client who could influence the selection of the broker.[87] The rule was challenged on free speech grounds and upheld by a federal court of appeals as serving a compelling government interest in preventing fraudulent and manipulative acts.[88]

The SEC has now proposed for public comment a similar antidote for investment advisers that manage public funds. In a recent rule proposal, the SEC stated that it "received reports that the selection of investment advisers . . . may be influenced by political contributions, and as a result, the quality of management services provided to funds may be affected."[89] The SEC Chairman recently remarked, "Just as the 'culture of pay-to-play' came to corrupt the municipal securities market, pay-to-play has tainted the management of public funds."[90] The SEC cited abuses in seventeen states and the District of Columbia, and as a result, proposed a similar rule to G-37 for investment advisers managing public funds.[91]

Why is the SEC proposing, in this instance, to regulate

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86. *See* In the Matter of Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Political Contributions and Prohibitions on Municipal Securities Business and Notice of Filing and Order Approving on an Accelerated Basis Amendment No. 1 Relating to the Effective Date and Contribution Date of the Proposed Rule, Exchange Act Release No. 33,868, 59 Fed. Reg. 17,621 (Apr. 7, 1994).

87. Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Political Contributions and Prohibitions on Municipal Securities Business, Securities Exchange Act Release No. 34-33868, File No. SR-MSRB-94-2 (Apr. 7, 1994); Self-Regulatory Organizataion and Municipal Securities Rulemaking Board, 59 Fed. Reg. 17,621 (1994).

88. Blount v. SEC, 61 F.3d 938 (D.C. Cir. 1995), *cert. denied*, 517 U.S. 1119 (1996).

89. Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. 1812 [Current] Fed. Sec. L. Rep. (CCH) ¶ 86,512, at § I (Aug. 4, 1999) [hereinafter Investment Advisers Act Release No. 1812].

90. Remarks by SEC Chairman Arthur Levitt, *In the Best Interests of Beneficiaries: Trust and Public Funds* (Mar. 30, 1999) <http://www.sec.gov/news/speeches/spch263.htm> (on file with the *Fordham International Law Journal*).

91. Investment Advisers Act Release No. 1812, *supra* note 89. SEC Investment Advisers Act Rule 206(4)-5, if adopted, would prohibit an adviser from providing advisory services for compensation for two years after the adviser (or its partners, officers, or solicitors) made a contribution to certain elected officials or candidates.

through a substantive ban on pay to play activities? Why not simply require disclosure of the political contributions to be consistent with other regulations under the Advisers Act?

In the case of pay to play, the milder medicine of disclosure was simply unavailable. In fact, in the SEC's release proposing the rule, the Commission stated that it "considered proposing a different approach" and at least tentatively rejected it.[92] In the case of pay to play, disclosure of a political contribution by the adviser to the political official would have to be made either to the trustee of the public pension fund, or to the beneficiaries of the plan themselves. Disclosure to these persons, however, would be meaningless. Disclosure to the plan trustee would often mean disclosure to the very political officials, or their appointees, to whom the contributions were made. Disclosure to the beneficiaries would be similarly ineffective because they would be unable to act on the information: they are likely to be powerless to affect hiring decisions of the adviser or to move their pension plan to a different adviser.[93]

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The rule proposal in the pay to play area makes plain that when disclosure would be ineffective, the SEC will consider regulating investment advisers through substantive rules. But that is likely to remain the exception rather than the rule.

Since the 1930s and 1940s, the regulation of advisers has centered on requiring disclosure, while the regulation of brokers has centered on disclosure plus placing substantive restrictions on their activities. Although there have been exceptions over the years, the basic approach remains the same.

92. *Id.* § II.A.
93. *Id.*