# INVESTMENT ADVISER REGULATION

RESEARCH HANDBOOK ON CORPORATE LAW AND GOVERNANCE,
Jerry W. Markham & Rigers Gjyshi eds., Edward Elgar,
forthcoming (2014)

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# *INVESTMENT ADVISER REGULATION*

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*ABSTRACT*

The Dodd-Frank Act and SEC implementation rules have changed investment adviser regulation. This book chapter summarizes the most pertinent rules for investment advisers, emphasizes recent changes in the law, and shows how the updated rules have been implemented into the existing regulatory framework for investment advisers.

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The Investment Advisers Act of 1940[1] (IAA) regulates investment advisers that manage funds through custodial accounts or investment companies and disseminate advice through newsletters and other publications. Non-exempt investment advisers are required to register with the SEC,[2] file periodic reports,[3] and subject themselves to periodic examinations[4]. Investment advisers cannot engage in fraudulent practices and make material misrepresentations when rendering investment advice.[5] Investment advisers who are exempt from registration are still subject to the IAA's antifraud provision,[6] which applies to negligent misstatements and misstatements made with the intent to defraud.

The IAA also regulates contracts between investment advisers and their clients. Because contingent fee arrangements could lead to inappropriate risk taking by investment advisers, contingent fee arrangements between investment advisers and their clients are prohibited.[7] Instead, investment adviser fees are based on the total value of the managed fund(s) at pre-specified times. Since 1985, however, certain qualifying large advisory contracts are exempt from the general prohibition of contingent fee arrangements. Moreover, to protect investors against changes in the character or quality of advisory services, the IAA prohibits the assignment of contracts with clients unless the

[1] Investment Advisers Act of 1940, ch. 686, tit. II, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1-80b-20 (2012)).
[2] 15 U.S.C. § 80b-3 (2012).
[3] *Id*. § 80b-4.
[4] *Id*. § 80b-4(b)(6).
[5] *Id*. § 80b-6.
[6] *Id*.
[7] 15 U.S.C. § 80b-5(a)(1) (2012).

client consents.[8] Should investment advisers violate the securities laws, the SEC has the authority to impose sanctions on registered and unregistered investment advisers.[9] Sanctions may include limiting the adviser's activities, imposing a bar order, as well as suspending or censuring the adviser.

### *1. Definitions*

A basic precept of securities law is the definition of a security. Providing investment advice and being considered an investment adviser under the IAA requires that a person renders advice with regard to a security. The investment adviser and the client have to deal with a security in order for the definition of investment adviser under the IAA to apply. Securities have traditionally been defined broadly.[10]

Assuming that the parties are dealing with a security, the IAA defines an "investment adviser" as "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 . . . ."[11]

Several factors determine if a person's rendering of investment advice falls within the definition of investment adviser. Generally speaking, a person must be in the business of rendering advice, and the more individualized his or her advice is, the

[8] *Id*. § 80b-5(a)(2).
[9] *Id*. § 80b-3(e).
[10] SEC v. W. J. Howey Co., 328 U.S. 293, 298-99 (1946).
[11] 15 U.S.C. § 80b-2(a)(11) (2012).

more likely the person is to be classified as an investment adviser. Several factors can determine if a person is in the business of providing investment advice. These factors include (i) holding oneself out as an investment adviser or as someone who provides investment advice and (ii) receiving separate or additional compensation. While providing investment advice without compensation makes the person less likely to provide investment advice as an investment adviser under the IAA's definition, the SEC is broadly construing the meaning of compensation for advisory services. Finally, the frequency of rendering investment advice helps define whether a person is an investment adviser. Providing investment advice occasionally or rarely and in a non-periodic fashion makes it less likely for a person to be considered an investment adviser.

Persons who are not covered by the "investment adviser" definition are excluded and not subject to regulation under the IAA. The IAA excludes banks, lawyers, accountants, engineers, and teachers from the definition if these persons are providing investment advice incidental to their professions.[12] Advisers who render advice solely with respect to United States government securities are also excluded from the definition of investment adviser.[13]

Perhaps the most important exclusion, however, is the exclusion for broker dealers. A broker dealer holding him or herself out as a financial planner alone does not trigger IAA registration obligations.[14] A broker dealer who provides investment advisory

[12] *Id*. § 80b-2(a)(11)(A), (B).
[13] *Id*. § 80b-2(a)(11)(E).
[14] 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, 39 SEC Docket 494 (Oct. 8, 1987) (superseding Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who

services that are "solely incidental to the conduct of his business as a broker or dealer" is also exempt from the IAA definition of broker dealer, provided the broker dealer does not receive "special compensation."[15] The burden of proof is on the plaintiff to show that the broker dealer received special compensation and that the investment advice was more than incidental to the brokerage activities.[16] A broker-dealer cannot be classified as an investment adviser without proof of special compensation.

### *2. Adviser Categories*

When it passed the Dodd-Frank Act,[17] Congress recognized that not all hedge fund advisers pose the same systemic risks and therefore require the same level of oversight. Congress therefore created different hedge fund adviser categories in Title IV of the Dodd-Frank Act.[18] Categorizing hedge fund advisers by size, Title IV and SEC forms suggest that the larger the hedge fund advisers, as measured by their assets under management (AUM), the higher the possible systemic threat the respective fund poses. Accordingly, the disclosure requirements increase with the AUM size of hedge fund advisers.

Investment advisers with between $25 and $100 million AUM are defined as mid-

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Provide Investment Advisory Services As an Integral Component of Other Financially Related Services, Investment Advisers Act Release No. 770, 23 SEC Docket 556 (Aug. 13, 1981)).

[15] 15 U.S.C. § 80b-2(a)(11)(C).

[16] SEC v. Kenton Capital, Ltd., 69 F. Supp. 2d 1, 13 (D. D.C. 1998).

[17] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of U.S.C. tits. 7, 12, 15, 18, 22, 31, 42 (2012)).

[18] *Id.* tit. IV, §§ 402, 403, 407, 408, 410 (codified at 15 U.S.C. §§ 80b-2(a), 80b-3(b), 80b-3, 80b-3, 80b-3a(a)); s*ee also* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3222, 101 SEC Docket 1649 (June 22, 2011).

sized investment advisers.[19] Under Title IV, state authorities are responsible for mid-sized investment advisers.[20] While mid-sized advisers are not required to register with the SEC, they may still be required to register with the state agency in the state of their principal place of business.[21] Should a particular state not provide sufficient regulation, the SEC will oversee the mid-sized investment adviser.[22]

Investment advisers having more than $150 million regulatory assets under management (RAUM) are defined as large private fund advisers and are required to register with the SEC.[23] The registration of large private fund advisers increases the availability of data and may help protect against systemic risk. Large private fund advisers are required to file Form PF with the SEC. Additional filing requirements apply to investment advisers that substantially exceed the general RAUM requirement of $150 million.

### *3. Registration*

The financial crisis of 2007-08 precipitated a renewed emphasis on regulatory oversight of the global hedge fund industry.[24] Congress enacted the Private Fund Investment Advisers Registration Act of 2010 in Title IV of the Dodd-Frank Act

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[19] Dodd-Frank Act § 410 (codified at 15 U.S.C. § 80b–3a(a); s*ee also* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3221, 101 SEC Docket 1467, 37-40 (June 22, 2011) [hereinafter IAA Release No. 3221].
[20] Dodd–Frank Act, § 410 (codified at15 U.S.C. § 80b–3a(a).
[21] *Id.; see also* IAA Release No. 3221, *supra* note 19, at 8-9.
IAA Release No. 3221, *supra*, note 19, at 8-9.
[23] 17 C.F.R. § 275.204(b)-1 (2013) (requiring private fund advisers to file Form PF with the SEC periodically).
[24] Dodd-Frank Act §§ 401-416 (incorporating the Private Fund Investment Advisers Registration Act (PFIARA) in Title IV); *Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives 2004/39/EC and 2009/…/EC*, COM (2009) 207 final (Apr. 30, 2009); *Alternative Investments*, EUROPEAN COMMISSION, http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm (last visited Sept. 17, 2013).

(PFIARA Act, or Title IV).[25] Title IV amends the IAA and establishes rules and regulations for the registration of private funds with the SEC. The SEC has rulemaking authority to implement the provisions in Title IV. All non-exempt investment advisers are required to register with the SEC by filing Form ADV.[26]

Several adviser categories are excluded from mandatory investment adviser registration. Until the enactment of Title IV in the Dodd-Frank Act of 2010, most hedge fund advisers were not subject to IAA registration requirements. Advisers with fewer than fifteen clients who did not hold themselves out as advisers either to the public or to investment companies were exempt.[27] Most hedge fund advisers set up their operations and legal structure to comply with the former exemption so as to avoid registration and supervision by the SEC.[28] In 2010, however, Congress repealed the exemption by enacting Title IV of the Dodd-Frank Act and substituted instead an exemption for foreign private advisers.[29] Foreign private advisers qualify for the foreign private adviser exemption if they have fewer than fifteen clients and investors in the United States, do not have a place of business in the United States, do not hold themselves out to the U.S. public as an investment adviser, and do not attribute more than $25 million AUM solely to U.S. clients and investors.[30]

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[25] Dodd–Frank Act §§ 401-416; *see also* Wulf A. Kaal, *Hedge Fund Regulation via Basel III*, 44 VAND. J. TRANSNAT'L L. 389 (2011) (stating that prior to the enactment of Title IV, the SEC had attempted to increase regulatory oversight of the hedge fund industry on several occasions).
[26] 15 U.S.C. § 80b-3(c) (2012); SEC, Form ADV Part 1A, Uniform Application for Investment Adviser Registration and Report by Exempt Reporting Advisers, *available at* http://www.sec.gov/about/forms/formadv-part1a.pdf [hereinafter Form ADV, Part 1A].
[27] Former Investment Advisers Act § 203(b)(3) (codified at 15 U.S.C. § 80b-3(b)(3) (2006) was repealed by the Dodd-Frank Act § 403.
[28] *See* Kaal, *supra* note 25.
[29] Dodd-Frank Act §§ 402(a), 403 (codified at 15 U.S.C. §§ 80b-2(a)(30), 80b-3(b)(3).
[30] Dodd-Frank Act § 402(a) (codified at 15 U.S.C. § 80b-2(a)(30)).

The threshold registration requirement for private fund advisers under Title IV of the Dodd-Frank Act requires a majority of hedge fund advisers who had previously relied on the fewer than fifteen clients exemption[31] to register with the SEC. Under Title IV, investment advisers that advise one or more private funds and manage more than $150 million AUM are required to register with the SEC.[32] Private fund advisers with less than $150 million AUM are exempt from registration.[33]

Advisers that do not provide advice with regard to exchange-listed securities and whose clients are residents of the adviser's principal place of business are exempt as local advisers.[34] Similarly, advisers with less than $25 million AUM that do not advise registered investment companies are subject to the exclusive regulatory jurisdiction of the states.[35] Advisers whose only clients are insurance companies,[36] advisers with less than $100 million AUM who provide advice to clients on investments other than private funds,[37] and venture capital fund advisers[38] are also excluded.

A person or entity that is exempt from registration as an investment adviser may otherwise still be subject to regulation under the IAA but is not required to comply with certain provisions. Exempt persons or entities are still subject to the IAA's antifraud

[31] Former Investment Advisers Act § 203(b)(3) (codified at 15 U.S.C. § 80b-3(b)(3) (2006) was repealed by the Dodd-Frank Act § 403.
[32] 17 C.F.R. § 275.204(b)-1 (2013) (requiring private fund advisers to file Form PF with the SEC periodically).
[33] Dodd-Frank Act § 408 (codified at 15 U.S.C. § 80b-3(m)).
[34] 15 U.S.C. § 80b-3(b)(1) (2012).
[35] *Id*. § 80b-3a. Since the enactment of Investment Advisers Act § 203A, Pub. L. No. 104-290 § 303, 110 Stat. 3410, 3437 (1996) took effect in 1997, the exemption has proven more important to advisers than the local adviser exemption in § 80b-3(b)(1) (2012).
[36] *Id.* § 80b-3(b)(2).
[37] Dodd-Frank Act § 410 (codified at 15 U.S.C. § 80b-3a(a).
[38] *Id*. § 407 (codified at 15 U.S.C. 80b-3(l)).

provisions,[39] which apply to misstatements made with the intent to defraud and negligent misstatements.

*4. Disclosure*

The registration of investment advisers facilitates the collection of data and enhanced disclosure by hedge fund managers. The Dodd-Frank Act increased the disclosure requirements for registered investment advisers to address concerns over systemic risk.[40] Registered investment advisers must maintain records and any other information the SEC and the Financial Stability Oversight Council (FSOC) may deem necessary.[41] They are also required to maintain records and must provide reports with respect to, among others,: trading and investment positions, the amount of AUM, trading practices, valuation policies, side letters, the use of leverage, and counterparty credit risk exposures.[42]

Investment advisers registering with the SEC are required to file Form ADV, which is also used for registration with state securities authorities. Part 1 of Form ADV requires disclosure of investment advisers' ownership, affiliations, clients, employees, business practices, and disciplinary events.[43] Part 2 of Form ADV requires investment advisers to provide a narrative brochure in plain English to prospective advisory customers. The brochure should contain the information set forth in Form ADV Part 2.[44] As the primary disclosure document for investment advisers' clients, the brochure must

[39] 15 U.S.C. § 80b-6.
[40] Dodd-Frank Act § 404 (codified at 15 U.S.C. § 80b-4(b)(3)(H)) .
[41] *Id*. (codified at 15 U.S.C. § 80b-4(b)(1)(A).
[42] *Id*. (codified at 15 U.S.C. § 80b-4(b)(3)(H).
[43] Form ADV Part 1A, *supra* note 26.
[44] 17 C.F.R. § 275.204–3 (2013).

describe the business and educational background of the adviser's managers and key advisory personnel, the adviser's fee schedule, the types of advisory services offered, conflicts of interest, and disciplinary information.[45] Registered investment advisers must file annual reports with the SEC using Form ADV-S.

Generally speaking, the information in an investment adviser's registration statement is available to the public. Advisers must maintain certain records and make them available to the SEC for periodic inspection. The records subject to SEC inspection include accounting statements such as income statements, balance sheets, and a journal of all accounts. Other records the SEC may inspect include advertisements sent to more than ten customers, records of all securities transactions, records pertaining to investment advice or order execution, as well as any notices.

The SEC amended Form ADV after the enactment of the mandatory registration requirements under Title IV of the Dodd-Frank Act. Investment advisers were required to file the amended Form ADV by March 30, 2012.[46] Both registered investment advisers and exempt reporting advisers are required to file reports with the SEC pertaining to the private funds they manage.[47] The version of Form ADV that was in effect on March 30, 2012 increased the mandated disclosures by adding several disclosure items, including the number of employees[48] registered as representatives of broker-dealers, employees performing advisory functions, employees registered with state authorities as investment

[45] SEC, Form ADV Part 2, Uniform Requirements for the Investment Adviser *Brochure* and *Brochure Supplements*, *available at* http://www.sec.gov/about/forms/formadv-part2.pdf. [hereinafter Form ADV Part 2].
[46] 17 C.F.R. 275.203A-5(b) (2013); *see also* IAA Release No. 3221, *supra* note 19, at 93.
[47] Form ADV Part 1A, *supra* note 26, Item 2.B.
[48] *Id*. Item 5.A.

adviser representatives, employees working as insurance agents,[49] and non-employees soliciting advisory clients on the adviser's behalf.[50] Advisers must also disclose the fund's investment strategy, its gross asset value, the percentage of AUM attributable to each client type,[51] the fund's structure and ownership, the fund's use of consultants and other gatekeepers, and the scope of services provided.[52] Finally, Form ADV requires disclosure of clients' assets in custody and the number of persons who are acting as qualified custodians for clients in connection with advisory services.[53] To prevent fraud or mistakes, any irregularities must be disclosed in Form ADV.[54] Investment advisers must also indicate the total number of clients' cash, bank accounts, or securities subject to adviser or related person custody and the total U.S. dollar amount held in custody.

To avoid potential conflicts of interest between different types of businesses and services, investment advisers must disclose compensation given or received for client referrals,[55] related persons status of brokers and dealers,[56] and soft dollar benefits, i.e., research or other products and services received in connection with client transactions.[57] Investment advisers also have to disclose their transactions[58] and any services provided

[49] *Id*. Item 5.B.
[50] *Id*. Item 5.
[51] Form ADV Part 1A, *supra* note 26.
[52] *Id.* Item 5.G.
[53] *Id*. Item 9.D.
[54] *Id*. Item 9.C.
[55] *Id*. Items 8.H, 8.I, 8.C.(3); Items 8.E, 8.D; Items 8.F, 8.G.(2); *see also* IAA Release No. 3221, *supra* note 19, at 77.
[56] Form ADV Part 1A, *supra* note 26, Items 8.D, 8.F.
[57] *Id*. Item 8.G.
[58] *Id*. Item 8.A; *see also* IAA Release No. 3221,*supra note* 19, at 77-78.

other than investment advice to advisory clients,[59] including the types of business activity,[60] and if one of those businesses is primary to the adviser.[61]

Information about voting on portfolio securities must be available to advisory clients; this requires registered investment advisers to adopt proxy policies and procedures[62] and inform advisory clients about advisers' proxy voting policies and procedures. Upon request, investment advisers must provide clients with a copy of the proxy voting policies and procedures, including information regarding how advisory clients may obtain information about the adviser's proxy voting. Similarly, managers of investment companies must disclose their voting of portfolio securities.

In addition to the registration and disclosure requirements included in Form ADV, Title IV of the Dodd-Frank Act also increased the periodic reporting requirements for registered investment advisers.[63] Form PF was enacted in October 2011[64] to improve investigations and examinations by the SEC and the Commodity Futures Trading Commission (CFTC) and to facilitate the FSOC's[65] monitoring of systemic risk in U.S. financial markets.[66] Unlike Form ADV, Form PF filings are confidential and not publicly available.

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[59] Form ADV Part 1A, Item 6.B.(3) (asking the adviser to describe other products and services).
[60] *Id*. Item 6.A.
[61] *Id*. Item 6.B.(1), (2).
[62] 17 C.F.R. § 275.206(4)-6 (2013).
[63] Dodd-Frank Act, Pub. L. No. 111-203, § 404, 124 Stat. 1376, 1571 (2010) (codified at 15 U.S.C. 80b-4).
[64] 17 C.F.R. § 275.204(b)-1 (2013) .
[65] Dodd-Frank Act § 112(d)(1) (codified at 12 U.S.C. § 5322(d)(1) (authorizing the FSOC to collect information to support its functions).
[66] Dodd-Frank Act § 112(a)(1) (codified at 12 U.S.C. § 5322(a)(1). ("The purposes of the Council are—(A) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace; (B) to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such

Investment advisers, commodity pool operators, and commodity trading advisers that manage at least $150 million AUM and are registered with the SEC must file Form PF periodically. Private funds with less than $150 million AUM, however, are not required to file Form PF. The frequency of Form PF filings is dictated by the size of the investment adviser's RAUM. Large private fund advisers, defined as investment advisers with at least $1.5 billion RAUM attributable to hedge funds,[67] must update Form PF filings on a quarterly basis.[68] Investment advisers with less than $1.5 billion RAUM only have to file Form PF on an annual basis.[69] The quarterly reporting for large private fund advisers is intended to provide the FSOC with timely data to identify emerging trends in systemic risk.

Form PF disclosures are unprecedented in the private fund industry and require disclosures pertaining to the investment adviser, the funds it manages, and individual investors.[70] Other significant Form PF disclosures include risks metrics, credit exposure, positions, the investment adviser's strategies, performance and changes in performance, the products used by the investment adviser, and financing information, among others.[71]

Form PF also requires certain disclosures pertaining to the funds managed by investment adviser. More specifically, Form PF requires investment advisers to list the

companies that the Government will shield them from losses in the event of failure; and (C) to respond to emerging threats to the stability of the United States financial system").

[67] SEC, Form PF, Reporting Form for Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors, General Instructions, instruction 3, sec. 2a, *available at* http://www.sec.gov/about/forms/formpf.pdf [hereinafter Form PF].

[68] *Id*. instruction 9 ("[Large hedge fund advisers] must file a quarterly update that updates the answers to all Items in this Form PF relating to the hedge funds . . . .")

[69] *Id*. instruction 1.

[70] Form PF, *supra* note 67, sec. 1a, 2; 17 C.F.R. § 279.9 (2013).

[71] Form PF, *supra* note 67, secs. 1b, 1c, 2a, 2b, 3, 4.

Net Asset Value (NAV) by hedge fund strategy.[72] The reporting fund's greatest net counterparty credit exposure is another important disclosure item for investment advisers.[73] This includes disclosure of information pertaining to the dollar amount owed to each creditor and the name of the creditor,[74] collateral and credit support,[75] and the effect of changes in market factors on the long and short components of the portfolio as a percentage of NAV.[76] Form PF also mandates the disclosure of the percentage of the reporting fund's NAV managed by using computer-driven trading algorithms.[77]

To help the SEC understand the liquidity of the reporting fund's portfolios, Form PF requires the investment adviser to disclose the reporting fund's positions and how long it would take to liquidate them.[78] Similarly, to enable the SEC to understand the exposure of the advised hedge funds and their assets, Form PF requires disclosure of the investment adviser's exposure of long and short positions[79] and the value of turnover by asset class.[80] Form PF requires investment advisers to disclose the reporting fund's restrictions of investor redemptions and withdrawals[81] and investors' liquidity, measured by time period and percentage of NAV locked.[82] Moreover, disclosures are required for the aggregate value of all derivative positions for each advised fund[83] and the value of the advised funds' borrowings and the types of creditors.[84] Finally, Form PF mandates the

[72] *Id.* sec. 1c, item B.20.
[73] *Id.* sec. 1c., items B.22-23.
[74] *Id.* sec. 2b, item D.47.
[75] *Id.* sec. 2b., item B.36.
[76] *Id.* sec. 2b., item C.42.
[77] *Id.* sec. 1c., item B.21.
[78] *Id.* sec. 2b., item B.32.
[79] *Id.* sec. 1c., items B.22-23, 30.
[80] *Id.* sec. 1c., item B.27.
[81] *Id.* sec. 2b., item E.49.
[82] *Id.* sec. 2b., item E.50.
[83] *Id.* sec. 2b, item D.45.
[84] *Id.* sec. 2b, item D.43.

disclosure of clearing mechanisms.[85]

### 5. *Blue Sky Laws*

In 1996, with the enactment of the National Securities Markets Improvement Act (NSMIA), Congress decided that the SEC should regulate larger investment advisers while states would oversee smaller investment advisers. The distinction between larger and smaller investment advisers manifests itself in the NSMIA's threshold requirement of $25 million in AUM for state regulation. The Dodd-Frank Act mandates state oversight for investment advisers with up to $100 million AUM. However, should the $100 million AUM threshold result in an adviser's registration with fifteen or more states, the adviser is allowed to register directly with the SEC.[86] Investment advisers that manage less than $25 million AUM can register with the SEC if they otherwise would have to be registered in fifteen or more states.[87] Newly formed investment advisers qualify for federal registration if they reasonably expect to satisfy the thirty-state test within ninety days of registering with the SEC. Regardless of the amount of AUM, investment advisers that provide investment advice exclusively through the Internet may register with the SEC.[88] Investment advisers that are exempt from federal registration may still be subject to disclosure and recordkeeping requirements.[89]

[85] *Id.* sec. 1c., item A.24.
[86] 15 U.S.C § 80b-3a(a)(2)(A) (2012) (as amended by the Dodd-Frank Act, Pub. L. No. 111-203, § 410, 124 Stat. 1376, 1576 (2010).
[87] 17 C.F.R. § 275.203A-2 (2013).
[88] *Id.* at § 275.203A-2(e).
[89] Dodd–Frank Act § 408 (codified at 15 U.S.C. § 80b-3(m)(2)) (giving the SEC authority to require even exempted advisers to keep records and make reports as it deems necessary).

## *6. Qualified Clients*

The Dodd-Frank Act also changed the IAA with regard to qualified client standards. The SEC has the authority to exempt any person or transaction from IAA requirements pertaining to investment advisory contracts with clients, provided the SEC determines that the person does not require the protections of the IAA. The Dodd-Frank Act added an inflation-based adjustment to the qualified client standard for exemption under the IAA.[90] If the SEC uses a net asset threshold or any other dollar-amount test to determine the qualified client standard for exemption under the IAA, the SEC is required to adjust the dollar-amount test for the effects of inflation within one year after enactment and every five years thereafter.[91]

Because persons who meet the net-worth test by virtue of including the value of their primary residence are less likely to be able to bear the risk of performance fee arrangements, the SEC excludes the value of a person's primary residence and related debts from the net-worth test.[92] The SEC reasoned that the value of a residence is only limitedly connected to a person's experience in finance and investments and the risks of performance fee arrangements. SEC estimates suggest that with the exclusion of the primary residence from the net-worth test, roughly 1.3 million households were excluded from qualifying under the revised net-worth test.[93] The net-worth test also excludes the amount of a person's debt secured by his or her primary residence, provided the value of

[90] Dodd-Frank Act § 418 (codified at 15 U.S.C. § 80b-5(e)).
[91] *Id*.
[92] 17 C.F.R. § 275.205-3 (2013); Investment Adviser Performance Compensation, Investment Advisers Act Release No. 3372, 103 SEC Docket 172, 3 (Feb. 15, 2012) [hereinafter IAA Release No. 3372].
[93] IAA Release No. 3372, *supra* note 92, at 9.

the debt is not greater than the primary residence's market value.[94] If the debt exceeds the value of the primary residence, it can be included as a liability in the net-worth calculation.

*7. Custody of Client Assets*

Custody of client assets plays an important role in protecting the clients of investment advisers. The SEC adopted rules to increase the standards for custodial accounts in 2009, before the enactment of the Dodd-Frank Act.[95] In 2010, in an effort to address concerns over theft and to lower clients' exposure to the risks of Ponzi schemes, the Dodd-Frank Act amended the IAA, heightening custodial practices by requiring safeguards for client assets and the use of independent accountants to verify assets.[96] The custodian requirements under the Dodd-Frank Act curtail investment advisers' ability to pay existing investors with the funds invested by new investors. Custodians can accept client instructions to buy or sell securities but cannot remit the sales proceeds to the investment adviser or to third parties.

*8. Internet Related Updates*

Providing investment advice in the age of the Internet presents regulatory challenges. Unregistered persons who provide investment advice via Internet chat rooms and websites may be required to register as an investment adviser with the SEC.

[94] 17 C.F.R. § 275.205-3(d)(1)(A)(2).
[95] Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2968, 97 SEC Docket 1849 (Dec. 30, 2009) (amending 17 C.F.R. § 275.206(4)-2).
[96] Dodd-Frank Act, Pub. L. No. 111-203, § 411, 124 Stat. 1376, 1577 (2010) (codified at 15 U.S.C. § 80b-18b (2012).

Registration is not required if the person provides impersonal investment advice.[97] The SEC has provided guidance on how to avoid registration requirements under the IAA when providing advice via the Internet. [98] For instance, the provider of a bulletin board is exempt from registration if he or she provides a mere "passive" electronic bulletin board by posting information about securities on the Internet. In order to remain exempt from registration as an investment adviser under the IAA, the provider of a "passive" electronic bulletin board cannot give advice regarding the merits of any particular trade and he or she cannot be involved in the purchase of securities or sale negotiations.

*9. Prohibited Practices*

The IAA prohibits fraudulent, deceptive, or manipulative acts or practices[99], as defined in SEC rules,[100] as well as any conduct that "operates as a fraud or deceit upon any client or prospective client."[101] Fraudulent practices include, among others, undisclosed conflicts of interest, excessive trading, splitting fees with unregistered persons, misleading advertising,[102] and scalping.

Investment advisers cannot commingle clients' funds and are required to keep accurate records and separate accounts. Investment advisers who are holding securities or funds must hold them in custodial accounts on behalf of the clients. Independent public accountants can inspect and certify these custodial accounts. Similarly, because

[97] SEC v. Park, 99 F. Supp. 2d 889, 898 (N.D. Ill 2000); Lowe v. SEC, 472 U.S. 181, 207-08 (1985).
[98] Angel Capital Electronic Network, SEC No-Action Letter, 1996 WL 636094 (Oct. 25, 1996); Internet Capital Corp., SEC No-Action Letter, 1998 WL 9357 (Jan. 13, 1998); Progressive Technology Inc., SEC No-Action Letter, 2000 WL 1508655 (Oct. 11, 2000);

[99] 15 U.S.C. § 80b-6(4).
[100] 17 C,F.R. pt. 275.
[101] 15 U.S.C. § 80b-6(2).
[102] 17 C.F.R. § 275.206(4)-1 (2013).

investment advisers are subject to a duty to obtain the best execution for customer orders,[103] investment advisers ought to periodically evaluate the executions on behalf of their clients.

Mandatory ethics codes, disclosures, and client consents can curtail fraudulent practices. An investment adviser must disclose and obtain a client's consent before acting as a principal in a transaction with a client.[104] Investment advisers are required to supervise their personnel as well as to adopt and enforce codes of ethics for supervised staff.[105] If the investment adviser's code of ethics has been violated, the adviser must report the incident to the SEC. The ethics code must include a provision that mandates reporting of any code violation to designated persons.

Reacting to several scandals in the mutual fund industry and in an effort to curb violations of the IAA, the SEC has mandated the implementation of written policies and procedures for investment advisers,[106] among other compliance measures. Registered investment advisers must designate a chief compliance officer. The chief compliance officer should have sufficient knowledge of IAA obligations and adequate authority to develop and enforce appropriate policies and procedures. These policies and procedures, at a minimum, should address the following investment management processes: (i) creation and maintenance of required records; (ii) valuation of client assets; (iii) assessment of fees; (iv) safeguarding of client assets; (v) business continuity plans; (vii)

[103] *See, e.g.*, Portfolio Advisory Servs., Investment Advisers Act Release No. 2038, 77 SEC Docket 2759 (June 20, 2002), *available at* http://www.sec.gov/litigation/admin/ia-2038.htm; Duties of Brokers, Dealers, and Investment Advisors, Investment Advisers Act Release No. 3558, Exchange Act Release No. 69013, 2013 WL 771910 (Mar. 1, 2013); Securities; Brokerage and Research Services, Exchange Act Release No. 23170, 51 Fed. Reg. 16004 (Apr. 23, 1986).
[104] 15 U.S.C. § 80b-6(3).
[105] *Id.* § 275.204a-1.
[106] *Id.* § 275.206(4)-7.

allocation of investment opportunities; (viii) assessment and compliance with clients' investment objectives and restrictions; (ix) best execution and soft dollar arrangements, among other trading arrangements; (x) proprietary trading of the investment adviser and personal trading activities of its employees; (xi) marketing services; and (xii) safeguards for client privacy protection. To ensure the adequacy and effectiveness of their policies, registered investment advisers must review their policies and procedures annually.

The enforcement of a violation of prohibited transactions under the IAA is limited. In Transamerica Mortgage Advisors, Inc. v. Lewis[107] the Supreme Court determined that a violation of the IAA's prohibited transactions provision[108] does not allow for implied private rights of action. Accordingly, the enforcement of the IAA's prohibited transactions provision is relegated to injunctive relief, administrative sanctions, and criminal prosecution.

*10. Fees*

The IAA restricts fee arrangements in advisory contracts.[109] It also prohibits performance-based compensation if the adviser's fee is linked to the performance of the client's account.[110] The IAA does, however, allow investment advisers to tie their compensation to the average value of the client's assets.[111]

Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11 (1979).
[108] *Id.* at 24.
[109] 15 U.S.C. § 80b-5 (2012).
[110] *Id.* § 80b-5(a)(1).
[111] *Id.* § 80b-5(b)(1).

The SEC limits the referral fees that investment advisers pay to third parties.[112] Advisers may pay referral fees provided the referral fee recipients are bona fide persons under securities laws, the fees have been disclosed to the investment adviser's clients, and the fees are paid in accordance with a written agreement.[113] Similarly, client referrals in exchange for an increased share of an investment adviser's advisory and order execution business have to be disclosed to the investment adviser's clients, especially if such arrangements are more expensive in comparison with other custody/brokerage options and could interfere with the investments adviser's best execution of client orders.

[112] 17 C.F.R. § 275.206(4)-3 (2013).
[113] *Id.*