

Chapter 2

Investment Adviser Status Questions

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§ 2:1 Introduction

The starting point for regulation under the Investment Advisers Act is section 202(a)(11), which defines an investment adviser. As will be seen, the definition is quite broad, but tempered by a variety of exclusions. Completing the picture are a number of exemptions from registration that were significantly changed by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).¹ Entities that are exempted from registration under the Investment Advisers Act remain subject to its antifraud and other substantive provisions. Furthermore, some of these entities that are entitled to an exemption from registration must still comply with certain

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (July 21, 2010).

new reporting requirements arising out of the Dodd-Frank Act's amendments to the Investment Advisers Act. Those entities that are excluded from the definition of investment adviser are removed from all of the Investment Advisers Act's requirements.

In addition to handling status determinations under the Investment Advisers Act, the investment management lawyer will often be called upon to address adviser status determinations under state law (particularly with respect to state-registered advisers), the Investment Company Act, and ERISA.

The definition of investment adviser in many state statutes parallels the definition in the Investment Advisers Act. Some variations include states that allow advisers to have a certain number of resident clients before registration is required;² states that do not require registration for advisers whose only clients are institutions; states that include in their definition of investment adviser persons who "hold themselves out" as investment advisers; and states that provide that broker-dealers and their agents who hold themselves out as advisers cannot rely on the broker-dealer exclusion.

Some novice investment management lawyers mistakenly believe that the definition of "investment adviser" under the Investment Advisers Act is identical to the definition of investment adviser in the Investment Company Act. In fact, investment adviser is defined in section 2(a)(20) of the Investment Company Act by reference to advisory services provided to investment companies. Practically speaking, entities that are investment advisers under the Investment Company Act are often investment advisers under the Investment Advisers Act, but many advisers fall within the definition of adviser under the Investment Advisers Act without falling within the definition of adviser under the Investment Company Act.

Status as a registered investment adviser has special significance with respect to ERISA. ERISA section 402(c)(3) permits a "named fiduciary" (for example, the employer) to select an "investment manager" to manage plan assets, and in so doing to obtain limited relief from the fiduciary provisions with respect to investment advisory activities. Those eligible to be investment managers include investment advisers registered under the Investment Advisers Act or under state law, along with banks and insurance companies.

2. The 1996 Amendments to the Investment Advisers Act, discussed in chapter 3, provided uniformity requirements on state law in this area. New § 222(d) provides that investment advisers may not be required to register in any state unless the adviser has a "place of business" in the state or during the preceding twelve-month period has had more than five "clients" who are residents of the state.

In this chapter, we examine status questions under the Investment Advisers Act, where the bulk of the status questions arise. We first discuss the broad definition of investment adviser under the Investment Advisers Act and we then turn to the exclusions and exemptions from that definition. Finally, we examine frequent status questions that arise under the Investment Advisers Act.

§ 2:2 Definition Under the Investment Advisers Act

“Investment adviser” is defined in section 202(a)(11) of the Investment Advisers Act 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.

This definition consists of three elements, each of which must be satisfied for an entity to be covered by the Investment Advisers Act. First, the entity must be engaged “in the business” of providing advice or of issuing analyses or reports concerning securities. Second, the advice, analysis, or report must be with respect to “the value of securities” or the “advisability of investing in, purchasing or selling securities.” Third, the advice, analysis, or report must be provided in return for “compensation.” As will be seen, the three elements are interrelated: The principles underlying one element are often relevant to the other elements.

The law in this area is based primarily on an SEC staff interpretative release, Release 1092,³ which sets forth basic principles to be used in applying the three definitional elements and some of the exclusions. The specific issue addressed by Release 1092 is the applicability of the Investment Advisers Act to financial planners and nontraditional financial service providers. However, the principles underlying the release are generally recognized to have broader application, particularly with respect to the three definitional elements. Numerous no-action letters have clarified the application of many of these principles. Below we examine the three elements.

3. Investment Advisers Act Release No. 1092 (Oct. 8, 1987) [hereinafter Release 1092] (superseding Investment Advisers Act Release No. 770 (Aug. 13, 1981) and modifying somewhat the terms of the earlier version). Release 1092 was developed jointly by the SEC staff and the North American Securities Administrators Association, Inc.

§ 2:2.1 “Engaging in the Business of Advising Others”

Whether this standard is satisfied depends primarily upon how frequently and regularly a person provides advice or analysis or reports concerning securities and whether such advisory services are provided under conditions that suggest that their provision constitutes a business activity. Release 1092 summarizes as follows:

The giving of advice need not constitute the principal business activity or any particular portion of the business activities in order for a person to be an investment adviser under Section 202(a)(11). The giving of advice need only be done on such a basis that it constitutes a business activity occurring with some regularity. The frequency of the activity is a factor, but is not determinative.

The release sets forth three factors that determine whether someone is engaging in the business of providing advice:

The staff considers a person to be “in the business” of providing advice if the person: (i) holds himself out as an investment adviser or as one who provides investment advice; (ii) receives any separate or additional compensation that represents a clearly definable charge for providing advice about securities, regardless of whether the compensation is separate from or included within any overall compensation, or receives transaction-based compensation if the client implements the investment advice, or (iii) on anything other than rare, isolated and non-periodic instances, provides specific investment advice. (Footnote omitted.)

No one factor is wholly determinative, the result reached being dependent upon “all the facts and circumstances.”

[A] Holding Out

The concept of “holding out” is essentially a concept of voluntary action (that is, a person voluntarily presents himself to the public as providing advisory services). In several no-action letters, the SEC staff has broadly defined when an individual will be considered to have held himself out as an investment adviser. Factors evidencing that an individual has done so include public advertising seeking advisory clients (for example, in the yellow pages, professional listings, newspapers, etc.); designating himself as an investment adviser on business stationery or on a business card; or encouraging word-of-mouth referrals from existing clients.⁴

4. See, e.g., Brighton Pacific Realty Asset Mgmt. Co., SEC No-Action Letter (Feb. 10, 1992); Weiss, Barton Asset Mgmt., SEC No-Action Letter (Mar. 12, 1981) (entity that held itself out to only utility company pension

[B] Special or Additional Compensation

“Special or additional compensation” is clearly established by a separate fee charged specifically for investment advice. Also, if the facts show that a “clearly definable” element of a single fee is being charged for investment advice, this would satisfy the compensation element. The concept of special or additional compensation has been addressed at length in SEC staff no-action letters mostly in the context of a broker-dealer’s provision of advisory services, which will be discussed later. In short, the key element is whether the facts show that the fee, though charged for a collection of services for establishing a nonadvisory service, varies according to whether investment advice is provided. The compensation received need not be paid by the client; it could be paid by a third party.⁵

[C] Specificity and Regularity of Investment Advice

As for “specific investment advice,” Release 1092 states that it includes advice respecting specific securities or categories of securities, allocation of capital in specific percentages between various investment media including life insurance, particular types of mutual funds, high-yield bonds, etc., but not “advice limited to a general recommendation to allocate assets in securities, life insurance and tangible assets.”⁶

plans, a single and specific class of investors, must register]; DJZ Assoc. Inv. Mgmt., SEC No-Action Letter (Feb. 28, 1976); Frank T. Hines, SEC No-Action Letter (Nov. 19, 1972). These factors were discussed in the Division of Investment Management’s Staff Legal Bulletin No. 11, Applicability of the Advisers Act to Financial Advisers of Municipal Securities Issuers (Sept. 19, 2000) [hereinafter Staff Bulletin No. 11], at n.18 and accompanying text. Staff Legal Bulletin No. 11 is reviewed at *infra* section 2:5.5.

5. Staff Bulletin No. 11, *supra* note 4, at nn.20–22 and accompanying text.
6. The “engaging in the business” standard was applied in *Zinn v. Parrish*, 644 F.2d 360 (7th Cir. 1981), where the Seventh Circuit excluded the personal and business manager of a professional football player from Investment Advisers Act coverage. The investment activities included obtaining and transmitting without evaluation several investment proposals of third parties and actually investing on one occasion \$1,500 of the player’s money in the agent’s company. The court held that these activities, if performed often enough to constitute a business activity, could cause the agent to be an adviser. However, the court found that these activities were not “regular” activities of the agent, and were moreover incidental to his contract negotiations and other more substantial noninvestment functions.

As for the regularity of advice, the staff has stated that the provision of advice only occasionally, as an accommodation to clients, will generally not be seen as providing advice with “regularity.”⁷

[D] Advising Others

The SEC staff has provided guidance regarding whether a person is providing advice to “others”; where such advice is provided to an affiliated entity. The staff has stated that a general partner of a limited partnership is advising others in connection with advice provided with respect to the investment of partnership assets.^{7.1} Recently, the SEC staff issued two no-action letters clarifying the meaning of “advising others” in connection with section 202(a)(11)’s definition of “investment adviser.” In both letters, the SEC staff granted no-action relief to organizations that were providing investment management services to affiliates. In the first letter, the SEC staff concluded that an organization was not “advising others,” and thus would not be required to register as an investment adviser under the Investment Advisers Act, based on the following representations:

- The organization was a wholly owned subsidiary of its parent entity (an insurance company), and was established and has been operated for the sole purpose of providing investment advisory services to the parent via private funds in which the parent is the only investor;
- The organization does not hold itself out to the public as an investment adviser, and provides investment advice only to the parent via the private funds; and
- The private funds (and any private funds established by the parent in the future) are established and operated solely for the benefit of the parent in order to enable the parent to pool and invest its premium proceeds in order to meet short, medium, and long term claim obligations and other operating costs of its insurance business, and consist solely of the parent’s assets.⁸

In the letter described above, the organization at issue was providing advice to private funds owned by the organization’s parent entity. In a subsequent letter, the SEC staff expanded the scope of the relief to include other affiliates. The SEC staff concluded that another organization was not “advising others,” and thus would not be required to

7. Staff Bulletin No. 11, *supra* note 4, at nn.26–27 and accompanying text. This factor, as applied to financial advisers of municipal securities issuers, is reviewed at *infra* section 2:5.5.

7.1. Robert R. Champion, SEC No-Action Letter (Sept. 22, 1986).

8. Zenkyoren Asset Management of America, Inc., SEC No-Action Letter (June 30, 2011).

register as an investment adviser under the Investment Advisers Act, based on the following representations:

- The organization was a wholly owned subsidiary of its parent entity (an insurance company), and was organized for the purpose of providing investment advisory services to U.S.-based and foreign insurance companies that are direct and indirect wholly owned subsidiaries of the parent entity;
- The organization did not hold itself out to the public as an investment adviser, and provided investment advice only to its affiliates and to their direct and indirect wholly owned subsidiaries; and
- The organization's affiliates beneficially own, directly or indirectly, 100% of the assets for which the organization provides investment advice.^{8.1}

§ 2:2.2 Providing Advisory Services Concerning Securities

Two factors must be considered in determining whether an entity is providing advice, analysis, or reports concerning securities. First, the advisory services provided must be with respect to an instrument or instruments that satisfy the Investment Advisers Act's definition of a "security." Second, there must be a "judgmental" element in connection with the service.

[A] Concerning Securities

Not all types of advice subject a person to coverage under the Investment Advisers Act. Coverage is limited to those persons providing advice about "securities," a term defined in section 202(a)(18). Therefore, advice limited to whether to invest directly in commodity futures, real estate, artwork, a nonsecurity business opportunity, or some other nonsecurity medium does not subject its provider to regulation as an investment adviser.⁹

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- 8.1. Allianz of America, Inc., SEC No-Action Letter (May 25, 2012).
9. See, e.g., *Zinn v. Parrish*, 644 F.2d 360 (7th Cir. 1981) (business opportunities adviser not subject to regulation); *Wang v. Gordon*, 715 F.2d 1187 (7th Cir. 1983) (sale by general partner of apartment house and certain incidental securities, the only assets of limited partnership, not subject to Act); *Mechigian v. Art Capital Corp.*, 639 F. Supp. 702 (S.D.N.Y. 1986) (advice respecting sale of original art work is not subject to regulation, because art work is not a security); Robert R. Champion, SEC No-Action Letter (Sept. 22, 1986) (party making recommendations concerning stock index futures contracts not required to register under the Investment Advisers Act).

[B] Judgmental

Merely providing information or performing record-keeping or other ministerial duties does not constitute advisory activity; there needs to be a judgmental element to the activity. The SEC staff has provided some guidance in this area. For example, a publication which contains merely a formula for evaluating investment alternatives or data readily available from public sources, with no element of selection, and which does not present the data in a manner which seeks to sell securities, is not subject to regulation under the Investment Advisers Act.¹⁰ Computer software providing a database meeting similar criteria which the purchaser can search to answer queries which it develops, or software containing formulae or other calculational methods to which the purchaser must add its own independent judgments about present or future economic or market conditions, is not investment advisory materials.¹¹

Also, the establishment of a listing service on a website to provide information to prospective buyers and sellers about the stock of certain companies does not require registration under the Investment Advisers

10. Charles St. Sec., Inc., SEC No-Action Letter (Feb. 27, 1987).

11. *See, e.g.*, No Load Mutual Fund Assoc., Inc., SEC No-Action Letter (Dec. 31, 1984); Computer Language Res., Inc., SEC No-Action Letter (Dec. 26, 1985); Dillon, Read & Co., SEC No-Action Letter (Nov. 17, 1973).

Where a computer program (based upon how it is advertised for sale, how it is characterized by its producers, its actual use by purchasers, and its contents) is directed at the preparation of specific buy, sell, or hold recommendations, and it incorporates judgments used to make such analyses, even if the specific judgment must be selected from several alternatives or may be replaced by the user, registration under the Act is required. On the other hand, factors which support non-registration include a target market of sophisticated investors, inclusion in the software package of only publicly available data and investment formulae, and lack of customization for a specific purchaser. *See* Marakon Sys., Inc., SEC No-Action Letter (Sept. 6, 1982); Syrus Assocs., Ltd., SEC No-Action Letter (Oct. 23, 1981); Alphadex Corp., SEC No-Action Letter (Feb. 21, 1972). In *Computer Language Res., Inc., supra*, the SEC staff refused to grant no-action assurance to a computer-software-based service in which the vendor provided questionnaires soliciting financial and other personal data from clients of an independent financial planner; it would then process the questionnaires and provide a report to the independent planner, who would use the report to recommend specific investments to the client. The SEC staff concluded that the program was evaluative rather than merely constituting data collection and reporting. Software and publications which contain no express recommendations or evaluation, but merely organize data in a manner which permits others to reach specific conclusions, may constitute investment advice unless substantial additional judgment or data must be added by the user.

Act where no advice would be given.¹² In considering this element, it is important to realize that advisory services concerning securities encompass more than just those circumstances where advice is provided which focuses upon specific impending investment decisions and specific investment alternatives available. For example, advice to buy, sell, or hold specific securities or categories of securities, market timing advice respecting switching between investment alternatives, and advice respecting the merits of investing in securities as compared to nonsecurity alternatives, are all considered advisory services about securities.

Persons who advise others on the selection of an investment adviser are providing advisory services.¹³ In contrast, activity in which a person serves merely to help an individual identify an adviser by providing a broad cross-section of pre-screened advisers, and where the person has no real interest in whether a particular adviser is selected, will not be providing advisory services.¹⁴

§ 2:2.3 Advisory Services Provided for “Compensation”

Release 1092 states that the “compensation element is satisfied by the receipt of any economic benefit, whether in the form of an advisory fee or some other fee relating to the total services rendered, commissions or some combination of the foregoing.” As noted above in the discussion of “engaging in the business,” a separate fee charged specifically for investment advice clearly establishes the presence of “compensation.”

In the case of a single fee charged for investment advice and other services, if a “clearly definable element” of the fee is assessed for investment advice, then the compensation requirement is satisfied. Here, the key element is whether the fee, though charged for a collection of services or ostensibly a nonadvisory service, varies according to whether investment advice is provided. We examine this in greater detail below in the discussion relating to “special compensation” with respect to the broker-dealer exclusion.

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12. Internet Capital Corp., SEC No-Action Letter (Jan. 13, 1998) (citing Angel Capital Elec. Network, SEC No-Action Letter (Oct. 25, 1996), and PerfectData Corp., SEC No-Action Letter (Aug. 5, 1996)).
 13. See Investment Company Act Release No. 21,260, Investment Advisers Act Release No. 1510 (July 27, 1995), and Release 1092, *supra* note 3. Because of this requirement, as discussed in chapter 5, brokerage firms sponsoring wrap-fee programs generally must register under the Investment Advisers Act.
 14. See, e.g., Nat'l Football League Players Ass'n, SEC No-Action Letter (Jan. 25, 2002) (citing Hopkins & Sutter, SEC No-Action Letter (Jan. 6, 1984), Hudson Valley Planning, Inc., SEC No-Action Letter (Feb. 25, 1978), and Sebastian Assocs., Ltd., SEC No-Action Letter (Aug. 7, 1975)).

Having discussed the three definitional elements, we now turn to the entities excluded under the definition of investment adviser.

§ 2:3 Entities Excluded from the Definition

Five specifically identified entities are excluded from the Investment Advisers Act's coverage as well as "such other persons not within the intent of [the definition], as the Commission may designate by rules and regulations or order." The effect of these exclusions is to remove these entities from the Investment Advisers Act's registration requirements and, more importantly, from all of its substantive provisions, particularly the section 206 antifraud prohibitions.

Generally, the exclusions are based on the existence of some alternative scheme of regulation (for example, bank regulation) or on the fact that the party is engaging in a professional discipline that does not pose the risks to investors against which the Investment Advisers Act seeks to protect (for example, teaching).

§ 2:3.1 Banks and Bank Holding Companies

Section 202(a)(11)(A) provides an exclusion for banks and bank holding companies.

The term "bank" is defined in section 202(a)(2) of the Investment Advisers Act to include national banks¹⁵ and members of the Federal Reserve.¹⁶ In addition, certain nonmember banks are included within the definition.¹⁷ These nonmember banks are generally required to be engaged in the same type of business engaged in by national banks;¹⁸ regulated by state or federal bank regulators;¹⁹ and not operated for purposes of evading the Advisers Act.

15. Investment Advisers Act § 202(a)(2)(A).

16. Investment Advisers Act § 202(a)(2)(B).

17. Investment Advisers Act § 202(a)(2)(C).

18. Section 202(a)(2)(C) requires, among other things, that the nonmember bank "be supervised and examined by State or Federal authority having supervision over banks." *See* Kanaly Co., SEC No-Action Letter (Sept. 7, 1977) (staff questioned whether a company falls within the definition of § 202(a)(2)(C) where that company was subject to bank regulator supervision but where the regulator was not required to exercise supervision).

19. Section 202(a)(2)(C) provides, among other things, that the bank must "derive a substantial portion of its business from the receipt of deposits or the exercise of fiduciary powers similar to those permitted national banks under the authority of the Comptroller of the Currency." *See* Kanaly Co., SEC No-Action Letter (Sept. 7, 1977) (staff indicated that a company would not satisfy the definition of "bank" under § 202(a)(2)(C) if the percentage of the company's revenues which are derived from its exercise of fiduciary powers are small as compared to the revenue that the company receives from conducting financial counseling services).

“Bank Holding Company” is defined in section 202(a)(11)(A) by reference to the Bank Holding Company Act of 1956. That Act generally defines a bank holding company as any company that owns or controls a bank.

The exclusion is limited to the bank or bank holding company itself; subsidiaries are not entitled to rely on the exclusion.²⁰ As such, subsidiaries providing investment advisory services routinely register under the Act.²¹ Exemptive relief has been granted in the case of subsidiaries providing advice only to affiliated entities and not to the public.²²

Also, foreign banks are not entitled to rely on the exclusion.²³ The exclusion is also not available to savings and loan associations.²⁴

[A] Banks and Bank Holding Companies That Act As Advisers to a Registered Investment Company

Prior to the Gramm-Leach-Bliley Act of 1999, banks and bank holding companies enjoyed a blanket exception from the Investment Advisers Act. Effective May 12, 2001, the exception does not apply to banks or bank holding companies that serve as the investment adviser to a registered investment company. Instead of registering the bank or bank holding company itself, a “separately identifiable department or division” within the entity can be registered.²⁵

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20. *See, e.g.*, First Commerce Investors, Inc., SEC No-Action Letter (Jan. 31, 1991) (citing Chase Investors Mgmt. Corp. N.Y., Investment Advisers Act Release No. 333 (Aug. 21, 1972)).
 21. First Commerce Investors, Inc., SEC No-Action Letter (Jan. 31, 1991) (citing Jeffries & Co., SEC No-Action Letter (June 16, 1989), Curtis L. Stewart, SEC No-Action Letter (Feb. 7, 1975), William Casey, SEC No-Action Letter (June 1, 1974)).
 22. *See, e.g.*, Marine Midland Grp., Inc., Investment Advisers Act Release No. 48 (Sept. 2, 1947) (order to permit company to avoid adviser registration where the company provided advice primarily to affiliated bank and trust companies and where the advisory services provided to the general public were very limited); First Serv. Corp., Investment Advisers Act Release No. 6 (Nov. 6, 1940) (order to permit a company to avoid registration as an adviser where the company provided advisory services exclusively to affiliated bank and trust companies).
 23. *See, e.g.*, NMB Bank, SEC No-Action Letter (Sept. 19, 1990), at n.7 (citing Letter to Larry R. McIntire (Nov. 15, 1989) and Letter to Congressman William J. Hughes (June 4, 1980)); Savoy Capitol Mgmt., SEC No-Action Letter (Nov. 15, 1989).
 24. *See, e.g.*, Ameriway Sav. Ass'n, SEC No-Action Letter (Apr. 28, 1986) (citing to Investment Company Act Release No. 13,666 (Dec. 19, 1983)).
 25. New § 202(a)(26) under the Investment Advisers Act defines “separately identifiable department or division.”

§ 2:3.2 Lawyers, Accountants, Engineers, and Teachers

In enacting the Advisers Act, Congress recognized that investment advice is provided in conjunction with the activities of certain professionals, particularly lawyers and accountants. Accordingly, section 202(a)(11)(B) excepts “any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession” from the definition of an investment adviser.

This exception, while covering those professionals who occasionally provide “investment advice” in conjunction with their primary professional services, does not cover those who provide such advice as an independent business. Here, the practitioner is forced to distinguish, for example, accountants that provide accounting services to a client from accountants that are, in effect, acting as investment advisers. The key to making this distinction lies in the “solely incidental” language of the exclusion.

The SEC staff has set forth three factors to determine whether advice is “solely incidental” to normal professional activities and therefore does not constitute a separate business activity. These tests are quite similar to the three criteria that make up the definition of an investment adviser. First, the professional must not hold himself or herself out as providing investment advice to the public. Second, the investment advisory services must also be connected with and reasonably related to the provision of primary professional services. Third, any fee charged for the advisory service must be based on the same factors as are used in developing fees for primary professional services.²⁶

Thus, an accountant who proposed to provide a service to its clients employing computer software to track and report upon mutual fund performance and whether the funds would satisfy the clients’ investment criteria was unable to rely on the exclusion, because such activity was not incidental to accounting services and because he held

26. For a discussion of these three factors, see, e.g., *Financial Planners: Report of Staff of United States Securities and Exchange Commission to the House Committee on Energy and Commerce’s Subcommittee on Telecommunications and Finance* (1988), reprinted in *Financial Planners and Investment Advisors, Hearing Before the Subcommittee on Consumer Affairs of the Senate Committee on Banking, Housing and Urban Affairs*, 100th Cong., 2d Sess., 78 (1988); *Crabtree Invs., Inc. v. Aztec Enters., Inc.*, 479 F. Supp. 448 (M.D. La. 1979); Hungerford, Aldrin, Nichols & Carter, SEC No-Action Letter (Dec. 10, 1991); Jan L. Warner, SEC No-Action Letter (Dec. 27, 1988); Kenisa Oil Co., SEC No-Action Letter (May 6, 1982); Suzanne Clark-James, SEC No-Action Letter (Aug. 30, 1984).

himself out as providing investment advice.²⁷ Similarly, accountants or lawyers who act as “offeree representatives” on behalf of limited partnerships, explaining the risks and possible returns of the investments, must register, as such advice is not incidental to accounting or legal services.²⁸

Teachers teaching a course on investment advisory methods must do so at an accredited school, as part of a curriculum or with a content that demonstrates that the course’s purpose is “education” and not simply the provision of investment advice.²⁹

§ 2:3.3 Broker-Dealers

By the very nature of their activity, virtually all broker-dealers and their registered representatives come within the broad sweep of section 202(a)(11)’s basic definition: They are in the business of advising others for compensation as to the advisability of investing in securities. However, in recognition of the comprehensive regulation to which broker-dealers are subject, section 202(a)(11)(C) provides an exclusion for “any broker or dealer whose performance of such [advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefore.” As will be seen, a broker-dealer’s registered representatives may also rely on the Investment Advisers Act’s broker-dealer exclusion under certain circumstances.

To rely on the broker-dealer exclusion, two tests must be satisfied: (1) the advice must be “solely incidental” to the firm’s brokerage activities, and (2) the broker-dealer may not receive “special compensation” for the investment advice.

Below we examine the elements of the broker-dealer exclusion and then look at special issues raised in connection with fee-based brokerage accounts, discount brokerage programs, dual registrants and, finally, touch on recent regulatory developments.

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27. Hungerford, Aldrin, Nichols & Carter, SEC No-Action Letter (Dec. 10, 1991).
 28. Jan L. Warner, SEC No-Action Letter (Dec. 27, 1988); Suzanne Clark-James, SEC No-Action Letter (Aug. 30, 1984); Kenisa Oil Co., SEC No-Action Letter (May 6, 1982).
 29. See, e.g., Fin. Strategies, Inc., SEC No-Action Letter (Feb. 14, 1994); DJZ Assoc. Inv. Mgmt., SEC No-Action Letter (Feb. 28, 1976); Frank T. Hines, SEC No-Action Letter (Nov. 19, 1972).

Table 2-1
Chronology
Convergence of Broker-Dealer and Advisory Services,
and the Regulatory Response³⁰

1995	<p>Report of the Committee on Compensation Practices (Tully Report) released in April 1995 that stresses “best practices,” including:</p> <ul style="list-style-type: none"> ○ compensation policies designed to align the interests of all three parties in the relationship (client, registered representative, and the brokerage firm); and ○ paying a portion of rep compensation based on client’s assets in an account, regardless of transaction activity.
1999	<p>SEC issues proposed fee-based brokerage account rule for comment. The proposal includes a “safe harbor” for those offering fee-based brokerage accounts and adhering to proposed requirements until SEC takes final action.</p>
1999–2004	<p>Many broker-dealers (wire houses and others) continued to offer fee-based brokerage accounts based on the November 1999 requirements.</p> <p>Other industry participants and non-industry participants (e.g., investment advisory firms, consumer trade groups) continued to provide comments to the SEC.</p>
2004	<ul style="list-style-type: none"> • The Financial Planning Association (FPA) submitted a letter to the SEC in June of 2004 seeking: <ul style="list-style-type: none"> ○ withdrawal of the November 1999 proposal; or ○ substantive amendment of it. • FPA filed suit against the SEC.

30. With thanks to Bruce Maisel, Vice President & Managing Counsel, Thrivent Financial for Lutherans, for his contribution to this chronology.

2005	<p>“Original” Rule 202(a)(11)-1 is approved. The Rule, commonly referred to as the “Merrill Lynch Rule,” is designed to better define when the provision of advisory services by a brokerage firm is subject to the “Advisers Act” broker-dealer exclusion. The Rule focused on substance of the activity instead of the nature of the compensation received in drawing the line between broker-dealer and adviser activity, and specifically addressed:</p> <ul style="list-style-type: none"> • Fee-Based Brokerage Activity; • Financial Planning; and • Discretionary Brokerage
2007	<ul style="list-style-type: none"> • “Original” Rule 202(a)(11)-1 is vacated. • Upon the rule’s invalidation, the SEC proposed a new interpretative rule, “New” Rule 202(a)(11)-1, which seeks to reinstate some of the interpretative positions that were nullified by the FPA 2004 decision, and had been reflective of industry practices in place prior to approval of “Original” Rule 202(a)(11)-1 (addresses discretionary brokerage, separate fee for advisory services, separate contract for advisory services—but passes on taking a position with respect to financial planning).
2008	SEC releases RAND Report, which studies brokerage and advisory services.

2009	<p>Efforts to demarcate broker-dealer activity from adviser activity gives way to call from regulators and others to harmonize the broker-dealer and adviser regulatory structures as they relate to a common function of broker-dealers and advisors—the provision of investment advice about securities to retail investors.</p> <ul style="list-style-type: none"> • July 10, 2009, the Obama Administration, through the Treasury, submits Proposal legislation to Congress entitled the “Investor Protection Act” (IPA), including, among other things, a harmonized standard of care applicable to those broker-dealers and advisors that provide investment advice about securities to retail investors. • December 3, 2009, the House Financial Services Committee approves its own version of the IPA as HR 3817.
2010	Senate Banking Committee Bill approved out of Committee on March 22, 2010.
2010	July 21, 2010, President Obama signs the Dodd-Frank Wall Street Reform and Consumer Protection Act.
2010	July 27, 2010, the SEC published a release requesting comment on issues that section 913 of Dodd-Frank mandates be studied regarding the standard of care. Comments were due to SEC by August 30, 2010.

<p>2011</p>	<p>January 21, 2011, the SEC released its Report on the effectiveness of legal and regulatory standards of care for broker-dealers and investment advisers called for under section 913 of the Dodd-Frank Act. The Study was released as a statement of the staff of the SEC, and not necessarily as a position of the SEC as a whole or of individual Commissioners. The Study makes two primary recommendations:</p> <ul style="list-style-type: none"> • The SEC should engage in rulemaking specifying a uniform fiduciary standard of conduct that is no less stringent than currently applied to investment advisers that would apply to broker-dealers and investment advisers when they provide personalized advice about securities to retail customers. (This core recommendation is accompanied by detailed recommendations addressing the implementation of the uniform fiduciary duty.) • The regulatory protections related to personalized investment advice about securities to retail customers provided by broker-dealers and investment advisers should be harmonized to the extent that harmonization appears likely to add meaningful investor protection.
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[A] Elements of the Broker-Dealer Exclusion

[A][1] Solely Incidental

Until 2005, the SEC had not provided a definitive standard with respect to what constitutes advisory services that are solely incidental to a firm's brokerage business. As in the case of the professionals covered in section 202(a)(11)(B), the advisory service must be "connected with and reasonably related" to traditional brokerage services, that is, not provided as an entirely separate business. But development of a more comprehensive standard has been impeded by the fact that broker-dealers have traditionally provided extensive and varied investment advisory services, making it difficult to set forth a clear rule as to when "incidental" brokerage services end and "investment advisory" services begin.

Clearly, a statement by ABC Brokers that “IBM seems to be a good buy at this price” would be solely incidental. On the other hand, to the extent that advice is less transaction-oriented and more directed to the long-term needs of particular investors, the less it can be said to be solely incidental. For example, the development of a financial plan for a substantial number of clients is arguably not solely incidental. Also, a broker-dealer whose business consists almost entirely of managing client accounts on a discretionary basis or who performs “investment supervisory services” for most clients may not be providing solely incidental services.³¹

In 2005, as part of its original Rule 202(a)(11)-1 rulemaking which dealt with fee-based brokerage accounts (discussed below), the SEC set forth its view on when advice is solely incidental to brokerage services. Original Rule 202(a)(11)-1 was subsequently vacated in 2007, and, shortly thereafter, the SEC proposed a new version of the rule seeking to reinstate some of the guidance in this area.

**[A][1][a] 2005 Rulemaking—“Original”
Rule 202(a)(11)-1**

In connection with its adoption of the original Rule 202(a)(11)-1, the SEC stated that advice is solely incidental to brokerage when the advisory services rendered are in connection with and reasonably related to the brokerage services provided.³² Original Rule 202(a)(11)-1(b) set forth three general circumstances, discussed below, under which the provision of advisory services by a brokerage firm was not solely incidental to brokerage. While original Rule 202(a)(11)-1 was vacated on October 1, 2007, a discussion of its provisions related to when a broker-dealer’s provision of advising services is not solely incidental will serve as helpful background.

31. See, e.g., Thomas P. Lemke, *Investment Advisers Act Issues for Broker Dealers*, 20 SEC. & COMM. REG. REV. 213, 214 (1987); Investment Advisers Act Release No. 626 (Apr. 27, 1978); Investment Advisers Act Release No. 471 (Aug. 20, 1975); Inv. Mgmt. & Res., Inc., SEC No-Action Letter (Jan. 27, 1977).

32. Investment Advisers Act Release No. 2376 (Apr. 12, 2005) [hereinafter Adopting Release], at nn.131–33 and accompanying text. The SEC extended the compliance date for certain provisions of Investment Advisers Act Rule 202(a)(11)-1. Compliance for the rule’s provisions dealing with the status of broker-dealers providing financial planning services and for those that exercise investment discretion over client accounts has been pushed back from October 24, 2005, until January 31, 2006. Investment Advisers Act Release No. 2426 (Sept. 12, 2005).

**[A][1][a][i] Circumstances Under Which Services
Were Not Incidental Under “Original”
Rule 202(a)(11)-1**

- *Separate Contract for Advisory Services.* Original Rule 202(a)(11)-1(b) provided that a broker-dealer that separately contracts with a customer for investment advisory services (including financial planning services) was not providing advice that is solely incidental to brokerage.³³
- *Financial Planning.* A brokerage firm was not providing advice that was solely incidental to brokerage if in connection with financial planning activity it held itself out generally to the public as a financial planner or as providing financial planning services; delivered to its customers a financial plan; or represented to customers that the advice was provided as part of a financial plan or financial planning services.³⁴

The SEC staff provided guidance that the original Rule 202(a)(11)-1 did not require a broker-dealer to treat as an investment advisory client a customer to whom the broker-dealer merely made it known that financial planning or other investment advisory services were available but to whom the broker-dealer did not provide such services.³⁵ A broker-dealer dually registered as an adviser was able to discontinue an advisory relationship with its client and then maintain only a brokerage relationship.³⁶

The SEC staff also drew a distinction between financial plans and financial tools. While a financial plan is a comprehensive tool seeking to address various long-term financial goals of the client, a financial tool is used to provide guidance to a customer with respect to a particular transaction or an application of customer funds and securities and that is confined in application.³⁷

- *Discretionary Services.* Discretionary investment advice was not solely incidental to brokerage services.³⁸ The original rule defined “investment discretion” to except discretion that is granted by a customer on a “temporary or limited basis.”³⁹

33. Investment Advisers Act Rule 202(a)(11)-1(b)(1).

34. Investment Advisers Act Rule 202(a)(11)-1(b)(2).

35. Sec. Industry Ass’n, SEC No-Action Letter (Dec. 16, 2005) (citing Adopting Release, *supra* note 32, at n.159).

36. *Id.*

37. *Id.* (citing Adopting Release, *supra* note 32, at III.E.2).

38. Investment Advisers Act Rule 202(a)(11)-1(b)(3).

39. Investment Advisers Act Rule 202(a)(11)-1(d).

The rule's adopting release explained that in such cases the customer is granting discretion primarily for execution purposes and not for discretionary supervisory services.⁴⁰ Temporary or limited discretion included situations where the broker-dealer is given discretion:⁴¹

- as to the price at which or the time to execute an order given by a customer for the purchase or sale of a definite amount or quantity of a specified security;
- on an isolated or infrequent basis, to purchase or sell a security or type of security when a customer is unavailable, for a limited period of time not to exceed a few months;
- as to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent;⁴²
- to purchase or sell securities to satisfy margin requirements;
- to sell specific bonds and purchase similar bonds in order to permit a customer to take a tax loss on the original position;
- to purchase a bond with a specified credit rating and maturity; and
- to purchase or sell a security or type of security limited by specific parameters established by the customer.

**[A][1][b] FPA Decision—Original Rule 202(a)(11)-1
Vacated**

On March 30, 2007, the Court of Appeals for the District of Columbia, in *Financial Planning Association v. SEC*,⁴³ vacated the original Rule 202(a)(11)-1, taking the position that the SEC lacked authority to except certain broker-dealers from the Investment Advisers Act definition of "investment adviser." The court did not address the interpretive positions of section 202(a)(11)(C) in the FPA Decision, creating questions with respect to the original validity of the

40. Adopting Release, *supra* note 32, at nn.178–81 and accompanying text.

41. *Id.* at nn.179–81 and accompanying text.

42. In UBS Fin. Servs. Inc., SEC No-Action Letter (Sept. 29, 2005), the staff provides no-action relief as to a firm's cash management program. The cash management program was for institutional customers only, limited to the trading of fixed-income and similar instruments in conformity with the customer's written guidelines.

43. *Fin. Planning Ass'n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007) [hereinafter FPA Decision].

interpretations. In response to this uncertainty, the SEC re-proposed the interpretations in the form of new Proposed Rule 202(a)(11)-1. We discuss this proposed rule below.

[A][1][c] 2007 Rulemaking—“New” Proposed Rule 202(a)(11)-1

“New” Proposed Rule 202(a)(11)-1 under the Investment Advisers Act of 1940 would clarify certain circumstances in which a broker-dealer is providing investment advice that is “solely incidental” to its brokerage business. The comment period on the proposal ended on November 2, 2007, and the rulemaking awaits further action by the SEC.

New Proposed Rule 202(a)(11)-1 would codify two of the three interpretations contained in the 2005 Release regarding some activities that are not considered “solely incidental” to brokerage services.⁴⁴

- *Separate Contract or Fee for Advisory Services.* The proposed rule would set forth that a broker-dealer that separately contracts with a customer for, or separately charges a fee for, investment advisory services cannot be considered to be providing advice that is solely incidental to its brokerage services.
- *Discretionary Investment Advice.* The proposed rule would clarify that discretionary investment advice (except investment discretion granted by a customer on a temporary or limited basis) is not “solely incidental” to the business of a broker-dealer within the meaning of section 202(a)(11)(C). A broker-dealer may not avail itself of the exception provided by section 202(a)(11)(C) for accounts it has investment discretion over regardless of the form of compensation and how the broker-dealer handles other accounts.
- *Financial Planning.* Unlike the 2005 Rule, the proposed rule does not currently contain guidance indicating that when a broker-dealer provides advice as part of a financial plan or in connection with providing financial 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; (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. The SEC indicated that it intends to consider financial planning after it analyzes the results of the recently released RAND Study, discussed below.

44. Proposed Rule 202(a)(11)-1(a).

[A][2] Special Compensation

Historically, the special compensation part of the test has received much greater development than the solely incidental standard. Special compensation was addressed at length in an early SEC General Counsel's Opinion that examined whether special compensation was received by a broker-dealer's charging of an "overriding commission" or "service charge" on securities transactions effected on exchanges where the broker was not a member.⁴⁵

The Opinion noted that these charges were being imposed under four different approaches. Under the first and second approaches, the charge would be imposed or not imposed or its magnitude would vary depending upon whether or how much advisory service was rendered to the client. Such charges, the Opinion concluded, were "clearly definable" as being compensation for investment advice. Under the third approach, a charge was made or not made or varied in magnitude based on some factor ostensibly other than investment advice; for example, the magnitude of brokerage business done by the client with the broker. Although in principle such a charge would not constitute special compensation because it was not imposed as the result of the provision or the magnitude of advice provided, nonetheless a variable charge was viewed as subject to challenge unless no-action assurance was obtained. In the fourth approach, all clients either paid or did not pay the same charge, thus establishing that no fee was being imposed on account of investment advice.

With the "unfixing" of brokerage commission rates, attention was paid to the issue of special compensation as competition forced down transaction fees and encouraged separate charges for other services provided, including advisory services.⁴⁶ The SEC, in a release issued to clarify application of the Investment Advisers Act to brokerage firms in the aftermath of the unfixing of commission rates, indicated that special compensation is "compensation to the broker-dealer in excess of that which he would be paid for providing a brokerage or dealer service alone." It further noted that such compensation would exist only where "there is a clearly definable charge for investment advice."

In determining whether a charge was being made for investment advice, the SEC staff will not compare one broker's fees with another's, nor will it consider individually negotiated fees to be indicative

45. Investment Advisers Act Release No. 2 (Oct. 28, 1940).

46. See, e.g., Exchange Act Release No. 11,203 (Jan. 23, 1975); Investment Advisers Act Release No. 626 (Apr. 27, 1978); Am. Capital Fin. Servs., Inc., SEC No-Action Letter (Apr. 29, 1985).

of a charge imposed because of investment advice. Rather, where the “differential” in fees offered a client could be said to be “primarily attributable” to the rendering of investment advice, a finding of special compensation will be made.

The special compensation factor has been the subject of several judicial decisions. In *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,⁴⁷ the court held that Merrill Lynch was not an investment adviser as it had not received any special compensation in its dealings with plaintiff for whatever investment advice it had provided. Although Merrill Lynch had received substantial income from brokerage transactions, the court held that such revenue “by itself,” and without evidence establishing that this revenue was received “specifically” for the rendering of investment advice, would not constitute special compensation.⁴⁸

[A][2][a] 2005 Rulemaking—“Original” Rule 202(a)(11)-1

The special compensation part of the test received attention in the 2005 rule adopted by the SEC, Rule 202(a)(11)-1, discussed above. This rulemaking was prompted by the introduction in the late 1990s of fee-based brokerage accounts and discount brokerage programs. Rule 202(a)(11)-1, among other things, provided that a broker-dealer was not deemed to be an investment adviser with respect to its brokerage accounts based solely on the form of compensation the broker-dealer receives.⁴⁹ The rule superseded prior staff interpretations, including Investment Advisers Act Release No. 2, which looked at tiering of compensation schedules to determine whether a brokerage firm was receiving special compensation and thereby subject to registration under the Investment Advisers Act.

[A][2][b] FPA Decision

As discussed above, on March 30, 2007, the Court of Appeals for the District of Columbia, in *Financial Planning Association v. SEC*, vacated the original Rule 202(a)(11)-1. Upon the rule’s invalidation,

47. *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 464 F. Supp. 528, 538 (D. Md. 1978).

48. *Accord SEC v. Nat’l Exec. Planners, Ltd.*, 503 F. Supp. 1066, 1074 (M.D.N.C. 1980); *Courtlandt v. E.F. Hutton, Inc.*, 491 F. Supp. 1066 (S.D.N.Y. 1979). *But see* FPC Sec. Corp., SEC No-Action Letter (Dec. 1, 1974) (brokerage fees can be “special compensation” where broker recommended adviser, shared its fees, and monitored and reported upon its performance for client).

49. Adopting Release, *supra* note 32.

the SEC proposed a new interpretative rule, Rule 202(a)(11)-1, which seeks to reinstate some of the interpretative positions that were nullified by the FPA Decision.

**[A][2][c] 2007 Rulemaking—Proposed “New”
Rule 202(a)(11)-1**

With respect to the compensation element of the broker-dealer exclusion, new Rule 202(a)(11)-1 would clarify that a broker-dealer will not be considered to have received “special compensation” solely because the broker-dealer charges a commission, mark-up, mark-down or similar fee for brokerage services that is greater or less than one it charges another customer.⁵⁰

The SEC indicated that “special compensation” includes situations where there is a clearly definable charge for investment advice, while it does not necessarily include situations where a firm negotiates different fees with its customers for similar transactions or establishes different fee schedules for full service brokerage accounts versus discount brokerage accounts (that is, automated transactions using an Internet website). The SEC stated that it would not look outside the fee structure of a given firm to determine whether special compensation exists.

[B] Fee-Based Brokerage Programs

Original Rule 202(a)(11)-1 clarified the application of the Investment Advisers Act to brokerage firms’ fee-based brokerage programs. Such programs provide various services (including execution, advice, arranging for delivery and payment, and custodial and record-keeping services) for a comprehensive fee that is asset-based or fixed.⁵¹

Original Rule 202(a)(11)-1 set forth that a broker-dealer’s receipt of fee-based compensation (as opposed to more traditional form of payment like commissions or dealer compensation) would not cause it to fall within the definition of adviser under the Investment Advisers Act, as long as the conditions of the rule are satisfied.

In order to satisfy the rule, any advice that the broker-dealer provided with respect to accounts from which it received special compensation had to be solely incidental to the brokerage services provided to those accounts.⁵² A broker-dealer’s exercise of investment discretion was not “solely incidental” under the rule.⁵³

50. Reproposed Rule 202(a)(11)-1(b).

51. Adopting Release, *supra* note 32, at nn.9–10 and accompanying text.

52. Investment Advisers Act Rule 202(a)(11)-1(a)(1)(i).

53. *Id.*

Also, account advertisements, contracts, agreements, applications and other such forms were required to include prominent disclosure that:

Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interests. We are paid both by you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits, and our salespersons' compensation, may vary by product over time.

The statement was also required to identify an appropriate person at the firm with whom the customer could discuss the differences.⁵⁴

With original Rule-202(a)(11)-1 being vacated by the FPA Decision, fee-based brokerage accounts are now required to be treated as advisory accounts (or else convert to traditional brokerage accounts). In order to facilitate the conversion of fee-based accounts into advisory accounts, the SEC adopted Temporary Rule 206(3)-3T which provides an alternative means for a firm to comply with section 206(3).

[C] Discount Brokerage Programs (Including Electronic Trading Programs)

The 2005 rulemaking also clarified the application of the Investment Advisers Act to discount brokerage programs (including electronic trading programs). Discount brokerage programs give customers the ability to trade securities at a lower commission rate. Electronic trading, a type of discount brokerage, allows customers to trade online. In contrast to full-service brokerage, discount brokerage allows customers to trade securities without paying for the assistance (including advice) that is provided by registered representatives.

Brokerage firms often offer discount brokerage programs alongside full-service programs. In this way, customers decide whether they want to pay extra for a full-service program. The difference between the costs of full-service and discount brokerage can be looked at as attributable to the involvement of a registered representative, including the advice that he or she provides. Under Investment Advisers Act

54. The rule does not require a specific name. Rather, a contact point that allows a customer to speak to a person at the firm is sufficient. The rule does not establish qualifications or criteria for contact personnel. Adopting Release, *supra* note 32, at n.125 and accompanying text.

Release No. 2,⁵⁵ this difference could be looked as a “clearly definable” compensation for investment advice. The original Rule 202(a)(11)-1(a)(2) superseded this prior staff interpretation and provided that a brokerage firm was not considered to have received special compensation solely because the firm charged one customer a commission, mark-up, mark-down or similar fee for brokerage services that was greater than or less than one it charged another customer. The proposed Rule 202(a)(11)-1 would reinstate this interpretation position.⁵⁶

[D] Dual Registrants

New Rule 202(a)(11)-1 would restate previous SEC statements providing that a broker-dealer that is registered under both the Securities Exchange Act of 1934 and the Investment Advisers Act is an investment adviser solely with respect to those accounts for which it provides advice or receives compensation that subjects the broker-dealer to the Investment Advisers Act.

[E] Recent Regulatory Developments

[E][1] The RAND Report

In January 2008, the SEC released the RAND Study of the broker-dealer and investment advisory industries.⁵⁷ The RAND Study examined how broker-dealers and investment advisers market and provide products and services to investors, and how investors understand the differences between investment advisers and broker-dealers. The chief purpose of the study was to provide the SEC with a description of the current state of the investment advisory and brokerage industries for its evaluation of the legal and regulatory framework applying to these industries.

By way of background, the SEC first suggested conducting a background study in 2005 in conjunction with its adoption of Rule 202(a)(11)-1.

In determining its findings, RAND gathered information using a variety of sources: a survey of both experienced and inexperienced investors; focus groups; interviews with interested parties and financial services firms; review of relevant literature; a review of samples of documentation used by investment advisers and broker-dealers; and a review of regulatory filings submitted to the Central Registration

55. See *supra* note 45.

56. Adopting Release, *supra* note 32, at n.127 and accompanying text.

57. RAND INSTITUTE, STUDY ON INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS, *available at* www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

Depository (CRD), Investment Adviser Registration Depository (IARD), and Financial and Operational Combined Uniform Single Reports (“FOCUS Reports”).

Notably, the RAND Study conclusion included that:

- investors, as a whole, do not understand the key distinctions between broker-dealers and investment advisers, and relationships among service providers;
- investors, although having a general sense about the differences in services provided, are not clear about the varying legal duties of and standards imposed on broker-dealers and investment advisers; and
- despite the confusion that exists among investors, investors polled were generally satisfied with their own financial service providers, and in particular with the personal attention that they receive.

[E][2] Calls for Harmonization of Broker-Dealer and Adviser Regulation

In 2009, past efforts to demarcate broker-dealer activity from adviser activity gave way to calls to harmonize the regulatory structures applying to broker-dealers and advisers. This was prompted, in large part, by the Madoff scandal. Many have claimed that the scandal was caused, at least in part, by a regulatory regime that calls for regulators to narrowly focus on either broker-dealer or adviser activity, as opposed to taking a more comprehensive approach.

[E][2][a] Background

Harmonization efforts have generally focused upon applying a consistent standard of care to both advisers and broker-dealers (akin to the adviser’s fiduciary duty), and imposing a self-regulatory organization on advisers, something that broker-dealers live with today.

With respect to a uniform standard of care, SEC Chairman Schapiro has stated that she believes that “all financial service providers that provide personalized investment advice about securities should owe a fiduciary duty to their customers or clients.”⁵⁸ Previously, SEC

58. Mary Schapiro, Chairman of the U.S. Securities and Exchange Commission, Remarks at the New York Financial Writers’ Association Annual Awards Dinner (June 18, 2009).

Commissioner Elisse Walter stated that she believes that every financial professional should be subject to a uniform standard of conduct.⁵⁹ At that time, Commissioner Walter suggested that in developing a uniform standard of conduct, regulators should not dwell on the label to be placed on the standard. The Commissioner also noted that it is important that any standard be accompanied by business practice rules that provide practical guidelines regarding the standard's parameters. In addition, the Commissioner explained that what a particular fiduciary duty requires would depend on the functional role being performed by the financial professional. Specifically, she stated that “. . . what a fiduciary duty requires depends on the scope of the engagement. Thus, it will mean one thing for a mere order taker, another thing for someone who provides a one-time financial plan, and yet something else for someone who exercises ongoing investment discretion over an account.”

Similarly, state securities regulators have urged the application of a fiduciary standard for broker-dealers providing investment advisory services.⁶⁰

[E][2][b] The 2009 Investor Protection Act

[E][2][b][i] Generally

On June 17, 2009, President Obama announced that his Administration was “proposing a sweeping overhaul of the financial regulatory system, a transformation on a scale not seen since the reforms that followed the Great Depression.”⁶¹ In turn, the U.S. Department of Treasury (“Treasury”) released a White Paper that stated two general goals with respect to the regulation and oversight of broker-dealers and investment advisers: establishing a “fiduciary duty” for broker-dealers and harmonizing the regulation of broker-dealers and investment advisers. This was followed, on July 10, 2009, with the Obama Administration, through Treasury, submitting proposed legislation to Congress entitled the “Investor Protection Act of 2009” (the “Investor Protection Act”). For the most part, the provisions of the Investor

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59. Commissioner Elisse Walter, Commissioner of the U.S. Securities and Exchange Commission, Remarks at the Mutual Fund Directors Forum Ninth Annual Policy Conference (May 15, 2009).
 60. Press Release, NASAA, NASAA Statement on Obama Financial Regulatory Reform Proposals (June 17, 2009), *available at* www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/10874.cfm.
 61. U.S. TREASURY DEPARTMENT, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION (June 17, 2009), *available at* http://financialstability.gov/docs/regs/FinalReport_web.pdf.

Protection Act were outlined in Treasury's proposal for financial regulatory reform (the "White Paper") issued in June.

[E][2][b][ii] Broker-Dealer Fiduciary Duty

The Investor Protection Act would add a new section 15(k) to the 1934 Act to articulate its view of the "fiduciary duty" owed by broker-dealers. Under proposed section 15(k), the SEC may promulgate rules to provide that the standard of conduct for a broker-dealer "providing investment advice about securities to retail customers or clients" shall be "to act solely in the interest of the customer or client without regard to the financial or other interest of the" broker-dealer providing the advice. The term "retail customer" is not defined, nor is there any express guidance on how and when a broker-dealer would be deemed to be providing investment advice.

[E][2][b][iii] Adviser Fiduciary Duty

The Investor Protection Act provides similar language for such a duty to be imposed on investment advisers under the Investment Advisers Act.

[E][2][b][iv] Compensation Practices

The proposal would give the SEC broad, unprecedented powers to ban certain compensation practices if the SEC were to find that such practices were not in the public interest. If adopted, this proposal would be a significant policy shift from the current disclosure-based approach that the SEC uses to regulate sales and compensation practices.

[E][2][b][v] SRO for Investment Advisers

The Investor Protection Act is silent with respect to establishment of SRO for advisers.

[E][2][c] The House Proposal

On November 4, 2009, the House Financial Services Committee approved its own version of the Investor Protection Act as H.R. 3817, which was included as part of the Consumer Protection Act that the House of Representatives passed on December 3, 2009 (the "House Bill" or "House IPA"). Among other things, the House IPA would impose a fiduciary standard on broker-dealers and investment advisers. Specifically, the House IPA would require the SEC to promulgate rules requiring broker-dealers and investment advisers "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” when broker-dealers and investment advisers are “providing personalized investment advice about securities to retail customers (and such other customers as the [SEC] may by rule provide).” The language also provides that “[i]n accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer.”

In an effort to better articulate the boundaries of the fiduciary duty, the House Bill contains language providing that “[t]he receipt of compensation based on commission or other standard compensation for the sale of securities shall not, in and of itself, be considered a violation of such [fiduciary] standard applied to a broker or dealer.” However, the House Bill would require special disclosure when a broker-dealer sells only proprietary products or other limited range of products, and would also provide that “[t]he sale of only proprietary or other limited range of products by a broker or dealer shall not, in and of itself, be considered a violation of the [fiduciary] standard set forth” above.

The House Bill defines “retail customer” as a natural person who “receives personalized investment advice about securities” from a broker, dealer, or investment adviser, and “uses such advice primarily for personal, family, or household purposes.” Similar to the Obama IPA, the House Bill directs the SEC to (1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest; and (2) examine and, where appropriate, promulgate rules prohibiting or restricting sales practices, conflicts of interest, and compensation schemes for broker-dealers and investment advisers that it deems contrary to the public interest and the protection of investors.

[E][2][d] Senate Banking Committee Proposal

On November 10, 2009, Senator Chris Dodd of the Senate Banking Committee unveiled his own financial reform bill package, “Restoring American Financial Stability Act of 2010” (RAFSA). In contrast to the approach taken by the Obama IPA and House Bill, the RAFSA would harmonize broker-dealer and adviser regulation by deleting the exclusion from the definition of “investment adviser” in section 202(a)(11)(C) of the Investment Advisers Act. This approach would effectively require broker-dealers providing advice on securities to clients to register as investment advisers under the Investment Advisers Act. All investment advice regarding securities provided by broker-dealers would then be subject to the requirements of the Investment Advisers Act and the rules and interpretive guidance thereunder, including those pertaining to fiduciary duty.

Senator Dodd's November 10th proposal was significantly altered by the revised version that was voted out of the Senate Banking Committee on March 22, 2010. The revised version eliminates the provision applying the fiduciary standard to brokers who provide investment advice. Instead, it requires a one-year study by the SEC concerning the effectiveness of existing standards for "providing personalized investment advice and recommendations about securities to retail customers."

[E][2][e] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which was signed into law by President Obama on July 21, 2010, called for the SEC to conduct a study of the obligations and standards of care of broker-dealers and investment advisers (the "SEC Study") when providing personalized investment advice about securities to retail customers. Most importantly, section 913 directed the SEC to study the standards of care applicable to broker-dealers and investment advisers and related issues, and it provides the SEC with authority to promulgate rules imposing a fiduciary duty on broker-dealers and investment advisers when providing investment advice to retail customers.

[E][2][e][i] The SEC Study

On July 27, 2010, as part of the SEC Study, the SEC published a release requesting comment on issues that section 913 of the Dodd-Frank Act mandates be studied, regarding the standard of care applied by brokers, dealers, and investment advisers when providing investment advice and making recommendations to retail clients.⁶² The SEC's release is simply a list of the issues that section 913 requires it to study without any further discussion or analysis by the SEC. These issues include:

- the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, and associated individuals for providing personalized investment advice and recommendations to retail customers imposed by the SEC, SROs, and other federal and state legal or regulatory standards;
- whether there are legal or regulatory gaps in legal or regulatory standards of care imposed on brokers, dealers, investment advisers, and associated individuals for the protection of retail customers;

62. Securities Exchange Act Release No. 62,577 (July 27, 2010).

- whether retail customers understand the differences in the standards of care applicable to brokers, dealers, investment advisers, and associated individuals;
- whether the differences are the source of confusion to retail customers;
- the regulatory, examination, and enforcement resources devoted to the enforcement of the standards of care for brokers, dealers, investment advisers, and associated individuals, including the effectiveness of the examinations, the frequency of the examinations, and the length of time of the examinations;
- the substantive differences in the regulation of brokers, dealers, investment advisers, and associated individuals;
- the existing legal and regulatory standards intended to protect retail customers;
- the specific instances in which regulation and oversight of investment advisers provide greater protection to retail customers than regulation and oversight of brokers and dealers, and such instances when the regulation and oversight of brokers and dealers provide greater protection than that of investment advisers;
- the potential impact of eliminating the broker and dealer exclusion from the definition of “investment adviser” under section 202(a)(11)(C) of the Investment Advisers Act on retail customers, brokers, and dealers;
- the potential benefits and harm to retail customers that could result from such a change, including any impact on personalized investment advice and recommendations, and the availability of such advice and recommendations;
- the impact on the number of additional individuals and entities that would be subject to investment adviser registration requirements and the additional costs to such individuals and entities as a result of this increase;
- the impact on SEC and state resources to conduct examinations and enforce the standard of care and other requirements under the Investment Advisers Act;
- the varying levels of services provided by brokers, dealers, investment advisers, and associated individuals, and the varying scope and terms of retail customer relationships with such persons and entities;

- the potential impact on retail customers that could result from changes in requirements or legal standards of care, including any impact on:
 - protection from fraud;
 - access to personalized investment advice and recommendations to retail customers; or
 - the availability of such services;
- the potential additional costs and expenses to retail customers, and the potential impact on the profitability of their investment decisions;
- the potential costs and expenses to brokers, dealers, and investment advisers resulting from changes in regulatory requirements or legal standards; and
- any other consideration that the SEC considers necessary and appropriate in determining whether to engage in rulemaking.

[E][2][e][ii] Review of Comments Submitted

In response to the SEC Study request for comments, the SEC has received over 2,000 comment letters. Many of the letters submitted on behalf of the broker-dealer and insurance industries have emphasized that the Study presents a unique opportunity for the SEC to focus on complex and important issues with respect to the provision of personalized investment advice about securities to retail customers by brokers, dealers, and investment advisers, and as such, have urged that the SEC:

- use the SEC Study as an opportunity to approach the issues in a comprehensive manner, and work with all interested parties to provide an effective, efficient and lasting framework that protects investors and instills confidence in the U.S. capital markets;
- perform a rigorous analysis of the applicable existing regulatory regime, identify those things that are working well and those that are not; and evaluate the likely consequences to the retail and other investing public and the industries from any potential changes. This is in keeping with the goal of better protecting retail customers and other investors without unnecessarily increasing costs and/or reducing investor choice and access to important personalized investment advice about securities; and

- recognize the benefits that retail customers derive from the choices presented by a diversity of business models providing personalized investment advice about securities to retail customers.

These letters have also urged that the SEC Study be advanced with a view toward preserving:

- retail customer investor protection;
- the full spectrum of retail customer choice regarding securities products and services; and
- the full spectrum of retail customer access to those securities products and services.⁶³

[E][2][e][iii] SEC Report

On January 21, 2011, the SEC released its study (the “Study”) on the effectiveness of legal and regulatory standards of care for broker-dealers and investment advisers called for under section 913 of the Dodd-Frank Act.

The Study was released as a statement of the staff of the SEC and not necessarily as a position of the SEC as a whole or of individual Commissioners. As described in the Study, the SEC is required to deliver a “report” on the Study under section 913 of the Dodd-Frank Act, and that report must “describe the findings, conclusions and recommendations from the Study.” Commissioners Casey and Paredes released a statement opposing the Study’s release as adopted, primarily because they believe it fails “to evaluate the ‘effectiveness of existing legal or regulatory standards of care’ applicable to broker-dealers and investment advisers.”

The Study is fashioned as a series of recommendations by the staff to the SEC. It will now be up to the SEC to determine whether, how, and when to advance any or all of the recommendations. The Study makes two primary recommendations:

1. The SEC should engage in rulemaking specifying a uniform fiduciary standard of conduct that is no less stringent than currently applied to investment advisers that would apply to broker-dealers and investment advisers when they provide

63. *See, e.g.*, Comment letters submitted by the FSI (dated August 30, 2010); SIFMA (dated August 30, 2010), the American Council of Life Insurers (dated August 30, 2010); the Committee of Annuity Insurers (dated August 30, 2010); Joint Submission by American Council of Life Insurers; Association for Advanced Life Underwriting; Financial Services Institute; Insured Retirement Institute; National Association of Insurance and Financial Advisors; Securities Industry and Financial Markets Association (dated August 30, 2010).

personalized advice about securities to retail customers. This core recommendation is accompanied by detailed recommendations addressing the implementation of the uniform fiduciary duty.

2. The regulatory protections related to personalized investment advice about securities to retail customers provided by broker-dealers and investment advisers should be harmonized to the extent that harmonization appears likely to add meaningful investor protection.

Finally, the staff states that it does not recommend pursuing two alternatives that were to be considered as directed under the mandate of section 913 of the Dodd-Frank Act: the repeal of the broker-dealer exclusion in the Investment Advisers Act, and imposing the standard of conduct and other requirements of the Investment Advisers Act on broker-dealers. The staff states that these alternatives would entail significant costs that would not be justified by any potential benefits.

The Dodd-Frank Act does not compel the adoption of any particular regulations at the conclusion of the Study, but rather says that the SEC “may commence a rulemaking, as necessary or appropriate in the public interest and for the protection of retail customers . . . to address the legal or regulatory standards of care for brokers, dealers, investment advisers . . . providing personalized advice about securities to such retail customers” and that such rulemaking shall “consider” the findings and recommendations of the Study. Therefore, there is no definitive timetable or next steps resulting from the Study.

Below, we review the recommendations:

Recommendation: The Commission should engage in rulemaking to implement the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. Specifically, the staff recommends that the uniform fiduciary standard of conduct established by the Commission should provide that:

The 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.

Recommendation: The Commission should engage in rulemaking and/or issue interpretive guidance on the components of the uniform fiduciary standard: the duties of loyalty and care. In doing so, the

Commission should identify specific examples of potentially relevant material conflicts of interest in order to facilitate a smooth transition to the new standard by broker-dealers and consistent interpretations by broker-dealers and investment advisers. The existing guidance and precedent under the Investment Advisers Act regarding fiduciary duty, as developed primarily through Commission interpretive pronouncements under the antifraud provisions of the Investment Advisers Act, and through case law and numerous enforcement actions, will continue to apply.

Recommendation: The Commission should facilitate the provision of uniform, simple, and clear disclosures to retail customers about the terms of their relationship with broker-dealers and investment advisers, including any material conflicts of interest. The Commission should consider the disclosures that should be provided (a) in a general relationship guide akin to the new Form ADV Part 2A that advisers deliver at the time of entry into the retail customer relationship, and (b) in more specific disclosures at the time of providing investment advice (for example, about certain transactions that the Commission believes raise particular customer protection concerns). The Commission also should consider the utility and feasibility of a summary disclosure document containing key information on a firm's services, fees and conflicts and the scope of its service (for example, whether its advice and related duties are limited in time or are ongoing). The Commission should consider whether rulemaking would be appropriate to prohibit certain conflicts, to require firms to mitigate conflicts through specific action, or to impose specific disclosure and consent requirements.

Recommendation: The Commission should address through guidance and/or rulemaking how broker-dealers should fulfill the uniform fiduciary standard when engaging in principal trading.

Recommendation: The Commission should consider specifying uniform standards for the duty of care owed to retail customers, through rulemaking and/or interpretive guidance. Minimum baseline professionalism standards could include, for example, specifying what basis a broker-dealer or investment adviser should have in making a recommendation to a retail customer.

Recommendation: The Commission should engage in rulemaking and/or issue interpretive guidance to explain what it means to provide "personalized investment advice about securities."

Recommendation: The Commission should consider additional investor education outreach as an important complement to the uniform fiduciary standard.

Recommendation: The Commission should consider articulating consistent substantive advertising and customer communication rules and/or guidance for broker-dealers and investment advisers regarding

the content of advertisements and other customer communications for similar services. In addition, the Commission should consider, at a minimum, harmonizing internal pre-use review requirements for investment adviser and broker-dealer advertisements, or requiring investment advisers to designate employees to review and approve advertisements.

Recommendation: The Commission should review the use of finders and solicitors by investment advisers and broker-dealers and consider whether to provide additional guidance or harmonize existing regulatory requirements to address the status of finders and solicitors, and disclosure requirements to assure that retail customers better understand the conflicts associated with the solicitor's and finder's receipt of compensation for sending a retail customer to an adviser or broker-dealer.

Recommendation: The Commission should review supervisory requirements for investment advisers and broker-dealers, with a focus on whether any harmonization would facilitate the examination and oversight of these entities (for example, whether detailed supervisory structures would not be appropriate for a firm with a small number of employees), and consider whether to provide any additional guidance or engage in rulemaking.

Recommendation: The Commission should consider whether the disclosure requirements in Form ADV and Form BD should be harmonized where they address similar issues, so that regulators and retail customers have access to comparable information. The Commission also should consider whether investment advisers should be subject to a substantive review prior to registration.

Recommendation: The Staff recommends that the Commission could consider requiring investment adviser representatives to be subject to federal continuing education and licensing requirements.

Recommendation: The Commission should consider whether to modify the Investment Advisers Act books and records requirements, including considering a general requirement to retain all communications and agreements (including electronic communication and agreements) related to an adviser's "business as such," consistent with the standard applicable to broker-dealers.

[E][2][f] Practical Implications to Consider—Potential Harmonized Standard of Care

Any legislation imposing a harmonized standard of care, including a fiduciary duty on broker-dealers when providing investment advice about securities to retail customers is likely to impact broker-dealers and investment advisers in a number of ways including:

- *Disclosure.* Disclosure of the broker-dealer's role and relationship vis-à-vis the product issuer and principal underwriter, and any conflicts of interest created by these relationships; sources of compensation; and compensation arrangement that creates a material conflict of interest for the broker-dealer or its associated persons.
- *Timing of Disclosure.* Indications are that key disclosures will likely need to be provided at "the point of sale" of the provision of the investment advice about a particular security or securities, not after the sale has been completed.
- *Conflicts of Interest.* Enhanced regulatory expectations that broker-dealers will conduct ongoing monitoring and reviews of conflicts of interests (their own as broker-dealers and those relating to their interactions and offerings of products issued by affiliates and/or third parties).
- *Suitability of Advice and Recommendations.* Increased regulatory scrutiny of the costs and expenses of securities that are recommended to customers.
- *Documentation.* Increased regulatory expectation regarding documentation relating to suitability of investment advice and recommendations made about securities.
- *Due Diligence.* Regulators may seek enhanced ongoing due diligence regarding customer investment needs and objectives.
- *Compensation.* There is expected to be an impact on the compensation practices of broker-dealers, such as enhanced disclosure. Additional impacts on certain compensation practices could include impacts on:
 - (i) paying out higher compensation for the sale of proprietary products;
 - (ii) sales contests, bonuses, and non-cash compensation that are based on sales of specific securities or types of securities; and
 - (iii) revenue sharing, and other compensation arrangements.

It is important to note that as of the time of printing of these materials there do not seem to be any legislative or regulatory initiatives that will likely result in:

- banning commissions or other transaction-based compensation;
- prohibiting the offering of proprietary products, such as those investment and other products issued by affiliates; and
- making impermissible “limited product sets” offered by broker-dealers.

§ 2:3.4 Registered Representatives

[A] Ability of Registered Representatives to Rely on Broker-Dealer Exclusion

A registered representative of a broker-dealer may also take advantage of the exclusion provided to broker-dealers in section 202(a)(11)(C). However, to do so, the registered representative providing advisory services must be acting within the scope of his or her employment with the brokerage firm, with the knowledge and consent of the firm, and fully subject to its control.⁶⁴

Therefore, a registered representative with an independent financial planning or other advisory business—that is not subject to the brokerage firm’s control—cannot rely on the broker-dealer exclusion. An issue that frequently arises is whether an insurance agent who is also a registered representative is eligible to rely on the broker-dealer exclusion if the agent/representative analyzes a client’s financial goals in connection with determining the proper amount of insurance to own. The SEC staff has permitted reliance on the exclusion provided the agent/representative does not hold himself out to the public as a financial planner or investment adviser, no special compensation is received for the financial analysis, and the broker-dealer controls the financial analysis activity.⁶⁵

64. See, e.g., Release 1092, *supra* note 3. Nathan & Lewis Sec., Inc., SEC No-Action Letter (Apr. 4, 1988); Am. Capital Fin. Servs., Inc., *supra* note 45; Elmer D. Robinson, SEC No-Action Letter (Jan. 6, 1986). The control exercised by the broker-dealer must satisfy the test for control provided by § 3(a)(18) of the Securities Exchange Act. Brent A. Neiser, SEC No-Action Letter (Jan. 21, 1985).

65. See Princor Fin. Servs. Corp., SEC No-Action Letter (Jan. 31, 1991); R.E. Fin., SEC No-Action Letter (June 29, 1989); Nathan & Lewis Sec., Inc., *supra* note 64. In Nathan & Lewis, a registered representative was permitted to sell insurance products to brokerage clients outside the capacity as a registered representative of the broker-dealer without registering as an investment adviser, in reliance on the broker-dealer exclusion. The SEC staff conditioned its no-action assurance on the following: that the registered representative not hold himself out generally as a financial

[B] Registered Representatives Engaging in the Advisory Business

Despite the availability of the exclusion, many registered representatives register as investment advisers or become an associated person of a registered adviser in order to engage actively in the advisory business. FINRA, however, requires that its member broker-dealers properly supervise the advisory activities of their registered representatives.

[B][1] Brokerage Firm Duty to Supervise Representative Advisory Activity

As noted, the FINRA requires brokerage firms to supervise advisory activity of their registered representatives. Supervision is required even where the representative conducts such activity away from his or her brokerage firm. FINRA, in Notice to Members 94-44, stated that Article III, section 40 of the Rules of Fair Practice (currently NASD Conduct Rule 3040), commonly known as the FINRA provision applying to "Selling Away," may apply to situations involving registered representative advisory activity.⁶⁶ Specifically, when the advisory services result in the execution of securities transactions through a brokerage firm that is different from the representative's employer, the representative must advise his brokerage employer. This would occur, for example, if the representative works for a full-service brokerage firm and provides advisory services that result in the execution of transactions at a discount brokerage firm.

Moreover, if the representative is compensated for his services, his brokerage firm employer must approve or disapprove of the transaction, must supervise it under the Rules of Fair Practice dealing with supervision (NASD Conduct Rule 3010), and must record it upon its books and records as though it were the employer's own transaction. In supervising the transaction, the employer is obligated to assure that it is performed in compliance with all securities laws and FINRA standards.

planner or provider of other advisory service; that advisory services be provided only in his role as a registered representative and subject to his broker-dealer's control; that he disclose his dual capacity to his clients (that is, securities and insurance product salesman); that he charge no clearly definable fee for investment advisory services; and fees or commissions charged to clients who obtain brokerage and insurance services are based on the same factors as those used to determine fees or commissions for clients who obtain only one of those services.

66. NASD Notice to Members 94-44 (May 15, 1994). In May 1996, the NASD issued Notice to Members 96-33, which presents the answers to some of the most frequently asked questions since the release of Notice to Members 94-44.

If the representative is not compensated for the transaction or if the advisory services do not entail the execution of securities transactions, then he still must notify his employer of his separate advisory business, and the employer must assure that the representative's advisory clients understand that it is not responsible for the advice and other services being provided.⁶⁷

§ 2:3.5 Publishers and Authors

Section 202(a)(11)(D) excludes from the definition of investment adviser "the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation." While this exclusion clearly applies to general newspapers and magazines (for example, the *Wall Street Journal*), its scope with respect to other types of publications, such as investment newsletters, has not been as certain.⁶⁸ In 1985, the scope of this exclusion was given greater certainty by the U.S. Supreme Court's decision in *Lowe v. SEC*.⁶⁹

In *Lowe*, the Court blocked an effort by the SEC to enjoin publication of an investment newsletter by Lowe because he was not registered under the Investment Advisers Act. Lowe was president and principal shareholder of a corporation which had been registered as an investment adviser. After the SEC found that Lowe engaged in fraudulent conduct, it revoked the corporation's registration and Lowe was ordered not to associate with any investment adviser. The court of appeals held that the newsletter was not a "bona fide newspaper" and therefore was unable to rely on the publisher's exclusion in the Investment Advisers Act.

The Supreme Court emphasized three factors with respect to the Investment Advisers Act legislative history which it found justified a broad construction of the publisher's exclusion. First, the Court noted that the exclusion was broadened during the Investment Advisers Act's redrafting near the end of the Congressional hearings, to add "business and financial publications" to the previously excluded group of newspapers and news magazines. Second, the SEC Report presented to Congress had excluded publications from the advisory entities which it examined and, in addition, Congress had before it a Report noting the need to avoid First Amendment concerns in regulating investment periodicals. Finally, the legislative hearings focused upon the existence of a personal and fiduciary relationship as being the essence of the investment advisory relationship being subjected to regulation, and

67. See FINRA Rule 3270 (which was preceded by former NASD Conduct Rule 3030).

68. Investment newsletters often provide general advice about securities as well as specific recommendations regarding stock selection.

69. *Lowe v. SEC*, 472 U.S. 181 (1985).

further that Congress's purpose in passing the Investment Advisers Act was to protect investors and responsible advisory professionals from the activities of "tipsters" and "touts."

The Court, therefore, concluded that:

Congress did not intend to exclude publications that are distributed by investment advisers as a normal part of the business of servicing their clients. The legislative history plainly demonstrates that Congress was primarily interested in regulating the business of rendering investment advice, including publishing activities that are a normal incident thereto. On the other hand, Congress, plainly sensitive to First Amendment concerns, wanted to make clear that it did not seek to regulate the press through the licensing of nonpersonalized publishing activities. . . .

The exclusion itself uses extremely broad language that encompasses any newspaper, business publication, or financial publication provided that two conditions are met. The publication must be "bona fide," and it must be "of regular and general circulation." Neither of these conditions is defined, but the two qualifications precisely differentiate "hit and run tipsters" and "touts" from genuine publishers. Presumably a "bona fide" publication would be genuine in the sense that it would contain disinterested commentary and analysis as opposed to promotional material disseminated by a tout.

Moreover, publications with a "general and regular" circulation would not include "people who send out bulletins from time to time on the advisability of buying and selling stocks . . .," or "hit and run tipsters." Because the content of petitioners' newsletters was completely disinterested, and because they were offered to the general public on a regular schedule, they are described by the plain language of the exclusion. (Footnotes omitted.)

The Court noted that there was "no suggestion" that Lowe's newsletters contained any false or misleading statements, or were designed to "tout" any security, and further that the "dangers of fraud, deception, or overreaching" that motivated adoption of the Investment Advisers Act are not present in "publications that are advertised and sold in the open market." Accordingly, the Court concluded that the newsletter fell within the publisher's exclusion.⁷⁰

In light of *Lowe*, many newsletters and other publications rely on the publisher's exclusion. However, publications that tout stocks in

70. A three-member concurrence strongly opposed virtually every element of the majority's reasoning, pointing out that it exempts most investment publications from the Investment Advisers Act's antifraud protections as well as its regulatory provisions. The concurrence would have decided the

which the publisher has an interest, those engaged in some other fraud, or those that render personalized investment advice are not entitled to rely on the publisher's exclusion.⁷¹ Since *Lowe*, the SEC staff has generally not responded to no-action requests with respect to the publisher's exclusion because of the very fact-specific standard set forth by the Supreme Court.⁷²

Recently, however, the SEC staff has been willing to respond to no-action requests regarding telephone stock tip services (which the staff determined not to fall within the *Lowe* criteria because they are not "general" or "regular"—that is, the tips are timed to take advantage of specific market events) and computer software investment publications (which the staff determined not to be investment advisory services because the publications provide only raw data readily available to the public, the categories of information presented are not highly selective, and the information is not organized or presented in a manner that suggests the purchase, holding, or sale of securities).⁷³

[A] Investment Website Operators

Recent SEC enforcement actions apply the principles enunciated in *Lowe* to investment website operators. Whereas *Lowe* looks at what constitutes an individualized communication in a "paper-world," the recent SEC cases examine the boundaries surrounding general and individualized communication in the context of the Web.

First, in a well-publicized action, the SEC alleged that a website operator was an adviser and engaged in fraudulent conduct including:

- (1) defrauding paying members of its Internet site by failing to disclose that it had already purchased shares of stocks that it was recommending and planned to sell into the buying flurry and subsequent price rise that followed its recommendations;

issue on a narrow First Amendment ground, that is, that an injunction could not be issued to prevent unregistered persons from offering impersonal investment advice through publications such as those of *Lowe*. See *Lowe*, 472 U.S. at 211–36 (White, J., concurring).

71. See, e.g., SEC v. Thomas E. Loyd, individually, and d/b/a Loyd Fin. Consulting, Litigation Release No. 16,495 (Mar. 31, 2000) (a publisher of an investment letter, engaged in a stock touting and scalping scheme, was found to have violated the antifraud provisions of the Investment Advisers Act, Securities Act, and Securities Exchange Act).
72. See, e.g., Eugene E. Castleberry, SEC No-Action Letter (June 17, 1991); Anthony Healy, SEC No-Action Letter (Mar. 25, 1991).
73. See, e.g., Mary Lee Botsaris, SEC No-Action Letter (Mar. 25, 1993); Charles L. Simpson, SEC No-Action Letter (July 7, 1992); J.D. Manning, Inc., SEC No-Action Letter (Feb. 27, 1986); No Load Mutual Fund Assoc., Inc., *supra* note 10.

- (2) touting one company to its members and to the public without disclosing that it had received shares of stock in the company in exchange for its recommendation; and
- (3) posting false and misleading performance numbers.⁷⁴

The enforcement action was ultimately settled by the adviser.

Before settling the case, the adviser unsuccessfully moved in U.S. District Court to dismiss the SEC's Complaint. In denying the motion to dismiss, the court found that the publisher's exclusion was unavailable to the adviser. In so doing, the court rejected the adviser's claim that its website publication was "bona fide," pointing to the misleading performance results used by the adviser and the SEC's contention that the adviser was acting as a "tout" by promoting stocks in which it had an interest. In addition, the court noted that the publication was not of "general and regular" circulation, rejecting the defendant's contention that its advice should be viewed as non-personalized and not tailored to the particular needs of any one client.⁷⁵ The court cited the defendant's use of individualized emails and that its website was geared to that particular category of individuals who subscribe to an Internet stock-picking website, as opposed to the general public.

In another action, the SEC alleged that a website operator was an adviser and had violated the antifraud provisions of the Investment Advisers Act by soliciting subscribers through false statements that individuals would be able to see actual trades of a successful day trader and would be able to approximate the performance of the trader by mimicking his trades.⁷⁶ The complaint alleged that the recommendations were not that of a successful day trader, they were fabricated. The SEC's complaint further alleged that claimed returns were unattainable because the prices posted for the trading recommendations were false.

§ 2:3.6 U.S. Government Obligations

Section 202(a)(11)(E) provides an exclusion for:

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

74. See SEC v. Yun Soo Oh Park & Tokyo Joe's Société Anonyme Corp., Litigation Release No. 16,925 (Mar. 8, 2001).

75. SEC v. Park, 99 F. Supp. 2d 889 (N.D. Ill. 2000).

76. SEC v. Dynamic Daytrader.com L.L.C. & David A. Rudnick, C.A., Litigation Release No. 16,475 (Mar. 20, 2000).

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, as exempted securities for the purposes of that Act.

This exception is consistent with the exceptions provided throughout the federal securities laws for securities issued or guaranteed by the federal government, states, or municipalities. This exclusion has not generated SEC staff interpretation or case law. It is frequently relied upon by entities, such as commodity trading advisers, which invest the cash positions in their clients' accounts in government securities.

§ 2:3.7 Family Offices

The Dodd-Frank Act added a new exclusion (section 202(a)(11)(G) of the Investment Advisers Act) from the definition of "investment adviser" for "family offices."⁷⁷ To implement this exclusion as well as incorporate a grandfathering provision required by the Dodd-Frank Act, the Commission recently adopted new rule 202(a)(11)(G)-1.⁷⁸

A "family office" is a company (including its directors, partners, trustees, and employees acting within the scope of their position or employment) that:

- has no clients other than family clients (with a one-year grace period for a person who becomes a client due to death or other involuntary transfer);
- is wholly owned and controlled (directly or indirectly) by family members; and
- does not hold itself out to the public as an investment adviser.

The rule includes a grandfather provision for family offices that were not registered or required to be registered with the SEC on January 1, 2010 and that meet all of the required conditions of the rule but for their provision of investment advice to certain clients specified in section 409(b)(3) of the Dodd-Frank Act.

The grandfathered clients are (A) natural persons who, at the time of their investment, (i) are officers, directors, or employees of the family office before January 1, 2010 and (ii) are accredited investors, as defined in Regulation D under the Securities Act of 1933; (B) any company owned exclusively and controlled by one or more family members; or (C) registered investment advisers that provide investment advice and identify investment opportunities to the family office

77. Investment Advisers Act § 202(a)(11)(G).

78. Investment Advisers Act Release No. 3098 (Oct. 12, 2010); Investment Advisers Act Release No. 3220 (June 22, 2011).

and invest in such transactions on substantially the same terms as the family office and meet certain other conditions.

Any adviser that relies on the grandfather provision will be subject to the Investment Advisers Act's general antifraud provisions.

§ 2:3.8 Parties Excluded by SEC Regulation or Order

Section 202(a)(11)'s final exclusion is for "such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order." The SEC has adopted no rules or regulations making any designations under this authority. It has, however, issued several orders finding certain persons not to be investment advisers.⁷⁹

On several recent occasions, parties to no-action letters have requested that the SEC staff exercise its section 202(a)(11)(F) exemptive authority. The SEC staff has routinely denied such relief, noting that section 202(a)(11)(F) requires the filing of a formal application with the Commission.⁸⁰

§ 2:4 Exemptions from Registration

Section 203(b) exempts various types of advisers from registration. As evident from the discussion below, the exemptions are generally very narrow. An additional exemption, that for advisers to mutual funds, was eliminated in 1970 to assure that mutual fund investors receive the protections of the Investment Advisers Act. Furthermore, the Dodd-Frank Act substantially changed the exemptions that are

79. Many of these orders have centered around the limited nature of the advisory services provided. *See, e.g.*, CSX Fin. Mgmt., Inc., Investment Advisers Act Release No. 1805 (June 23, 1999) (Notice of Application) and Investment Advisers Act Release No. 1808 (July 20, 1999) (Order) (entity advising only affiliated company deemed to be outside the intent of the definition of investment adviser in § 202(a)(11)).

Early in its administration of the Investment Advisers Act, the SEC issued several orders under this section finding that trustees, subsidiaries of bank holding companies advising only affiliated banks, and family-owned corporations advising only their family members/shareholders were not investment advisers as they were not engaged in "advising others" and thus need not register under the Investment Advisers Act. *In re* Roosevelt & Son, 29 S.E.C. 879 (1949); *In re* Pitcairn Co., 29 S.E.C. 186 (1949); *In re* Augustus P. Loring, Jr., 11 S.E.C. 885 (1942); *In re* Donner Estates, Inc., 10 S.E.C. 400 (1941); *In re* First Serv. Corp., 8 S.E.C. 152 (1940).

In subsequent no-action letters, the SEC staff narrowed the scope of these orders, particularly as applied to trustees. *See* Joseph J. Nameth (Jan. 31, 1983).

80. *See, e.g.*, First Commerce Investors, Inc., SEC No-Action Letter (Jan. 31, 1991); Reuters Info. Servs., Inc., SEC No-Action Letter (Jan. 17, 1991); New Directions Grp., Inc., SEC No-Action Letter (Mar. 6, 1985).

available to investment advisers, particularly to investment advisers of private funds. A private fund is generally defined as a company that would be an investment company but for section 3(c)(1) or 3(c)(7) of the Investment Company Act.

§ 2:4.1 The Intrastate Exemption (Section 203(b)(1))

The “intrastate exemption” exempts any adviser whose clients are all residents of the state within which the adviser maintains its place of business, and who does not furnish advice or issue reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange.⁸¹ The prohibition against recommendations of exchange-traded securities prevents all but highly specialized or very small advisers from taking advantage of the intrastate exemption. Also, effective July 21, 2011, an adviser may not rely on this exemption if it is an adviser to a private fund (that is, any issuer that would be an investment company, as defined in the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of the Investment Company Act).

§ 2:4.2 The Insurance Company Exemption (Section 203(b)(2))

The “insurance company” exemption exempts any adviser whose only clients are insurance companies.

§ 2:4.3 Historical Note: The Defunct Private Investment Adviser Exemption

The now defunct “private investment adviser” exemption exempted any adviser who did not hold itself out⁸² generally to the public as an

81. The SEC considered the adoption of a proposed rule to expand the intrastate exemption in § 203(b)(1), which was not adopted. *See* Investment Advisers Act Release No. 1140 (Sept. 16, 1988). Had it been adopted, the proposal would have expanded the intrastate exemption to permit the recommendation of exchange-traded securities by an adviser operating in a single state who has no more than fifty clients during the prior twelve months and managed a securities portfolio with an aggregate fair market value of not more than \$10 million at the end of his last fiscal year.

82. The SEC staff has read “holding out” very broadly. The staff has stated that advisers may be holding themselves out as investment advisers if they advertise advisory services, use the label “investment adviser” on business cards or stationery, list themselves as advisers in telephone, business, or building directories, or let it be known generally of their desire to accept new advisory clients. *See, e.g.*, Thompson Fin., Inc., SEC No-Action Letter (July 10, 2002), at n.8 and accompanying text (citing Investment Advisers Act Release No. 1140 (Sept. 16, 1988), at n.10 and accompanying text).

adviser, did not act as an investment adviser for any registered investment company or business development company, and during the course of the preceding twelve months had fewer than fifteen clients.⁸³ As a result of the Dodd-Frank Act, on July 21, 2011, this exemption, which was formerly located at section 203(b)(3) of

The staff has also stated that an adviser's use of publicly available electronic media (for example, the World Wide Web) to provide information about its services would render the 203(b)(3) exception unavailable. The SEC staff did, however, provide no-action relief to an adviser posting certain information concerning private investment companies on a website. In its letter, the SEC staff stated that an adviser would not be deemed to be holding itself out generally to the public as an investment adviser under section 203(b)(3) where access to such information was limited to a select group of accredited investors through certain pre-qualification procedures and a password-protection system. Lamp Techs., Inc., SEC No-Action Letter (May 29, 1997).

In a subsequent letter to Lamp Technologies, Inc., the staff clarified that their position would not be affected if the private companies were structured as domestic or foreign partnerships, limited liability companies, trusts, or other entities. This issue required clarification because the staff's original response suggested that the funds would be organized as limited partnerships exclusively. In requesting clarification of this point, Lamp noted that the form of organization should have no impact on the staff's analysis under section 203(b)(3). Also, in Thompson Fin., Inc., SEC No-Action Letter (July 10, 2002) the staff issued a no-action letter permitting unregistered investment advisers, including those who manage private funds, to provide a financial reporting company with biographical and contact information (such as the identity of portfolio managers telephone numbers, fax numbers, email addresses, and sub-accounts managed) for inclusion in password-protected Internet websites maintained by the reporting company and made available to its subscribers. The no-action letter provides that unregistered investment advisers who provide such information will not be deemed to be holding themselves out to the public as investment advisers on the condition that: (1) the websites are made available exclusively to the institutional sales and desks of registered broker-dealers to streamline their communication with institutional investors for brokerage services and to fund managers to monitor their competition; and (2) procedures are implemented that effectively prevent persons who seek advisory services from gaining access to the websites.

83. The SEC staff has issued no-action guidance with respect to the fifteen-client limit. For example, advisers must count each member of a limited partnership unless Rule 203(b)(3)-1, discussed below and also in *infra* section 2:5, under "Specific Contexts," applies. Alexander, Holburn, Beauden & Lang, SEC No-Action Letter (Aug. 13, 1984); S&R Mgmt. Co., SEC No-Action Letter (May 8, 1975). Separate subsidiaries incorporated in an effort to avoid registration by providing advisory service to no more than fifteen clients through each subsidiary will be combined and required to register pursuant to section 208(d). See Investment Advisers Act Release No. 1140 (Sept. 16, 1988); Steve A. Flamm, SEC No-Action Letter (Mar. 18, 1993).

the Investment Advisers Act, was replaced by a new exemption for “foreign private advisers.” However, the Dodd-Frank Act did create a new exemption for advisers to private funds⁸⁴ with less than \$150 million in assets under management, which is discussed in further detail below. Accordingly, under this new regulatory framework, advisers to certain private funds will be subject to registration, while others will be exempt from registration, but required to submit certain reports to the SEC.

Table 2-2

REGULATORY DEVELOPMENTS AT A GLANCE	
1985	The SEC adopted Investment Advisers Act Rule 203(b)(3)-1, typically referred to as “The Counting Rule.” The rule sets forth certain conditions under which an entity, and not its investors may be counted as the client for purposes of determining the availability of the exemption from registration afforded by section 203(b)(3) of the Investment Advisers Act.
2004	The SEC adopted Investment Advisers Act Rule 203(b)(3)-2 and related rule amendments, requiring advisers to count each investor in a “private fund” towards the threshold of fourteen clients for purposes of determining the availability of the exemption from registration afforded by section 203(b)(3) of the Investment Advisers Act. The rule is designed to increase the number of hedge fund managers who must register as advisers.
2005	In December 2005 the SEC staff issued a no-action letter where it expressed its position on a number of questions raised by the American Bar Association’s Subcommittee on Private Investment Entities regarding Rule 203(b)(3)-2. The letter provides guidance about various aspects of the rule, including the two-year redemption element in the definition of private fund.

84. The Dodd-Frank Act also amended the Investment Advisers Act to include a definition of “private fund.” Investment Advisers Act § 202(a)(29) defines a private fund as an issuer that would be an investment company under section 3 of the Investment Company Act of 1940, but for an exclusion provided from that definition by either section 3(c)(1) or 3(c)(7) of the Investment Company Act.

REGULATORY DEVELOPMENTS AT A GLANCE (<i>cont'd</i>)	
2006	The U.S. Court of Appeals for the District of Columbia overturns Rule 203(b)(3)-2 in the <i>Goldstein</i> decision.
2007	In response to Rule 203(b)(3)-2 being overturned, the SEC adopts a new antifraud rule, Rule 206(4)-8, that covers all advisers, including unregistered advisers.
2010	July 21, 2010, President Obama signs the Dodd-Frank Act. The Private Fund Advisers Registration Act, located in Title IV of the Dodd-Frank Act, deletes the exemption from registration for advisers to private funds, and replaces it with a new exemption for foreign private advisers.
2011	July 21, 2011, the Dodd-Frank Act's deletion of the exemption from registration for advisers to private funds becomes effective. Also on this date, the SEC's new rule 203(m)-1, which provides the new exemption for small private fund advisers and addresses several interpretive questions raised by new section 203(m) under the Investment Advisers Act, becomes effective.

For historical context, Appendix 2A provides background on what at one time was the exemption relied upon by advisers to private funds.

§ 2:4.4 Foreign Private Adviser Exemption (Section 203(b)(3) and Rule 202(a)(30)-1)

As noted above, the Dodd-Frank Act deletes the exemption for advisers to private funds in section 203(b)(3) and replaces it with an exemption for foreign private advisers.

A "foreign private adviser" is defined in section 202(a)(30) as an adviser that:

- has no place of business in the United States;
- has, in total, fewer than fifteen clients in the United States and investors in the United States in private funds advised by the adviser;
- has aggregate assets under management attributable to U.S. clients and investors in the United States in private funds advised by the adviser of less than \$25 million; and
- neither holds itself out generally to the U.S. public as an investment adviser, nor acts as an investment adviser to a registered investment company or a business development company.

The SEC recently adopted revisions to Form ADV, the investment adviser registration form, that provides instructions on how to calculate assets under management for purposes of this exemption and certain other purposes.⁸⁵

As stated in recently adopted rule 202(a)(30)-1,⁸⁶ an “investor” is:

- any person that would be included in determining the number of beneficial owners of the outstanding securities of a private fund under section 3(c)(1) of the Investment Company Act or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3(c)(7) of the Investment Company Act; and
- any beneficial owner of any outstanding short-term paper issued by the private fund.

Whether a client or investor is “in the United States” generally depends on whether that person is a “U.S. Person” under Regulation S, except that any discretionary account or similar account that is held for the benefit of a U.S. person by a non-U.S. dealer or other professional fiduciary would be deemed to be “in the United States” if the dealer or professional fiduciary is a related person of the investment adviser relying on the exemption. For example,

- a natural person would be a U.S. person (and therefore “in the United States”) if that person is a resident in the United States; and
- a partnership or corporation would be a U.S. person if it is either (i) organized or incorporated under the laws of the United States; or (ii) organized or incorporated under the laws of any foreign jurisdiction and formed by a U.S. person principally for the purpose of investing in securities not registered under the Securities Act of 1933 (for example, interests in a private fund), unless it is organized or incorporated, and owned, by accredited investors who are not natural persons, estates or trusts.

Newly adopted Rule 202(a)(30)-1 would allow an adviser to treat as a single client:

- (1) a natural person and: (A) that person’s minor children (whether or not they share the natural person’s principal residence); (B) any relative, spouse, or relative of the spouse

85. Investment Advisers Act Release No. 3221 (June 22, 2011).

86. Investment Advisers Act Release No. 3222 (June 22, 2011).

of the natural person who has the same principal residence; (C) all accounts of which the natural person and/or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries; and (D) all trusts of which the natural person and/or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries;

- (2) a corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization to which the adviser provides investment advice based on the organization's investment objectives; and
- (3) two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries.

In addition, an adviser would have to count a shareholder, partner, limited partner, member, or beneficiary (each, an "owner") of a corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization, as a client if the adviser provides investment advisory services to the owner separate and apart from the legal organization. The adviser is not required to count an owner as a client solely because the adviser, on behalf of the legal organization, offers, promotes, or sells interests in the legal organization to the owner, or reports periodically to the owners as a group solely with respect to the performance of or plans for the legal organization's assets or similar matters. Rule 202(a)(30)-1 client counting requirements incorporate many aspects of the client counting requirements that formerly appeared in rule 203(b)(3)-1.

The newly adopted rule also provides that an adviser will not be deemed to be holding itself out generally to the public in the United States as an investment adviser solely because it participates in a non-public offering in the United States of securities issued by a private fund.

An adviser exempt under section 203(b)(3) is subject to certain Investment Advisers Act antifraud rules including Rule 206(4)-5 (the "Pay-to-Play Rule") and Rule 206(4)-8 (addressing fraud by advisers who defraud investors and potential investors in pooled investment vehicles).

§ 2:4.5 Exemption for Small Business Investment Company Advisers (Section 203(b)(7))

Effective July 21, 2011, section 203(b)(7) of the Investment Advisers Act provides an exemption from registration to any adviser, other than an entity that has elected to be regulated or is regulated as a business development company, that solely advises:

- small business investment companies that are licensees under the Small Business Investment Act of 1958 (the “Small Business Investment Act”);
- entities that have received notice to proceed to qualify as a small business investment company under the Small Business Investment Act; and
- affiliates of the entities described in the first clause who have a pending application to be licensed under the Small Business Investment Act.⁸⁷

§ 2:4.6 Venture Capital Fund Adviser Exemption (Section 203(l) and Rule 203(l)-1)

The Dodd-Frank Act provided for an exemption from registration under the Investment Advisers Act for venture capital fund advisers (that is, section 203(l)). Under the exemption, any investment adviser that acts as an investment adviser solely to one or more “venture capital funds” (defined below) is not required to register under the Investment Advisers Act.

A “venture capital fund” is defined in Rule 203(l) as a private fund that satisfies the following requirements:

- Invests primarily in the equity securities of qualifying portfolio companies. A qualifying portfolio company is defined as any company that: (i) is not a reporting or foreign traded company and does not have a control relationship with a reporting or foreign traded company; (ii) does not incur leverage in connection with the investment by the private fund and distribute the proceeds of any such borrowing to the private fund in exchange for the private fund investment; and (iii) is not itself a fund (that is, is an operating company). The SEC believes that these criteria would operate to exclude most private equity funds and hedge funds from the definition of venture capital fund;
- Is not leveraged except for a minimal amount on a short-term basis;
- Does not offer redemption rights to its investors except in extraordinary circumstances (but does entitle investors generally to receive *pro rata* distributions);
- Represents itself to investors and potential investors as pursuing a venture capital strategy; and
- Is not registered under the Investment Company Act and has not elected to be treated as a business development company.

87. Investment Advisers Act § 203(b)(7).

A manager of a venture capital fund may invest up to 20% of the fund's committed capital in assets (other than short-term holdings⁸⁸) that are not qualifying investments. The rule requires that the fund's compliance with the 20 percent limit be calculated at the time any non-qualifying investment is made, based on the non-qualifying investments then held in the fund's portfolio.

Investment advisers that rely on the Venture Capital Fund Adviser Exemption will be subject to a certain amount of Investment Advisers Act regulation and SEC oversight. Such advisers will be required to file an abbreviated Form ADV; these advisers, however, will not be required to file Form PF (the systemic risk-related private fund reporting form). Such advisers will also be subject to SEC examination and will be subject to certain Investment Advisers Act antifraud rules including Rule 206(4)-5 (the "Pay-to-Play Rule") and Rule 206(4)-8 (addressing fraud by advisers who defraud investors and potential investors in pooled investment vehicles).

§ 2:4.7 Small Private Fund Adviser Exemption

As noted above, effective July 21, 2011, the Dodd-Frank Act eliminates the private adviser exemption from registration. However, the Dodd-Frank Act did create a new exemption from registration under the Investment Advisers Act for certain private fund advisers.

[A] Exemption Under the Investment Advisers Act (Section 203(m) and Rule 203(m)-1)

Certain advisers to private funds are exempt from registration under the Investment Advisers Act pursuant to Investment Advisers Act section 203(m) and Rule 203(m)-1.⁸⁹ The availability of this exemption is based on whether the adviser's principal place of business is in the United States (a "U.S. Adviser").

For a U.S. Adviser, (i) the adviser must act as investment adviser solely to private funds and (ii) the assets under management of the adviser (managed from any office wherever located) must be less than \$150 million.

For a Non-U.S. Adviser, (i) the adviser must have no client that is a U.S. person other than a private fund, and (ii) the assets of the private funds managed by the adviser from a place of business in the United States must be less than \$150 million.

88. Short-term holdings means cash and cash equivalents, U.S. Treasuries with a remaining maturity of 60 days or less, and registered shares of a money market fund.

89. Rule 203(m)-1, adopted in June 2011. *See* Investment Advisers Act Release No. 3221 (June 22, 2011).

Note that a Non-U.S. adviser with no place of business in the United States, that does not provide investment advice with regard to any U.S. person who is not a private fund, would be exempt from registration under this provision, regardless of the amount of money it manages.

An adviser relying on this exemption must calculate its assets under management annually.

Investment advisers that rely on the Small Private Fund Adviser Exemption will be subject to a certain amount of Investment Advisers Act regulation and SEC oversight. Such advisers will be required to file an abbreviated Form ADV; these advisers, however, will not be required to file Form PF (the systemic risk-related private fund reporting form). Such advisers will also be subject to SEC examination and will be subject to certain Investment Advisers Act antifraud rules including Rule 206(4)-5 (the “Pay-to-Play Rule”) and Rule 206(4)-8 (addressing fraud by advisers who defraud investors and potential investors in pooled investment vehicles).

[B] NASAA’s Proposed Model Rule

Certain advisers eligible for the small private fund adviser exemption may still be required to register with the states. NASAA recently proposed an amended model rule that would generally require the state registration of an adviser to a 3(c)(1) private fund with \$150 million or less in assets under management if such adviser avails itself of the exemption for small private fund advisers under the Investment Advisers Act. Under NASAA’s amended proposed model rule, advisers to 3(c)(7) private funds, including venture capital funds, would be exempt from state registration. In addition, according to the amended proposed model rule a limited sub-set of advisers to 3(c)(1) private funds—that is, those that advise funds that are only made up of investors who satisfy the “qualified client” standard contained in Investment Advisers Act Rule 205-3(d)(1)—would also be exempt from state registration.

§ 2:4.8 Charitable Organization Exemption (Section 203(b)(4))

Exceptions are also available to an adviser that is a charitable organization or a charitable organization’s employee benefit plan, including a trustee, officer, employee, or volunteer of the organization or plan to the extent that the person is acting within the scope of the person’s employment or duties.⁹⁰

90. Sections 203(b)(4) and (5).

§ 2:4.9 Exemption for Commodity Trading Adviser (Section 203(b)(6))

Another exemption was added with the enactment of the Commodity Futures Modernization Act (CFMA) in December 2000. The CFMA adds section 203(b)(6), which exempts from registration any person that is regulated with the CFTC as a commodity-trading adviser whose business does not consist primarily of acting as an investment adviser, including serving as an adviser to a registered investment company or business development company.⁹¹ Also, effective July 21, 2011, an adviser may not rely on this exemption if it is an adviser to a private fund, (that is, a company that would be an investment company but for section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940), and the adviser's business has become predominantly the provision of securities-related advice after July 21, 2010.

§ 2:5 Specific Contexts

We discuss here certain specific status questions which the investment management lawyer may encounter. These questions include the status of

- (1) financial planners;
- (2) general partners in limited partnerships;
- (3) affiliates of registered investment advisers;
- (4) real estate advisers; and
- (5) financial advisers to municipal issuers.

§ 2:5.1 Financial Planners

Financial planners perform a variety of services for a client, including:

- (1) calculating net worth;
- (2) reviewing insurance needs and investments;
- (3) devising a budget; and
- (4) reviewing retirement goals.

91. Issues related to entities providing advice regarding futures are discussed in *infra* section 2:5.5.

Many financial planners prepare a written plan which, among other things, provides advice concerning how a client's assets should be directed into various general investment vehicles (for example, 60% in stock mutual funds, 30% in bond mutual funds, and 10% in bank CDs).

In many cases, the financial planner's job is complete with the presentation of the plan. The client pays the planner a fee and the client implements the recommendations as he or she sees fit. In other cases, especially where the financial planner is affiliated with an insurance company or a brokerage firm, the planner suggests specific products sponsored by his or her organization in order to implement the general recommendations in the plan. In these cases, commissions from product sales are often a more important component of the planner's compensation than the fee.

In the financial planning community, investment advisers are viewed as a specialized type of financial planner. While financial planners generally make, on a sporadic basis, broad recommendations concerning investments, investment advisers actively manage a client's assets. Advisers manage client money on a discretionary basis (without obtaining the client's preapproval for each transaction) or a nondiscretionary basis (the client's preapproval is required).

Even though the financial community distinguishes between financial planners and investment advisers, one should not assume that financial planners are not investment advisers under the Investment Advisers Act. Release 1092 gives guidance concerning the applicability of the Investment Advisers Act to financial planning activities. Indeed, under the principles set forth in Release 1092, financial planners generally fall within the definition of section 202(a)(11) and are required to register as advisers.

The Dodd-Frank Act mandated that the General Accounting Office (GAO) study the oversight of financial planners. The GAO concluded that existing statutes and regulations appear to cover the great majority of financial planning services; that individual financial planners nearly always fall under one or more regulatory regimes, depending on their activities; and that an additional layer of regulation specific to financial planners is not warranted at this time. The GAO did recommend that "more robust enforcement of existing laws could strengthen oversight efforts."⁹²

92. See Regulatory Coverage Generally Exists for Financial Planners, but Consumer Protection Issues Remain, GAO-11-235 (Jan. 18, 2011).

§ 2:5.2 General Partner in a Limited Partnership

Limited partnerships are a popular form of investment vehicle in which investor funds are pooled and invested in security and non-security instruments. These organizations are typically formed by a “sponsor” and are managed by a general partner, which may or may not be the same entity as the sponsor.

The general partner will often select investments, manage those investments, and report upon their characteristics and performance to the limited partners. These activities are typically “advisory,” and where performed for compensation and with sufficient regularity to constitute a business, they will entail the general partner’s being an investment adviser under the Investment Advisers Act.⁹³

Practically speaking, regulation of a general partner as an adviser can be quite onerous. For example, some have argued that because many limited partnerships by their nature invest in complicated and high-risk instruments, a performance-based advisory compensation scheme is often appropriate. This permits the general partner to share in profits achieved which exceed its investment share. However, as discussed in chapter 9, registered investment advisers are severely restricted under the Investment Advisers Act from using performance-based compensation arrangements. Moreover, some have contended that general partners should not be subject to the Investment Advisers Act requirements regarding disclosure which impose monetary costs and may interfere with free alteration of investment strategy.⁹⁴

Prior to the Dodd-Frank Act, many limited partnerships were structured to avoid regulation under the Investment Advisers Act (except

93. The principal case reaching this conclusion is *Abrahamson v. Fleschner*, 568 F.2d 862 (2d Cir. 1977). The Second Circuit concluded that a general partner who received performance-based compensation from the limited partnership of 20% of net profit and capital gains in return for selecting the stocks invested in, and who reported to the limited partners on the characteristics and results of the investments made, was an adviser subject to regulation under the Investment Advisers Act.

94. See, e.g., Thomas W. Briggs, *Private Investment Partnership Funds under the “New” Investment Advisers Act*, 22 SEC. REG. L.J. 3 (1994); C. David Zoba, *The Investment Advisers Act of 1940: Is a General Partner of a Limited Partnership an Investment Adviser?*, 29 CASE W. RES. L. REV. 634 (1979) (arguing that general partners who actively manage limited partnerships should be treated as principals or trustees and held not to be advisers); Robert C. Hacker & Ronald D. Rotunda, *SEC Registration of Private Investment Partnerships and Abrahamson v. Fleschner*, 78 COLUM. L. REV. 1471 (1978); Robert C. Hacker & Ronald D. Rotunda, *Sponsors of Real Estate Partnerships as Brokers and Investment Advisers*, 23 UCLA L. REV. 322 (1975).

for the antifraud prohibitions) by relying upon the section 203(b)(3) exemption for advisers having less than fifteen clients and not holding themselves out to the public as advisers. In 1985, the SEC adopted a nonexclusive safe harbor, Investment Advisers Act Rule 203(b)(3)-1, which set forth certain conditions where the limited partnership, and not its multiple limited partners, may be counted as the client for purposes of determining status under section 203(b)(3).

To rely on the rule, the limited partnership interests were required to be in securities and advice must be provided to the partnership based on the investment objectives of the limited partnership, not the objectives of one or more of the specific partners. The effect of the rule is to permit an entity or sponsor to be the general partner in up to fifteen limited partnerships, each of which may have numerous limited partners, before registration is required.

§ 2:5.3 Affiliates of a Registered Investment Adviser

Section 208(d) of the Investment Advisers Act prohibits any person from doing indirectly or through any other person that which the Investment Advisers Act prohibits it from doing directly. In the same vein, there has been concern that the protections of the Investment Advisers Act could be effectively frustrated if an entity were permitted to set up an affiliate or subsidiary as an “adviser” though the entity itself provided the actual advice and received the profits. For these reasons, substantial attention has been devoted to “entity segregation.” The basic question is whether two related entities should be viewed as united or as separate for purposes of determining whether one or the other or both should be required to register and be responsible for compliance with the Investment Advisers Act.⁹⁵

The practitioner may encounter the issue of entity segregation in various contexts. In analyzing this area, reference should be made to other situations that have been addressed by the SEC staff, particularly with respect to insurance companies forming subsidiaries to provide advisory services in connection with variable insurance products and

95. It is easy to see how the protections of the Investment Advisers Act would be frustrated if the actual providing of advice were separated from either the profit or the expertise behind the advice. In the extreme case, a subsidiary would be established as a mere shell without significant financial resources, it would register as the adviser, and it would provide advice actually conceived by others. Such a subsidiary would be judgment-proof and could always be replaced with a new shell if its advice proved fraudulent or unworkable, thus robbing the Investment Advisers Act’s antifraud provisions of their effectiveness. Disclosure requirements would similarly be frustrated.

foreign advisers establishing U.S. subsidiaries. Also, reference should be made to two significant no-action letters.⁹⁶ These matters are discussed below.

[A] Insurance Companies

The issue of separateness was focused on in the 1970s when many insurance companies, mainly for administrative reasons, established separate subsidiaries as advisers to provide advice to their separate accounts offering variable products. These advisory subsidiaries were often shells, without capital and without dedicated employees.

In contrast to banks and broker-dealers, insurance companies are not afforded an exclusion from the Investment Advisers Act's definition of investment adviser. However, before 1970, significant questions concerning registration did not arise because the advisory subsidiaries generally relied on an exemption from registration provided to investment advisers to investment companies.⁹⁷ When the 1970 amendments to the Investment Advisers Act eliminated this exemption, the SEC was required to decide whether the insurance company parent, its subsidiary, or both were required to register under the Investment Advisers Act.

The SEC first responded to this issue by publishing a notice that stated that an insurance company establishing an investment advisory subsidiary need not register as an adviser until further notice was provided.⁹⁸ No further notice was provided.

The SEC then proposed Rule 202-1.⁹⁹ That rule would have provided that, where the subsidiary satisfied certain "independence" tests (similar to those that were ultimately relied upon in the *Ellis* no-action letter discussed below), the subsidiary alone could register and be responsible for complying with the Investment Advisers Act, but that otherwise the parent must do so. The rule also would have provided that the parent insurance company may become an "investment adviser" under the Investment Advisers Act if the advisory subsidiary is merely a conduit for the advisory services provided by the parent insurance company and if the parent insurance company

96. Richard Ellis, Inc., SEC No-Action Letter (Sept. 17, 1981); Thomson Advisory Grp. L.P., SEC No-Action Letter (Sept. 26, 1995).

97. Separate accounts are often registered as investment companies.

98. Investment Advisers Act Release No. 308 (Feb. 10, 1972) (modifying Investment Advisers Act Release No. 302 (Dec. 1, 1971) and Investment Advisers Act Release No. 305 (Jan. 12, 1972)).

99. See Investment Advisers Act Release No. 353, Investment Company Act Release No. 7565 (Dec. 18, 1972); Guardian Life Ins. Co. (June 23, 1971) (advisory subsidiary of insurance company having no capitalization or employees is not separate from parent and may not register under the Investment Advisers Act; rather, the parent must register).

and the advisory subsidiary share any key personnel. Rule 202-1 (which was subsequently redesignated as Rule 202-2) was never adopted and was withdrawn without explanation three years later.¹⁰⁰

This issue has been mostly dormant since the 1970s; today many insurance companies register subsidiaries to provide advisory services while the parent insurance company does not register. The SEC has not focused on the degree of separateness between the insurance company parent and the subsidiary.

Alternatively, when the insurance company parent does register as an adviser, the SEC has provided flexibility with respect to the completion of the Form ADV, the registration form discussed in chapter 3. Significantly, the SEC staff has permitted the Form ADV to reflect only those insurance company personnel who are engaged in the insurer's investment advisory activities.¹⁰¹

[B] The *Richard Ellis* No-Action Letter

The next significant regulatory development in this area was the *Richard Ellis* no-action letter.¹⁰² In *Ellis*, the SEC staff looked to the conditions in proposed Rule 202-1 as guidance in developing conditions to determine if a subsidiary should be permitted to register separate from and in place of the parent. Five conditions were required in order for a subsidiary to be considered "separate and independent" of its parent. The subsidiary must

- (1) be adequately capitalized, that is, have sufficient capital to support the extent of its business operations;
- (2) have a "buffer," such as an independent board of directors, between the subsidiary's personnel and the parent;
- (3) have employees, officers, and directors who, if engaged in providing advice in the day-to-day business of the subsidiary entity, are not otherwise engaged in the investment advisory business of the parent;

100. See Investment Advisers Act Release No. 497 (Feb. 19, 1976).

101. Northwestern Nat'l Life Ins. Co., SEC No-Action Letter (Jan. 6, 1983); Mutual Life Ins. Co. of N.Y., SEC No-Action Letter (Mar. 2, 1978); Prudential Ins. Co., SEC No-Action Letter (June 3, 1977). The management of assets held in separate accounts that are not investment companies pursuant to § 3(c)(11) of the Investment Company Act does not constitute advisory business. The assets in those separate accounts are assets of the insurer, and such separate accounts, like the insurer's general account, are not, and are not recognized as, entities "other" than the insurance company to which the insurance company could be said to give investment advice.

102. Richard Ellis, Inc., SEC No-Action Letter (Sept. 17, 1981).

- (4) make its decisions as to what advice is to be provided independently of its parent and have sources of information independent of the parent; and
- (5) keep its investment advice confidential until communicated to its clients, thereby denying the parent the opportunity to trade in advance upon such advice.

Although *Ellis* spoke directly to a parent-subsidiary relationship, its conditions apply with equal force to other types of affiliated relationships.

Another significant development in this area was a 1995 no-action letter to Thomson Advisory Group L.P.¹⁰³ In that letter, the SEC staff gave no-action assurance to an unregistered affiliate of a registered adviser. The staff conditioned its relief on the unregistered affiliate not providing investment advice; the unregistered affiliate and each of its employees being deemed “associated persons” of the registrant when they have access to the investment recommendations of the registered adviser or information concerning the recommendations prior to the effective dissemination of the recommendations; and the SEC’s having access to the unregistered affiliate’s books and records to the extent necessary to examine the business of the registered adviser. The conditions in *Ellis* were not present in the *Thomson* letter.

[C] Foreign Advisers

Another significant development in this area came with respect to foreign advisers. In a 1992 Report, the Division of Investment Management proposed a new approach to determining the need for and scope of regulation of foreign investment advisers.¹⁰⁴ The 1992 Report noted that the Investment Advisers Act was applied to foreign advisers on an “entity” basis. That is, when an investment adviser, whether domestic or foreign, registered under the Investment Advisers Act, all of its activities everywhere in the world became subject to the Investment Advisers Act. This created problems for a foreign adviser that was subject to different and usually less intrusive regulatory requirements (particularly with respect to performance-based compensation) in its home country and other countries of operation.

103. Thomson Advisory Grp. L.P., SEC No-Action Letter (Sept. 26, 1995).

104. SEC, DIVISION OF INVESTMENT MANAGEMENT, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION (1992).

A foreign adviser to clients residing outside the United States may use limited U.S. jurisdictional means without triggering the registration requirements of the Investment Advisers Act, including acquiring information about securities of U.S. issuers and effecting transactions in securities through U.S. broker-dealers. *See* Gim-Seong Seow, SEC No-Action Letter (Nov. 30, 1987).

Foreign advisers sought to avoid these problems by forming subsidiaries or affiliates that registered under the Investment Advisers Act and concentrated solely upon serving the U.S. market. Consistent with the *Ellis* no-action letter discussed above, only that entity's operations were required to comply with the Investment Advisers Act. However, to rely on *Ellis*, satisfaction of five conditions was necessary in order to be considered "separate and independent" of its parent or affiliates. Three of these conditions, particularly that requiring separation of personnel employed in foreign and U.S. operations, were viewed as unworkable by foreign advisers. Practically, this denied U.S. investors access to the most knowledgeable of foreign advisers, who were reserved by the adviser for its foreign clients.

The 1992 Report recommended a "conduct and effects" test, a standard historically applied in defining the extraterritorial reach of the securities laws' antifraud provisions. Under the conduct test, services performed in the United States, whether for foreign or domestic investors, must be provided by a registered adviser in compliance with U.S. securities laws. Under the effects test, where advice is provided to a U.S. citizen or resident or has other significant effects upon the United States, that advice must be provided in compliance with U.S. securities laws. Advice provided to a foreign national by advisers located in a foreign country would generally not be considered subject to U.S. securities laws.

Accordingly, the 1992 Report recommended modifying the *Ellis* conditions with respect to foreign advisers, consistent with the conduct and effects test. Under the new approach, the SEC would recognize separateness if the affiliated companies are separately organized and the U.S. registered affiliate was staffed with personnel capable of providing investment advice. In addition, all personnel involved in U.S. advisory activities were required to be "associated persons" of the registered U.S. affiliate and subject to its supervision. Finally, the SEC must be provided with access to trading and other records and to personnel of affiliates as necessary to monitor conduct that might harm U.S. investors.

The SEC staff has issued several no-action letters applying the conduct and effects approach, thereby adopting a clearly less restrictive policy than that applied under *Ellis*. In *União de Bancos de Brasileiros S.A.*,¹⁰⁵ the staff granted no-action relief where a foreign adviser created a U.S. registered subsidiary to provide advice to U.S. citizens, and further stated that U.S. securities laws would not be applied to investment advice that that subsidiary provided to its non-U.S. clients unless that advice involved conduct or effects in the United States.

105. *União de Bancos de Brasileiros S.A.*, SEC No-Action Letter (July 28, 1992).

In subsequent letters, the SEC staff addressed two approaches by which foreign advisers could operate in the U.S. market.¹⁰⁶ First, as under *Ellis*, the foreign adviser could incorporate a subsidiary and register it under the Investment Advisers Act. Unlike the entity standard, however, the U.S. registered subsidiary would not be required to comply with U.S. securities laws, including the substantive provisions of the Investment Advisers Act, if it operated in foreign countries and its operations did not transcend the conduct and effects standard. Moreover, other subsidiaries or affiliates of the foreign adviser would be permitted to assist the U.S. registered adviser by the provision of advice and access to their specialized personnel without themselves registering as advisers under the Investment Advisers Act. Second, the foreign adviser or its foreign affiliates could itself register and not thereby subject its foreign operations to regulation under the Investment Advisers Act, again only to the extent not required by the conduct and effects test.

The effect of these letters is a more flexible standard for entity segregation, one which still requires a “substantive” and “effective” corporate entity before its independence and registrability under the Investment Advisers Act will be recognized, but which eliminates the broader separation requirements of the *Ellis* conditions. It is important to note that the SEC staff has not specifically addressed whether the *Ellis* conditions should be modified in situations other than those involving foreign advisers.

[D] Special Purpose Vehicles

In a letter to the American Bar Association’s Subcommittee on Private Investment Entities (the “2005 Letter”), the SEC staff stated that, subject to certain enumerated conditions, a special purpose vehicle (SPV) to which a registered investment adviser provides

106. See, e.g., Nat’l Mutual Grp., SEC No-Action Letter (Mar. 8, 1993) (no-action relief granted to permit four affiliated U.S. registered advisers not to comply with specified Investment Advisers Act requirements respecting their non-U.S. clients); Mercury Asset Mgmt. plc, SEC No-Action Letter (Apr. 16, 1993) (foreign adviser parent permitted to register under Act but not comply with its restrictions as to foreign clients, and affiliates of parent and U.S.-registered company permitted to provide advice through U.S. registrants without themselves registering); Kleinwort Benson Inv. Mgmt. Ltd., SEC No-Action Letter (Dec. 15, 1993) (no-action relief granted even though affiliate of foreign adviser would not permit SEC access to its books and records and personnel, arguing various other safeguards sufficed and this requirement should not be imposed).

investment advice would not be required to separately register as an investment adviser.¹⁰⁷ In a subsequent letter, the Business Law Section of the American Bar Association asked whether the 2005 Staff Letter continues to represent the position of the staff despite the Dodd-Frank Act's repeal of the exemption previously provided by section 203(b)(3) of the Investment Advisers Act.¹⁰⁸ In its response letter, the SEC staff confirmed that the 2005 Staff Letter continues to represent the staff's position.

In the same letter, the SEC staff was asked to respond to a number of other questions relating to the guidance it provided in the 2005 Letter. In its response, the SEC staff confirmed that: (i) the position expressed in the 2005 Letter was not limited to a registered adviser with a single SPV; (ii) an SPV would not be required to separately register if independent directors of the adviser engaged in certain activities relating to the SPV; and (iii) under certain circumstances, related advisers conducting a single advisory business may collectively register on a single Form ADV.

§ 2:5.4 Real Estate Advisers to Pension Plans

Several years ago, a significant issue arose concerning entities that advise pension plans about real estate. Despite the fact that these entities did not provide advice about securities and were not required to register under the Investment Advisers Act, many were in fact so registered. Practically, these entities registered so that they would be classified as "investment managers" under ERISA, an important factor to a plan sponsor (for example, the employer) because hiring an investment manager relieves the sponsor of certain potential liabilities relating to the management of plan assets.¹⁰⁹

In 1992, the SEC staff stated that it opposed permitting real estate advisers to register under the Investment Advisers Act and that it was examining options to deregister those already registered. According to the SEC, this action was necessary because it lacked both the resources and the expertise to regulate such advisers, the latter because of the

107. See American Bar Association Subcommittee on Private Investment Entities at Question and Answer G.1, SEC No-Action Letter (Dec. 8, 2005).

108. See American Bar Association, Business Law Section, SEC No-Action Letter (Jan. 18, 2012).

109. As discussed in chapter 1, only banks, insurance companies, and advisers registered under the Investment Advisers Act or under state law are eligible to be investment managers.

significant differences between the securities and real estate markets.¹¹⁰

After the SEC gave notice of its intention to deregister real estate advisers, the industry responded that such action would cause considerable harm and, in fact, would cause many to cease managing plan assets. As a result, the SEC decided not to proceed with deregistering real estate advisers. Instead, the SEC staff took steps to address the special regulatory issues presented by these advisers. For example, the staff prepared an examination module specifically designed to facilitate SEC inspections of real estate advisers.

§ 2:5.5 Financial Advisors to Municipal Issuers

In September 2000, the SEC staff issued a legal bulletin to provide guidance on the applicability of the Investment Advisers Act to financial advisors of municipal securities issuers.¹¹¹ According to the bulletin, these types of advisers typically provide various services concerning the structuring, timing, and issuance of bonds and also may provide advice concerning the investment of the proceeds of the bond offerings.

In the bulletin, the staff noted that an adviser limiting its advice as to whether and how a municipality should issue debt securities, including advice with respect to the structuring, timing and terms concerning such issue would generally fall outside the Investment Advisers Act.¹¹²

If, on the other hand, the adviser provides advice concerning the investment of the proceeds of the municipal bond offerings, it could be deemed an investment adviser and subject to the Investment Advisers Act.

The staff noted that in such cases these financial advisors generally would satisfy two of the three elements of the definition of investment adviser because their advice is clearly advice or analyses concerning securities, and because they receive compensation for providing such

110. Letter from Arthur Levitt, SEC Chairman, to the Honorable Edward J. Markey, Chairman, & the Honorable Jack Fields, Ranking Republican Member, House Subcommittee on Telecommunications and Finance (Dec. 12, 1994).

111. Staff Bulletin No. 11, *supra* note 4. The bulletin was prompted by concerns expressed by financial advisors about their status after two recent enforcement actions. *Id.* at nn.4–6, in which it cites *In the Matter of O'Brien Partners, Inc.*, Investment Advisers Act Release No. 1772 (Oct. 27, 1998); and *In the Matter of Rauscher Pierce Refsnes, Inc., et al.*, Investment Advisers Act Release No. 1863 (Apr. 6, 2000).

112. Staff Bulletin No. 11, *supra* note 4, at n.12 and accompanying text (citing *Arkad Co.*, SEC No-Action Letter (Mar. 19, 1992); *Magnuson, McHugh & Co.*, SEC No-Action Letter (Nov. 13, 1989); *Bruce H. Gemmel*, SEC No-Action Letter (July 14, 1976)).

advice. Accordingly, whether these financial advisors fall within the definition of “investment adviser” under the Investment Advisers Act, will depend on the remaining element of the definition of investment adviser: whether they are “in the business” of providing investment advice.

The staff then looked at three factors to determine whether a financial advisor would be “in the business” of providing investment advice:

- (1) how it “holds itself out”;
- (2) whether it receives compensation for providing advice; and
- (3) the regularity of the advice.¹¹³

First, with respect to holding itself out as an investment adviser, the staff noted that a financial advisor could hold itself out as an investment adviser by: advertising its investment advisory services; referring to itself as an “investment adviser”; maintaining a listing as an investment adviser in a telephone, business, building or other directory; using letterhead indicating any investment advisory activity; or letting it be known, through word of mouth or otherwise, that it is willing to provide investment advisory services. A financial advisor also may hold itself out if its financial advisory contracts with those clients specifically contemplate that the financial advisor will advise municipal issuers about investing the proceeds of bond offerings in non-government securities.

Second, the compensation element will be satisfied if the financial advisor:

- (a) charges its financial advisory clients for investment advice separately from its financial advisory fee;
- (b) receives any compensation that represented a “clearly definable” charge for providing advice about securities, regardless of whether that compensation is separate from or included in any overall compensation; or
- (c) receives transaction-based compensation if the client implemented the advice.

Third, as to the regularity of providing advice, the staff noted that a financial advisor that provides specific advice about the investment of temporarily idle bonds proceeds routinely or “with some regularity” is “in the business” of providing investment advice and therefore is an adviser under the Investment Advisers Act. On the other hand, the

113. The three factors were stated in Release 1092, *supra* note 3. See *supra* section 2:2.1[C].

staff noted that a financial advisor that provides such advice on “rare, isolated and non-periodic instances,” will not be deemed to be “in the business” of providing investment advice, and thus will not be deemed to be an investment adviser, provided that it receives no separate, additional or transaction-based compensation for performing such services and does not hold itself out as an investment adviser. In making this determination, the staff noted that an advisor should consider the number of times that it has provided advice during the past twelve months. An advisor that has provided advice several times during the period—even if the advice was provided to a single client multiple times—would likely be an adviser.

The staff modified its past position regarding advice concerning investment in money market funds. Under previous positions, a financial advisor giving advice about investing proceeds of a bond offering in a money market fund would be required to register as an investment adviser unless (1) it received no separate, additional or transaction-based compensation for the advice about money market funds; and (2) it provided advice about money market funds only on rare isolated occasions, or provided only very general advice about money market funds.¹¹⁴

The new staff position permits an adviser to provide advice about investments in specific money market funds without being “in the business” if:

- (a) the advice about the money market funds is solely incidental to the financial advisory services that the financial advisor provides to its financial advisory client;
- (b) the financial advisor receives no separate, additional or transaction-based compensation for the advice about the money market funds;
- (c) the financial advisor does not hold itself out as an investment adviser; and
- (d) the financial advisor does not have discretionary authority over the assets of its financial advisory client that are invested in the money market funds.

[A] Municipal Advisor Rule

Financial advisors of municipal securities issuers may be required to register with the SEC if they fit within the definition of “municipal advisor” as set forth in section 15B(e)(4)(A) of the Exchange Act, as amended by section 975 of the Dodd-Frank Act. That section defines a “municipal advisor” to include a person:

114. Staff Bulletin No. 11, *supra* note 4, at n.29 and accompanying text.

- (a) that provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues, or
- (b) that undertakes a solicitation of a municipal entity.

The definition explicitly excludes any investment adviser registered under the Investment Advisers Act, or persons associated with such investment advisers who are providing investment advice.

Beginning on September 1, 2010, municipal advisors were required to register with the SEC by completing Form MA-T. This registration scheme was put in place as a temporary measure while the SEC promulgated rules to establish a more permanent regime. The SEC has proposed, but not yet finalized, a number of rules under the Exchange Act that would define certain terms that appear within the definition of “municipal advisor.”¹¹⁵

115. See Exchange Act Release No. 63576 (Dec. 20, 2010).

