THE INVESTMENT ADVISERS ACT OF 1940: REGULATION BY ACCRETION

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INTRODUCTION

The centerpiece of U.S. regulation of money managers—the Investment Advisers Act of 1940—is perhaps best known for its brevity. Particularly when compared to its companion statute, the Investment Company Act of 1940,[1] the Advisers Act places relatively few substantive burdens on entities that fall within its registration requirements.[2] Indeed, by its terms, the Advisers Act sets out few specific prohibitions on conduct, relying instead on broad proscriptions to curtail fraudulent conduct by investment advisers.[3]

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1. The Investment Advisers Act deals generally with persons providing money management advice. Investment Advisers Act of 1940, 15 U.S.C. § 80b (2000). The Investment Company Act deals generally with pooled investment vehicles whose shares are available for purchase by the public. Investment Company Act of 1940, 15 U.S.C. § 80a (2000). Both were originally adopted as part of the same bill and reflect a complementary effort to regulate the investment management industry in the United States following the turbulence of the 1930s. Sections 12, 15, and 17 of the Investment Company Act, for example, set out comprehensive and detailed rules of conduct for companies that come within the Act's definition of "investment company." *Id.* §§ 80a-12, -15, -17.

2. *See, e.g.*, Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (noting that the Advisers Act sets out minimal basic requirements for registered advisers rather than a detailed set of rules).

3. 15 U.S.C. § 80b-6.

Reflecting the general nature of these proscriptions, the Act has been traditionally cited as a disclosure and recordkeeping statute. Officials of the Securities and Exchange Commission have, from time to time, suggested that these characteristics make the Advisers Act a "principles-based" regulatory scheme rather than one based on rules.[4]

In keeping with the notion that "[s]unlight is . . . the best of disinfectants,"[5] the Advisers Act places a significant obligation on advisers to disclose important information to their clients. As the U.S. Supreme Court noted in the landmark 1963 case, *SEC v. Capital Gains Research Bureau, Inc.*, "[a] fundamental purpose [of the Advisers Act was] to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* . . . ."[6] In a noteworthy case of more recent vintage, the D.C. Circuit Court also took the position that the Advisers Act was "mainly a registration and anti-fraud statute" and reiterated the Supreme Court's maxim from *Capital Gains* that Congress' intent in enacting the Advisers Act was to protect investors by ensuring adequate disclosure by investment advisers.[7]

The perception of the Advisers Act as principally a disclosure statute seems not to match the reality that money managers face today in complying with the Act. Over the course of time, the SEC and its staff have effectively imposed a substantial number of standards of conduct on investment advisers registered under the Act—and even on those exempt from registration. Many of these standards have been developed through the Commission's institution and contemporaneous settlement of enforcement actions under the Advisers Act rather than through the Commission's rulemaking authority under the Act.

This article reviews the use of SEC enforcement actions as a tool for rulemaking in the context of the Advisers Act, taking an in-depth look at how the Commission has effectively set standards for investment advisers through enforcement in a number of different areas. The article then

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4. In 2008, the Director of the SEC's Division of Investment Management, who is responsible for implementation of the provisions of the Investment Advisers Act, noted, for example: "When enacting the Investment Advisers Act of 1940, Congress recognized the diversity of advisory relationships and through a principles-based statute provided them great flexibility, with the overriding obligation of fiduciary responsibility." Andrew J. Donohue, Dir., Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm'n, Keynote Address at the 9th Annual International Conference on Private Investment Funds (Mar. 10, 2008), http://www.sec.gov/news/speech/2008/spch031008adj.htm.

5. LOUIS BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (Augustus M. Kelley Publishers 1971) (1914).

6. 375 U.S. 180, 186 (1963).

7. Goldstein v. SEC, 451 F.3d 873, 876 (D.C. Cir. 2006).

discusses the anti-fraud rule recently adopted by the Commission under the Advisers Act, asserting that the rule is the latest means through which the Commission can be expected to impose, through enforcement actions, other substantive requirements on advisers. Following this discussion is a critique of the rules of conduct for investment advisers developed through enforcement and suggests that the time may be right for a comprehensive review of those rules with an eye toward improving or replacing them with ones that are the product of the Commission's formal rulemaking procedures.

I. THE ADVISERS ACT ANTI-FRAUD PROVISIONS: ENFORCEMENT LEADING TO RULES OF CONDUCT

A principal tool of the SEC in establishing standards of conduct for persons meeting the Advisers Act's definition of investment adviser[8] is Section 206, the Act's prohibition on fraudulent conduct.[9] Similar in spirit to the better-known Section 10(b) of the Securities Exchange Act,[10] Section 206 generally

8. Section 202(a)(11) of the Act defines the term "'investment adviser' [as] any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities . . . ." Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11) (2000). Under the Advisers Act, any person meeting the Act's definition of investment adviser and not otherwise excluded from the definition must register with the SEC pursuant to the Act, unless the person is precluded from registering, or the person qualifies for any one of a number of exemptions from registration set out in Section 203(b) of the Act. *Id.* § 80b-3(b). Of these exemptions, the one set out in Section 203(b)(3) is of the greatest practical importance; the exemption is typically relied upon by the sponsors and/or advisers to pooled investment vehicles not registered under the Investment Company Act of 1940, which are typically referred to as "hedge funds" or "private funds." *Id.* § 80(b)-3(b)(3). A person otherwise required to register under the Act, but qualifying for one of the exemptions from registration, is not subject to the Act's substantive provisions. Such a person is subject nonetheless to Section 206's anti-fraud provisions. *Id.* § 80(b)-6.

9. *Id.*

10. Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2000). Section 10(b) of the Exchange Act prohibits a person from using "any manipulative or deceptive device or contrivance" in connection with the sale or purchase of securities and authorized the SEC to prescribe rules to implement the prohibition as necessary. *Id.* Rule 10b-5, adopted pursuant to Section 10(b) of the Exchange Act, more specifically prohibits any person from employing "any device, scheme, or artifice to defraud," from making materially misleading statements or omissions, or engaging in conduct that operates as a fraud "in connection with the purchase or sale of a security." 17 C.F.R. § 240.10b-5 (2007).

prohibits fraud by an investment adviser against a client.[11] Under Section 206(1), an investment adviser is prohibited from "employ[ing] any device, scheme, or artifice to defraud any client . . . ."[12] Section 206(2) precludes an adviser from "engag[ing] in any transaction, practice, or course of business which operates as a fraud . . . upon any client . . . ."[13]

The anti-fraud provisions of Section 206 have served for more than forty years as the basis for seemingly countless actions against investment advisers. Lurking behind the use of the provisions in this way is their breadth and the relative ease with which the SEC can prove that an investment adviser has violated them. The Commission may bring enforcement actions under Section 206 against investment advisers regardless of whether they are required to register with the Commission under Section 203 of the Advisers Act.[14] And to prove a violation of Section 206(2), the Commission need not show that an investment adviser intended to commit fraud against its client—it is sufficient that the adviser acted recklessly or negligently[15] and the conduct operated as a fraud.[16] The only significant limitation on the boundaries of Section 206 applies not to the SEC, but to clients of advisers; the U.S. Supreme Court nearly thirty years ago held that no implied private right of action for fraud exists with respect to the Section.[17]

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11. 15 U.S.C. § 80b-6.

12. *Id.* § 80b-6(1).

13. *Id.* § 80b-6(2).

14. The Commission has brought enforcement actions under Section 206 against advisers exempt from registration by virtue of Section 203(b)(3). *E.g.*, SEC v. Beacon Hill Asset Mgmt., L.L.C., No. Civ. A. 02-8855 (LAK), 2004 WL 2404096, at *1-2 (S.D.N.Y. Oct. 28, 2004) (bringing an enforcement action under Section 206 against a hedge fund adviser exempt from registration under the Advisers Act); *see also* 15 U.S.C. § 80b-3.

15. In *SEC v. Steadman*, the U.S. Court of Appeals for the District of Columbia stated that "a violation of Section 206(2) of the Investment Advisers Act may rest on a finding of simple negligence." 967 F.2d 636, 643 n.5 (D.C. Cir. 1992). Nevertheless, it is not clear that the decision in *Capital Gains*, which speaks to whether the SEC is required to show scienter (i.e., intent) in obtaining an injunction under Section 206, necessarily supports such an assertion. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963). As others have noted, negligence is a low threshold for proving fraud, even in the context of a fiduciary relationship. *See* Audrey Strauss, *Redefining Negligence as Fraud: SEC's Rule 206(4)-8*, N.Y. LAW J., Nov. 1, 2007, at 2.

16. 15 U.S.C. § 80b-6(2); Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 24 (1979).

17. *Transamerica Mortgage*, 444 U.S. at 11. For that reason, only the SEC—not clients of investment advisers—can bring claims of fraud against advisers under Section 206. *Id.* (finding that the Advisers Act does not contain a private right of action or give rise to civil liabilities).

Armed with Section 206, the SEC over time has used its enforcement authority to bring a wide array of cases against investment advisers and in the process has set substantive standards for advisers generally. The foundation of these cases is the decision in *SEC vs. Capital Gains Research Bureau, Inc.*, which interpreted the scope of Section 206.[18] Citing *Capital Gains*, the SEC has brought enforcement cases alleging violations of the Section by advisers engaging in all types of conduct the Commission has deemed problematic.

This part of the article first reviews the Supreme Court's decision in *Capital Gains*. It then looks at examples of conduct by advisers that the Commission has concluded are inconsistent with the Section: taking investment opportunities that should be offered to clients; failing to provide impartial advice by causing clients to invest in securities in which an adviser or its employees have an interest; failing to achieve best execution in purchasing or selling securities on behalf of clients; inappropriately allocating securities transactions among clients; and engaging in, or facilitating, market timing of mutual fund shares.[19]

A. SEC v. Capital Gains*: Confirming and Expanding Upon a Fundamental Fiduciary Duty*

At issue in *Capital Gains* was whether the SEC, in seeking an injunction against a registered investment adviser for engaging in a practice commonly known as "scalping," needed to show that the adviser had met the common-law elements of fraud.[20] The Supreme Court held that the SEC did not have to make such a showing, and in the process confirmed the position asserted by the Commission that a breach of an investment adviser's fiduciary duties to a client constitutes fraud for the purposes of Section 206 of the Advisers Act.[21] Perhaps more importantly, in reaching its result, the Court in *Capital Gains* analyzed closely the nature of the relationship between an investment adviser and a client and how fraud under Section 206 of the Act should be interpreted in light of that relationship.[22]

18. *Capital Gains*, 375 U.S. at 199-200.

19. These examples have been selected as representative of the types of conduct for which the SEC has used enforcement proceedings to set substantive standards. The Commission has set such standards in other areas not discussed in this article.

20. 375 U.S. at 181, 195.

21. *Id.* at 180, 181, 194-201.

22. *Id.* at 194, 201.

The SEC instituted an action under Section 206 against Capital Gains Research Bureau, a registered investment adviser, seeking to preclude certain employees of the company from profiting from transactions in which they engaged involving securities the company had recommended for its clients to purchase.[23] The SEC alleged that, under a scheme devised by its employees, Capital Gains would periodically distribute reports to its clients recommending purchases of thinly-traded securities for long-term investment.[24] Following the distribution of a report, the prices of the recommended securities would increase as clients purchased the securities.[25] Employees who had prior access to the information contained in the reports purchased the recommended securities before the reports were distributed—while the prices of the recommended securities were still relatively low—and sold the securities shortly after the increase in price resulting from the report.[26] This practice in which the employees were engaging—scalping—was not disclosed to Capital Gains' clients.[27] Although the employees made money on their transactions, the SEC offered no evidence that the transactions resulted in any monetary losses to the clients.[28]

The Court found the conduct of the employees caused Capital Gains to breach a fiduciary duty to its clients, specifically the duty to provide impartial investment advice, and that the breach was a fraud within the meaning of Section 206.[29] The Court said that the employees, by purchasing the same securities for short-term profit that were recommended to clients for long-term investment, had placed themselves in conflict with the interests of their clients.[30] By not disclosing their investments to the clients, the

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23. *Id.* at 182-83.

24. *Id.* at 183. The decision is silent on whether the securities were thinly-traded, but the pattern of trading and the profits made with respect to the trading suggest that the securities had that characteristic. *See id.*

25. *Id.* at 182-83.

26. *Id.* at 183.

27. *Id.*

28. *Id.* at 184.

29. *Id.* at 194. The case is sometimes cited for the proposition that the Advisers Act has imbedded within it certain federal fiduciary duties. *E.g.*, David Henry Disraeli and Lifeplan Associates, Inc., Administrative Proceeding File No. 3-1288, (Mar. 5, 2007); Michael Flanagan, Administrative Proceeding File No. 3-9784, 71 SEC Docket 1415-54 (Jan. 31, 2000); Monetta Financial Services, Inc., Administrative Proceeding File No. 3-9546, 72 SEC Docket 77-63 (Mar. 27, 2000). Such an interpretation seems strained at best. Although it clearly concluded that a breach of a fiduciary duty can be a fraud for purposes of Section 206, the Court at no point said that the Section, or any other provision of the Advisers Act, imposes any such duty. *See generally Capital Gains*, 375 U.S. 180.

30. *Id.* at 196.

employees denied the clients the opportunity to make fully informed decisions regarding the advice contained in the Capital Gains reports.[31]

The heart of the Court's opinion is its distinction between traditional notions of common-law fraud and the application of fraud to conduct between investment advisers and their clients. Common-law fraud, the Court noted, evolved in the context of arms-length commercial transactions; in contrast, the investment advisory relationship is one involving a pre-existing "affirmative duty of 'utmost good faith.'"[32] An investment adviser is a fiduciary, and as such must show a "high standard of conscientiousness" towards its clients.[33] This standard involves not only a duty to act in good faith, but also to fully disclose all material facts and "employ reasonable care to avoid misleading . . . clients."[34]

Following from this heightened standard of care is the Court's determination that the Commission, in bringing cases against allegedly fraudulent advisers, does not have to prove all of the common-law elements of fraud. Citing the legislative history of the Advisers Act, the Court found that, under Section 206 of the Act, the Commission was not required to show "intent to injure [or] actual injury to the client."[35] The Act, the Court said, was intended to prohibit fraudulent conduct by fiduciaries,[36] so it was sufficient for the SEC to show that a practice operated as a fraud against an adviser's client.[37]

Having laid out this framework, the Court provided investment advisers with clear guidance on fulfilling their obligations under the Act: appropriate disclosure can cure a conflict of interest. As the Court said, an adviser may "make full and frank disclosure" of the conduct in question to address the concerns raised by the Commission under the Advisers Act.[38] The disclosure, the Court went on to say, would serve the purposes of the Act's anti-fraud provisions by allowing clients to evaluate "overlapping motivations . . . in

31. *Id.* at 196-97.

32. *Id.* at 194.

33. *Id.* at 193 (quoting HAROLD GREVEILLE HANBURY, MODERN EQUITY: THE PRINCIPLES OF EQUITY [643] (8th ed. 1962)).

34. *Id.* at 194 (quoting 1 FOWLER V. HARPER & FLEMING JAMES, JR., THE LAW OF TORTS 541 (1956)).

35. *Id.* at 195.

36. *Id.* at 186, 195-96.

37. *Id.* at 192.

38. *Id.* at 197.

deciding whether an adviser is serving 'two masters' [i.e., the client and its own economic self-interest] or only one."[39]

Capital Gains both expanded the scope of the duties owed by an investment adviser to its client as a fiduciary and, consistent with the Advisers Act's approach, found disclosure an effective tool in curing conflicts of interest faced by an adviser. This opinion set the stage for the SEC enforcement actions to follow.

B. Taking Investment Opportunities

During the 1960s, 1970s, and 1980s, the SEC from time to time brought enforcement cases against investment advisers for violations of Section 206. Many of these cases dealt with alleged scalping, the practice described in *Capital Gains*, or with relatively straightforward fraudulent conduct such as the alleged misstatement of prior investment performance by advisers.[40] At the beginning of the 1990s, however, the Commission seems to have increased the frequency with which it brought cases under Section 206. More significantly, the Commission seemingly became more aggressive in its use of the Section. Drawing on the principles set out in *Capital Gains*, the Commission instituted actions against advisers engaging in conduct the Commission concluded was inconsistent with the fiduciary nature of an adviser's services to its clients.

Representative of the way the SEC began to use Section 206 is its 1994 action against Joan Conan, a portfolio manager in the high-yield bond department of a registered investment adviser.[41] The SEC asserted that, through her position as a portfolio manager, Ms. Conan purchased, for her personal account, securities that were appropriate for the investment companies[42] over which she had investment responsibility without either first offering the securities to the funds or making disclosure to the funds regarding her purchases.[43] These transactions resulted in a sizable profit for

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39. *Id*. at 196 (quoting United States v. Miss. Valley Generating Co., 364 U.S. 520, 549 (1961)).

40. *See, e.g.*, Fred Alger Mgmt., Inc., Investment Company Act Release No. 17,358, Investment Advisers Act Release No. 1222, 45 SEC Docket 790 (Feb. 26, 1990) (finding a violation under Section 206 of the Advisers Act where an investment adviser published misleading annual rate returns for a fund managed by the adviser).

41. Conan, Exchange Act Release No. 34,756, Investment Advisers Act Release No. 1446, 57 SEC Docket 1952 (Sept. 30, 1994).

42. *Id.* The investment companies Ms. Conan managed were unregistered investment funds. *Id.*

43. *Id.*

Ms. Conan—more than $200,000 on an initial $12,500 investment within a month.[44] Citing to "general principles of agency and fiduciary law," the Commission found that having been presented with a "conflict between her personal gain and the financial interests of the [f]unds,"[45] Conan defrauded her client (the investment companies) by not disclosing the opportunity to purchase the securities to the client and failing to obtain the client's consent, either prior to or following her purchase of the securities.[46] The Commission's order in *Conan* would seem to fairly clearly reflect the view on the part of the Commission that Section 206 imposes a standard of conduct on registered advisers; such an adviser has an obligation to disclose to a client if or when the adviser takes an investment opportunity appropriate for a client. *Conan* also seems to make clear that the Commission believes that an employee of an adviser—not simply the adviser itself—is subject to such a disclosure obligation.

Although the SEC confirmed the existence of an obligation that can be enforced under Section 206 with respect to investment opportunities available for clients of registered advisers, *Conan* left open many questions about that obligation. The Commission's settlement order in the case offers no indication whether a registered investment adviser, for example, that engages in a practice of regularly usurping investments appropriate for clients, but that tells clients that it engages in the practice, could nonetheless be deemed to have violated Section 206. The order also gives no answer to the question of whether the obligation enforceable under Section 206 under *Conan* would be equally enforceable against an employee of an investment adviser not registered under the Advisers Act but subject to the Section.[47]

A third issue not addressed by *Conan*—whether an adviser can be comfortable taking an investment opportunity that the adviser reasonably concludes is not appropriate for any particular client—appears to be answered in the negative in a subsequent action brought by the Commission against Ronald Speaker, a portfolio manager for a mutual fund.[48] In the later action, the Commission alleged a violation of Section 206 in connection with

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44. *Id.*

45. *Id.*

46. *Id.*

47. *See supra* note 8 for a description of these advisers.

48. Ronald V. Speaker, Exchange Act Release No. 38,161, Investment Company Act Release No. 22,461, Investment Advisers Act Release No. 1605, 63 SEC Docket 1588 (Jan. 13, 1997). Such a fund is in technical terms an open-ended investment company registered with the SEC under the Investment Company Act of 1940. Investment Company Act of 1940, 15 U.S.C. § 80a-3 (2000).

Mr. Speaker's having purchased for his own account securities he had earlier rejected as inappropriate for the mutual fund.[49] According to the SEC, Mr. Speaker, after having concluded that investments in certain debentures were inappropriate for the fund, engaged in an arbitrage transaction for his personal account involving the same debentures.[50] Although the SEC acknowledged that a transaction would have been "a deviation from the fund's normal method of investing," the Commission concluded that Mr. Speaker violated Section 206 because "the fund was legally and financially able" to engage in the transaction and Mr. Speaker had failed to obtain consent for the transaction from his client.[51]

Viewed in the least favorable light for Mr. Speaker, the Commission's settlement order is consistent with an investment adviser's fiduciary duty not to take investment opportunities from clients without consent; the mutual fund could have legally engaged in the transaction, so Mr. Speaker should not have engaged in it unless he had first offered the debentures to the mutual fund. Facts noted in the order, however, make this a strained interpretation of Mr. Speaker's actions. According to the order, Mr. Speaker learned of the arbitrage opportunity after he had decided that the debentures were not appropriate for the fund.[52] The opportunity available at the later time was a same-day arbitrage transaction to take advantage of a price differential on the securities—a kind of transaction in which a mutual fund, typically a longer-term investor, does not generally engage.[53] The Commission itself did not claim that the transaction would have been an appropriate investment for the fund.[54] To the contrary, the Commission confirmed that the fund did not normally engage in a same-day purchase and sale of securities as Mr. Speaker did with respect to the debentures.[55]

It seems hard not to conclude that the Commission's action against Mr. Speaker reflects a public policy determination that the personnel of an investment adviser should not engage in any kind of transaction in instruments eligible—even if only in theory—for investment by clients of the

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49. Ronald V. Speaker, Exchange Act Release No. 38,161, Investment Company Act Release No. 22,461, Investment Advisers Act Release No. 1605, 63 SEC Docket 1588 (Jan. 13, 1997).

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.* The order does not specify the investment strategy of the mutual fund managed by Mr. Speaker, so it is not clear how unusual it would have been for the fund to make the investment. *Id.* Generally, however, few mutual funds engage in arbitrage transactions.

54. *Id.*

55. *Id.*

adviser. The settlement order does not say, and presumably could not have said, that such a transaction is precluded by Section 206. [56] Although at least implicitly recognizing that investment advisers and their personnel can enter into such a transaction, the SEC provides no guidance as to how the transaction could or should be structured. Advisers and their counsel are thus left to answer for themselves difficult practical questions such as whether engaging in a particular transaction needs prior approval by a person not involved in the transaction and when a particular transaction can or should be deemed ineligible for investment by a client or clients of the adviser.

C. Failing to Provide Impartial Advice

One month after announcing its settlement in *Conan*, the Commission settled another Section 206 enforcement case and again set standards of conduct for registered advisers and their employees. In *Chancellor Capital Management, Inc.*, the SEC brought an action against a registered investment adviser and several of its employees in connection with investments made on behalf of clients of the adviser.[57] The Commission alleged that Mr. Saxena, one of Chancellor Capital's portfolio managers, recommended over a period of several years that clients of the adviser invest in several start-up companies to whose founder Mr. Saxena had previously provided consulting services. In return for his services, Mr. Saxena was offered, and later exercised for his person account, stock options at nominal prices in the start-up companies.[58]

The Commission asserted that Chancellor Capital, through Mr. Saxena, made recommendations in companies in which Mr. Saxena held shares and purchased securities in companies affiliated with the founder to whom Mr. Saxena acted as consultant.[59] Such action, the Commission said, was contrary to Chancellor Capital's stated policy that employees were to "avoid conflicts of interest by evaluating all relevant facts and circumstances

56. *Id.* The only way in which such a transaction could be precluded by Section 206 would be for the Commission, acting in accordance with its authority in paragraph four of the Section, prohibited the transactions. *See* Investment Advisers Act of 1940, 15 U.S.C. § 80b-6(4) (2000) (providing the Commission with rulemaking authority to define and prescribe fraudulent conduct by investment advisers).

57. Chancellor Capital Mgmt., Inc., Investment Advisers Act Release No. 1447, 57 SEC Docket 2204 (Oct. 18, 1994).

58. *Id.*

59. *Id.*

and consulting, when necessary, with Chancellor's Legal Department."[60] The Commission noted that, although Mr. Saxena had obtained approval from Chancellor Capital's legal department prior to exercising his options in the start-up company shares, Mr. Saxena did not seek further guidance from Chancellor Capital or make further disclosure to the firm or its clients when causing the shares to be purchased on behalf of clients.[61]

In bringing an enforcement action against both Chancellor Capital and Mr. Saxena under Section 206 of the Advisers Act, the Commission said that Mr. Saxena's ownership in the start-up companies created a conflict of interest with the clients of Chancellor Capital.[62] In recommending investments in those companies on behalf of clients in contravention of Chancellor Capital's policies and without disclosing the conflict of interest to clients, the SEC said that both Mr. Saxena and Chancellor Capital violated fiduciary duties and Section 206.[63]

Like *Conan*, *Chancellor Capital* reflects the view, consistent with *Capital Gains*, that Section 206 imposes on a registered investment adviser the obligation to disclose conflicts of interest potentially detrimental to the clients of the adviser. *Chancellor Capital* also indicates, as does *Conan*, that the SEC believes that the disclosure obligation extends to employees of the adviser. The Commission's settlement order in *Chancellor Capital*, however, seems to elaborate on and refine the nature of the obligation and how it needs to be met.

The *Chancellor Capital* order identified two principal conflicts of interest Mr. Saxena and his employer faced. First, Mr. Saxena, the SEC said, recommended securities for client purchase in which he held a direct interest.[64] Second, Mr. Saxena recommended to clients securities in entities that were affiliated, presumably by virtue of being under the common control of the same founder, with companies in which Mr. Saxena held a direct interest. The latter course of action, the SEC said in the order, "created the appearance that [Mr. Saxena's] purchases and recommendations to purchase the securities of those companies and other companies affiliated with the [f]ounder for Chancellor's clients may have been influenced by those

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.* Under the settlement order, Mr. Saxena was required to pay a fine to the Commission of $250,000, and Chancellor Capital paid a fine of $500,000. At the time, both were substantial sums in connection with an action under Section 206. *Id.*

64. *Id.*

circumstances, and therefore created a conflict of interest."[65] The Commission's statement appears to indicate that disclosure pursuant to Section 206 is required even in cases in which an adviser does not have any direct interest in instruments it recommends to clients. The statement also appears to say that disclosure needs to be made upon the mere appearance of a conflict facing an adviser.

Having concluded that Mr. Saxena had a disclosure obligation, the Commission found that he had violated Section 206 for, among other things, failing to take "sufficient" measures in disclosing conflicts of interest to Chancellor's clients.[66] The Commission went on to say that it was insufficient for him to have obtained approval from Chancellor Capital's legal department to exercise his stock options in companies he later recommended to advisory clients.[67] The standard for compliance with Section 206's disclosure requirements instead, according to the Commission, entailed "rais[ing] again the fact that [Mr. Saxena] owned the securities and had the arrangement with the [f]ounder at those times when there arose a conflict with the interests of Chancellor's clients . . . ."[68]

Divining the Commission's view as to the disclosure obligations of a registered adviser under Section 206 requires at a minimum, as the discussion above suggests, a very close reading of the Commission's published settlement order in *Chancellor Capital*. It is also the case that advisers and their counsel could read the language differently.

All would probably agree that the *Chancellor Capital* order leaves open various questions. Left unanswered, for example is whether it would have been sufficient for Mr. Saxena to have more completely informed Chancellor Capital of the conflicts he faced or whether Chancellor Capital would have needed to inform its clients of the conflict under all circumstances. The order also provides no indication of the Commission's view of whether circumstances exist when an investment adviser's relationship to a potential investment is so close that the adviser cannot recommend the investment to clients under any circumstances. As is typical of settlement orders under Section 206, although the order in *Chancellor Capital* includes detailed descriptions of conduct that, in the view of the Commission, constitutes a violation of Section 206, it provides little specific guidance as to actions

65. *Id.*
66. *Id.*
67. *Id.*
68. *Id.*

advisers and their employees should or must undertake to comply with the Section.

D. Failing to Achieve Best Execution for Client Transactions

Conan, *Speaker*, and *Chancellor Capital* deal generally with the obligation of investment advisers and their employees when investing on their own behalf. The Commission has also relied on Section 206 in addressing the obligations of advisers when investing solely on behalf of clients. The Commission has long taken the position that an investment adviser is subject to the common-law duty to act in a client's best interest, which duty entails, among other things, to seek "best execution" in connection with transactions undertaken on behalf of clients. Violation of the duty to seek best execution, the SEC has made clear, is enforceable under Section 206.[69]

The term "best execution" is neither included in the U.S. federal securities laws nor uniformly defined by securities industry participants or regulators. It is generally accepted, however, that an investment adviser may fulfill its duty by executing securities transactions on behalf of a client with the goal of "maximizing value for the client under the particular circumstances occurring at the time of the transaction."[70]

Three SEC enforcement settlements of relatively recent vintage illustrate the Commission's use of Section 206 in the context of best execution. In the first of the cases, the SEC alleged that Founders Asset Management, a registered investment adviser, had violated its duty of best execution in causing different clients to pay brokerage commissions at different rates.[71]

Founders had a stated policy to seek best execution for its clients. Over a period of several years, the company had entered into arrangements on behalf of certain, small client accounts with brokerage firms under which the company agreed to pay a standard commission rate of twenty cents per share. At the same time, the company caused larger client accounts to pay

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69. Kidder, Peabody & Co., Inc., Exchange Act Release No. 8426, 43 SEC Docket 911 (Oct. 16, 1968) (finding an investment adviser violated Section 206 by failing to "execute securities transactions for clients in such a manner that the clients' total cost or proceeds in the transaction in the most favorable under the circumstances," i.e., not seeking best execution).

70. Securities Industry and Financial Markets Association (SIFMA), BEST EXECUTION GUIDELINES FOR FIXED-INCOME SECURITIES 1, 5 (2008), http://sifma.org/asset_management/docs/SIFMA-AMG-Best-Execution-White-Paper-Jan2008.pdf; *see also* Gene A. Golke, *What Constitutes Best Execution*, AIMR Conference Proceedings (May 5, 2000).

71. Founders Asset Mgmt. L.L.C., Investment Advisers Act Release No. 1879, 73 SEC Docket 1627 (June 15, 2000).

commissions at a significantly lower rate, between six and eight cents per share. Clients of the company were not informed of the different rates.

The SEC found that Founders' practice of paying different commission rates on behalf of clients without disclosing the rates was inconsistent with its duty and a violation of Section 206.[72] The SEC's settlement order seems to reflect the view that an investment adviser's stated policy of seeking best execution connotes the adviser's paying the same rate of commissions on behalf of all clients in the absence of disclosure to the contrary. The order also appears to indicate that Founders could have avoided a violation under Section 206 if it had simply disclosed the different rates of commission paid with respect to client accounts.

To be contrasted with *Founders* are two subsequent SEC settlements with registered investment advisers, *Sage Advisory Services, L.L.C.* and *Jamison, Eaton & Wood*.[73] *Sage* involved an agreement between Sage Advisory, a registered investment adviser, and a broker on behalf of Sage Advisory's largest client under which Sage would pay the broker commissions at an agreed upon rate for transactions for the client.[74] According to the Commission's settlement order, the specified rate, thirty cents per share, was "at least twice as high" as that available for other transactions placed by the same broker on behalf of other of Sage's clients.[75] In addition, the order explains that the broker had offered, in writing to Sage, to lower its rates.[76]

Two years after *Sage*, the Commission brought an enforcement action against Jamison, Eaton and Wood, another registered investment adviser.[77] The facts in *Jamison, Eaton & Wood* in relevant part resemble those in *Sage* and *Founders*. According to the settlement order, Jamison offered different brokerage options to clients based on whether they had been referred to Jamison by a particular brokerage firm, which was a full-service broker that generally charged higher commission rates than those available from so-called discount brokers.[78] If a client had been referred by the full-service

72. *Id.*

73. Jamison, Eaton & Wood, Inc., Investment Advisers Act Release No. 2129, 80 SEC Docket 599 (May 15, 2003)

74. Sage Advisory Servs., L.L.C., Securities Act Release No. 7997, Exchange Act Release No. 44,600, Investment Advisers Act Release No. 1954, 75 SEC Docket 1073 (July 27, 2001).

75. *Id.*

76. *Id.*

77. Jamison, Eaton & Wood, Inc., Investment Advisers Act Release No. 2129, 80 SEC Docket 599 (May 15, 2003).

78. *Id.*

broker, Jamison would automatically direct all of that client's brokerage transactions to the brokerage firm that had referred the client to Jamison.[79] If, on the other hand, the client had not been referred by the broker, Jamison would offer the client a choice between the full-service brokerage and lower-cost, discount brokerage.[80] As was the case in *Founders* and *Sage*, Jamison did not disclose its brokerage practices to its clients.[81]

The Commission found that Sage and Jamison, like Founders, violated Section 206.[82] The nature of the violations, as explained in the Commission settlement orders, appears different from, and more extensive than, that described in *Founders*.[83] In all three cases, the Commission found that the advisers violated Section 206 by virtue of not providing meaningful disclosure to clients regarding commission rates.[84] In *Sage* and *Jamison*, however, the Commission suggested an additional basis for the violation—that the advisers caused clients to pay brokerage commissions that were simply too high.[85]

In *Sage*, the Commission's order said that Sage violated its duty to see best execution "by directing that the [b]roker charge the [client] commissions averaging $0.30 per share," which "vastly exceeded commissions generated by [the broker's] other managed accounts."[86] In *Jamison*, the Commission pointed to a "lack of any apparent corresponding benefit" for Jamison's

79. *Id.*

80. *Id.*

81. *Id.*

82. *See id.*; Sage Advisory Servs., L.L.C., Securities Act Release No. 7997, Exchange Act Release No. 44,600, Investment Advisers Act Release No. 1954, 75 SEC Docket 1073 (July 27, 2001); Founders Asset Mgmt. L.L.C., Investment Advisers Act Release No. 1879, 73 SEC Docket 1627 (June 15, 2000).

83. Jamison, Eaton & Wood, Inc., Investment Advisers Act Release No. 2129, 80 SEC Docket 599 (May 15, 2003); Sage Advisory Servs., L.L.C., Securities Act Release No. 7997, Exchange Act Release No. 44,600, Investment Advisers Act Release No. 1954, 75 SEC Docket 1073 (July 27, 2001).

84. Jamison, Eaton & Wood, Inc., Investment Advisers Act Release No. 2129, 80 SEC Docket 599 (May 15, 2003); Sage Advisory Servs., L.L.C., Securities Act Release No. 7997, Exchange Act Release No. 44,600, Investment Advisers Act Release No. 1954, 75 SEC Docket 1073 (July 27, 2001); Founders Asset Mgmt. L.L.C., Investment Advisers Act Release No. 1879, 73 SEC Docket 1627 (June 15, 2000).

85. Jamison, Eaton & Wood, Inc., Investment Advisers Act Release No. 2129, 80 SEC Docket 599 (May 15, 2003); Sage Advisory Servs., L.L.C., Securities Act Release No. 7997, Exchange Act Release No. 44,600, Investment Advisers Act Release No. 1954, 75 SEC Docket 1073 (July 27, 2001).

86. Sage Advisory Servs., L.L.C., Securities Act Release No. 7997, Exchange Act Release No. 44,600, Investment Advisers Act Release No. 1954, 75 SEC Docket 1073 (July 27, 2001).

clients paying the higher brokerage rates and asserted further that those clients were "paying unnecessarily high commissions for their trades, while a lower cost alternative was available."[87] In causing its clients to pay unnecessarily high commissions, the SEC indicated, Jamison failed to meet its best-execution obligation and in the process violated Section 206.[88]

Continuing its incremental extension of the best-execution duty, the Commission in *Jamison* includes yet another basis for finding advisers liable under the Section, this one related to Jamison's not regularly describing its brokerage practices to clients. As the SEC said, Jamison had an obligation to "revisit with the client the issue of brokerage placement or commission rates . . . [and] periodically and systematically review its brokerage arrangements for purposes of analyzing best execution."[89] Jamison failed to meet this element of its best execution obligation and was liable under Section 206.

Sage would appear to represent the first time that the Commission expressly stated that an adviser's best-execution duty contemplates clients of the adviser not paying commission beyond a certain level and *Jamison* would appear to represent the Commission's first speaking of a continuing periodic and systematic review requirement on the part of an advisers in connection with the duty. It also appears that no member of the Commission or the staff had, to the point at which the orders were published, spoken of those duties. A diligent adviser and/or its counsel reading the *Founders* order certainly would have no clear indication of the existence of those duties.

That the substance of the elements, as seen by the SEC, of a fundamental obligation of an adviser is made public through the means of a settlement order relating to Section 206 at a minimum raises a question of fairness. An adviser unaware of those elements risks being found to have committed a fraud, a finding that can have severe repercussions on the adviser's business. Compounding the questionable fairness of the *Sage* and *Jamison* orders is their not explaining fully the substantive elements of best execution. The orders, for instance, offer no guidance on what constitutes an "unnecessarily high" commission rate or how frequently an adviser should review its commission rate policy with its clients.

87. Jamison, Eaton & Wood, Inc., Investment Advisers Act Release No. 2129, 80 SEC Docket 599 (May 15, 2003).

88. *Id.*

89. *Id.*

E. Inappropriate Allocations of Investment Positions

The Commission's use of Section 206 enforcement actions as the means to make public its view as to the elements of a significant fiduciary duty of an investment adviser extends beyond best execution to the responsibilities of an adviser to allocate investment opportunities among multiple clients. At the core of a series of settlements dealing with allocation of investment opportunities is the tenant that an adviser in allocation investment opportunities among eligible clients, must treat all of its clients fairly.

In at least two well-known Section 206 settlements, the Commission cited the fiduciary duty of an adviser to treat its clients fairly in assessing the manner in which advisers allocate potential investments among clients. In both *F.W. Thompson Co.* and *McKenzie Walker Investment Management, Inc.*, the SEC asserted that the adviser had allocated potentially profitable shares offered through initial public offerings (IPOs)[90] in a manner that favored clients paying the adviser a fee based on the performance of the client's account over clients paying the adviser a fee based on the size (aggregate value) of the client's account.[91] The Commission asserted further that favoring the performance-fee-paying clients in this way was potentially more lucrative for the adviser, as performance fees generally tend to result in higher fees for advisers. Noting that this possibility presented the adviser with a conflict of interest, and finding that the adviser had made no disclosure of that possibility, the Commission concluded that the adviser had violated Section 206.

It seems hard to argue with the Commission using Section 206 to enforce the traditional notions of fiduciary and agency law that an investment adviser not give preferential treatment to some clients or systematically exclude eligible clients from participating in specific opportunities without providing the clients with an explanation of the treatment. The SEC's settlement orders relating to allocation of investment positions, however, have gone beyond confirmation of those notions and have suggested procedures for advisers to follow to avoid potential liability under Section 206. In particular, the

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90. The Commission referred to these shares as "Hot" IPO shares. The term does not appear in the federal securities laws but is imbedded in rules adopted by the Financial Industry Regulatory Authority (FINRA), a self-regulatory organization of broker-dealer firms. *See* NAT'L ASS'N OF SEC. DEALERS, NASD MANUAL, RULES OF THE ASS'N 2790, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403 &element_id=605.

91. F.W. Thompson Co., Investment Advisers Act Release No. 1895, 73 SEC Docket 486 (Sept. 7, 2000); McKenzie Walker Inv. Mgmt., Inc., Investment Advisers Act Release No. 1571, 62 SEC Docket 1010 (July 16, 1996).

Commission has indicated that: an adviser should adopt an allocation policy covering at least IPO shares and disclose the policy to clients;[92] the adviser should put into effect internal control procedures incorporating fairly specific rules for the adviser's personnel to use in allocating investments among clients;[93] and the adviser should provide specific disclosure to clients to the extent favorable performance of a client's account is based on a preferential allocation of IPO shares.[94]

Like its Section 206 settlement orders relating to other activities, the Commission's orders relating to allocation of investments leave numerous questions unanswered. The orders do not provide an answer to the significant question of whether an investment adviser making explicit disclosure that it favors one set of clients over another in allocating investment positions could nonetheless be deemed to have violated Section 206. Nor do the orders provide an indication of the attributes making a particular security so potentially profitable as to necessitate an adviser's making specific disclosure and implementing other procedures of the sort the Commission has suggested need to be undertaken with respect to Hot IPO shares.

F. Engaging in and Facilitating Problematic Market Timing

Perhaps the SEC's most publicized and potentially most memorable use of Section 206 as a tool to police the conduct of registered investment advisers occurred in response to what has come to be known as the mutual fund market timing debacle of 2003 through 2005.[95] In this context, "market timing" refers to an investment strategy through which an investor seeks to exploit arbitrage opportunities that arise from differences created by market movements against the once-a-day pricing of mutual funds shares. Most mutual funds registered under the Investment Company Act of 1940 follow the business convention of determining the price of their shares once a day, typically as of 4:00 p.m. Eastern time, the close of trading on the New York

92. F.W. Thompson Co., Investment Advisers Act Release No. 1895, 73 SEC Docket 486 (Sept. 7, 2000).

93. McKenzie Walker Inv. Mgmt., Inc., Investment Advisers Act Release No. 1571, 62 SEC Docket 1010 (July 16, 1996).

94. Dreyfus Corp., Securities Act Release No. 7857, Investment Company Act Release No. 24,450, Investment Advisers Act Release No. 1870, 72 SEC Docket 946 (May 10, 2000); Van Kampen Inv. Advisory Corp., Investment Company Act Release No. 23,996, Investment Advisers Act Release No. 1819, 70 SEC Docket 1213 (Sept. 8, 1999).

95. For a succinct account of the problematic market timing that took place during that period of time, see MARK FAGAN & TAMAR FRANKEL, TRUST AND HONESTY IN THE LAW, BUSINESS AND PUBLIC POLICY: AN INTER-DISCIPLINARY TEACHING APPROACH 29-31 (2007).

Stock Exchange, through a calculation based on the value of the funds holdings of securities.[96] The securities or other instruments held by a mutual fund, however, may be valued more frequently than, or may trade at different times from,[97] the mutual fund's shares. Because the identity of the holdings of a mutual fund are not required to be, and are generally not, disclosed on a real-time basis, an investor in the fund who receives specific information about these holdings can engage in linked purchase and redemption transactions in shares of the fund to take advantage of the differences in the daily calculated price of the mutual fund's shares and the market prices of its holdings. The ability to engage rapidly in large purchase-and-redemption transactions can enhance an investor's potential returns. For reasons that may never be known fully, attempts to employ this type of strategy became widespread between 1999 and 2004, particularly by hedge funds.[98]

As the SEC and its staff have repeatedly made clear, market timing is not, in itself, illegal;[99] none of the federal securities laws, including the Advisers Act and the Investment Company Act, prohibits market timing practices. Nonetheless, market timing can harm a mutual fund's long-term shareholders by, among other things, lowering returns for shareholders as market timers draw off profits realized from short-term gains and by increasing the fund's costs, such as those associated with selling its securities to facilitate investors' redemptions. Mutual fund managers historically have recognized the possible detriment to shareholders from allowing market timing, and some funds, in attempting to deal with the practice, have adopted policies such as restricting the ability of investors to engage in frequent and related purchases and sales of shares of the funds or imposing fees on redemption transactions.

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96. Rule 22c-1 under the Investment Company Act of 1940 requires shares of a registered investment company, including a mutual fund, to be repurchased or redeemed at a price based on the investment company's current net asset value. 17 C.F.R. § 270.22c-1 (2008). The Rule, by its terms designates the directors or trustees of the investment company as responsible for setting the time or times at which the company's net asset value is to be calculated. *Id.* Valuation of the investment company's assets for these purposes needs to be determined in accordance with other rules under the Investment Company Act. *See id.*

97. An instrument, for instance, may trade at a different time because it is listed and traded on a non-U.S. market.

98. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72,054 (Dec. 10, 2004); Thierry Olivier Desmet, *Understanding Hedge Fund Adviser Regulation*, 4 HASTINGS BUS. L.J. 1, 31 (Winter 2008).

99. *E.g.*, Thomas C. Bridge, Administrative Proceeding File No. 3-12626, 2008 SEC Lexis 533 (Mar. 10, 2008) at 17.

In 2003, the SEC and the New York Attorney General commenced actions against numerous financial institutions for market-timing practices associated with mutual funds managed by those institutions or by affiliated entities.[100] Supplementing charges of common-law fraud and statutory violations brought in state court by the New York Attorney General and violations of the Investment Company Act asserted by the SEC, the Commission brought enforcement actions against mutual fund managers on the bases of Sections 206(1) and 206(2) of the Advisers Act.[101]

The theories underlying the Commission's various Section 206 actions relating to market timing were hardly revolutionary. Two of the more well-publicized of those actions, *Alliance Capital* and *Putnam Investment*, reflect these theories.[102]

In *Alliance Capital*, the Commission asserted that an arrangement entered into between Alliance, a registered investment adviser, and several investors constituted, among other things, a violation of Section 206.[103] The arrangement involved Alliance's providing to an investor in several Alliance-managed mutual funds the right, not generally available to other investors in the fund, to engage in numerous purchase-and-redemption transactions in exchange for the investor's making investments in hedge funds also managed by Alliance.[104] Investments in the hedge funds, according to the Commission, presented Alliance with a conflict of interest, as those investments would generate additional fees for Alliance.[105] The Commission

100. *See, e.g.*, SEC v. PIMCO Advisors Fund Mgmt., L.L.C., 341 F. Supp. 2d 454 (S.D.N.Y. 2004); Invesco Funds Group, Inc., Exchange Act Release No. 50,506, Investment Company Act Release No. 26,629, Investment Advisers Act Release No. 2311, 83 SEC Docket 2872 (Oct. 8, 2004); Janus Capital Mgmt., L.L.C., Investment Company Act Release No. 26,532, Investment Advisers Act Release No. 2277, 83 SEC Docket 1766 (Aug. 18, 2004).

101. *See, e.g.*, *PIMCO*, 341 F. Supp. 2d at 462; Invesco Funds Group, Inc., Exchange Act Release No. 50,506, Investment Company Act Release No. 26,629, Investment Advisers Act Release No. 2311, 83 SEC Docket 2872 (Oct. 8, 2004); Janus Capital Mgmt., L.L.C., Investment Company Act Release No. 26,532, Investment Advisers Act Release No. 2277, 83 SEC Docket 1766 (Aug. 18, 2004); *see also* Investment Advisers Act, 15 U.S.C. § 80b-6(1), (2) (2000).

102. Alliance Capital Mgmt., L.P., Investment Company Act Release No. 26,312, Investment Advisers Act Release No. 2205, 81 SEC Docket 2800 (Dec. 18, 2003); Putnam Inv. Mgmt., L.L.C., Investment Company Act Release No. 26,255, Investment Advisers Act Release No. 2192, 81 SEC Docket 1913 (Nov. 13, 2003).

103. Alliance Capital Mgmt., L.P., Investment Company Act Release No. 26,312, Investment Advisers Act Release No. 2205, 81 SEC Docket 2800 (Dec. 18, 2003).

104. *Id.*

105. *Id.*

found the arrangement to be a defrauding device, scheme, or artifice within the meaning of Section 206(1) and a fraudulent transaction, practice, or course of business within the meaning of Section 206(2).[106] The Commission also found that the arrangements generally violated Section 206 by virtue of not having been disclosed to the board of directors of the Alliance mutual funds or to the investors in the funds.[107]

The Commission's action against registered investment adviser, Putnam Investment Management, involved similar allegations of market timing by employees of Putnam.[108] As described in the Commission's order, several Putnam employees "engaged in excessive short-term trading of Putnam mutual funds in their personal accounts."[109] Of the six employees charged, four had investment discretion over the funds in whose shares they were trading and had access to non-public information regarding the funds' holdings of securities and trading activity.[110] The SEC said that Putnam was aware that these employees were engaged in short-term trading of the funds but did not take sufficient steps to stop the trading or to remedy past trades that may have been improper and harmed investors in the funds.[111] The Commission concluded that Putnam management violated Section 206 because the company failed to disclose the trading activities of its employees to the boards of the mutual funds whose shareholders were potentially harmed by those activities.[112] In addition, the Commission's order suggests that Putnam's failure to address the short-term trading activities of its employees over the five-year period when it knew the activities were taking place, violated Section 206(1).[113]

The SEC did not allege that either Alliance or Putnam violated Section 206 for making materially misleading disclosures to their mutual fund

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106. *Id.* The Commission offered no express explanation as to elements of the activities that caused them to be precluded by Sections 206(1) and 206(2). For that reason, the *Alliance Capital* order, as well as the *Putnam* order discussed in the text, provide little insight into the scope of the Sections. Alliance Capital Mgmt., L.P., Investment Company Act Release No. 26,312, Investment Advisers Act Release No. 2205, 81 SEC Docket 2800 (Dec. 18, 2003); Putnam Inv. Mgmt., L.L.C., Investment Company Act Release No. 26,255, Investment Advisers Act Release No. 2192, 81 SEC Docket 1913 (Nov. 13, 2003).

107. Alliance Capital Mgmt., L.P., Investment Company Act Release No. 26,312, Investment Advisers Act Release No. 2205, 81 SEC Docket 2800 (Dec. 18, 2003).

108. Putnam Inv. Mgmt., L.L.C., Investment Company Act Release No. 26,255, Investment Advisers Act Release No. 2192, 81 SEC Docket 1913 (Nov. 13, 2003).

109. *Id.*

110. *Id.*

111. *Id.*

112. *Id.*

113. *Id.*

shareholders regarding market timing in the shares of the mutual funds in which they were investors.[114] The SEC did rely on that theory in bringing actions against a substantial number of other mutual fund managers.[115]

The SEC can hardly be faulted for using Section 206 as a tool to address problematic market timing in mutual fund shares, and the way in which the Commission applied the Section was relatively straightforward. That the Commission brought so many Section 206 actions regarding market timing, however, legitimately raises the question whether the Section was the best tool for dealing with the practice.

Soon after the New York Attorney General brought to light problematic market timing practices affecting mutual funds sponsored by a number of major financial services firms,[116] the SEC characterized those practices as potentially widespread throughout the U.S. mutual fund industry.[117] Highlighting the problematic market timing as rampant throughout the mutual fund industry and commencing countless enforcement cases related to the practice had the not unforeseeable effect of damning the entire industry.

In light of the potentially widespread nature of the problematic practices, the SEC, as the principal overseer of the industry, may well have better served mutual fund shareholders and the industry alike by relying solely on its administrative rulemaking authority to adopt remedial measures applicable to the industry as a whole.[118] Had the Commission not sought to

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114. Alliance Capital Mgmt., L.P., Investment Company Act Release No. 26,312, Investment Advisers Act Release No. 2205, 81 SEC Docket 2800 (Dec. 18, 2003); Putnam Inv. Mgmt., L.L.C., Investment Company Act Release No. 26,255, Investment Advisers Act Release No. 2192, 81 SEC Docket 1913 (Nov. 13, 2003). No representations were made regarding market timing in the prospectuses for either Alliance or Putnam mutual funds. *See, e.g.*, Putnam Int'l Equity Fund, Post-Effective Amendment to Registration Statement (Form 485BPOS) (Oct. 28, 2003), *available at* http://www.secinfo.com/dsB1v.2Jg.htm; Alliance Ams. Gov't Income Trust, Inc., Post-Effective Amendment to Registration Statement (Form 485BPOS) (Feb. 27, 2003), *available at* http://www.secinfo.com/ds2zp.2yw.htm.

115. *E.g.*, Mass. Fin. Servs., Co., Investment Company Act Release No. 26,347, Investment Advisers Act Release No. 2213, 82 SEC Docket 341 (Feb. 5, 2004).

116. One of the first of the market-timing cases brought by the New York Attorney General was against Canary Capital Partners, L.L.C. Complaint, State v. Canary Capital Partners, L.L.C. (N.Y. Sup. Ct. Sept. 3, 2003), *available at* http://www.oag.state.ny.us/press/2003/sep/canary_complaint.pdf.

117. STEPHEN M. CUTLER, DIRECTOR, DIV. OF ENFORCEMENT, SEC, TESTIMONY CONCERNING RECENT COMMISSION ACTIVITY TO COMBAT MISCONDUCT RELATING TO MUTUAL FUNDS 9-10 (2003), *available at* htt://www.sec.gov/news/testimony/ts110403smc.htm.

118. The SEC did seek to use its rulemaking to address market timing. *See, e.g.*, Amendments to Rules Governing Pricing of Mutual Fund Shares, 68 Fed. Reg. 70,388, (proposed Dec. 11, 2003) (proposing amendments to Rule 22c-1 to require a deadline of 4:00

regulate market-timing practices through excessive numbers of enforcement actions, it may have prevented fund companies that took aggressive and effective action against problematic market timing from being considered as operating in a business characterized by widespread fraud. It could also have resulted in companies whose funds were subject to less extensive amounts of problematic market timing not being deemed equal in degree of wrongdoing to companies that, for example, facilitated egregious market timing.

II. THE ANTI-FRAUD RULE

In the later part of 2007, the Commission adopted a new rule pursuant to its authority under Section 206(4).[119] The rule—Rule 206(4)-8 under the Advisers Act—embodies the Commission's continuing, and to some, unrelenting efforts to police the activities of hedge funds and other private funds. For the investment adviser community at large that is subject to the Advisers Act, the Rule more importantly represents the most recent, and an additional means, through which the Commission can set substantive standards by enforcement actions under the Act.

The Commission adopted Rule 206(4)-8 in response to *SEC vs. Goldstein*, a decision by the U.S. Court of Appeals for the District of Columbia invalidating an Advisers Act rule designed to result in the managers of most hedge funds having to register as advisers under the Advisers Act.[120] In what might be termed dicta, the Court appeared to narrow the scope of Sections 206(1) and 206(2) of the Advisers Act.[121] In particular, the Court articulated the position that the word "client," as used in those Sections and as applied to a pooled investment vehicle, refers to the pooled vehicle but not to the investors in the pooled vehicle.[122] Stated somewhat differently, the Court's conclusion is that Section 206 precludes fraudulent activities perpetrated against a pooled vehicle by the adviser of the vehicle, but does not reach those activities if taken by the adviser against the vehicle's investors. Whether consistent with the Sections or their underlying

pm Eastern time daily for all fund purchase and redemption orders); Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, 68 Fed. Reg. 70,402 (Dec. 17, 2003) (to be codified 17 C.F.R. pts. 239, 274) (proposing requirements for fund prospectus disclosure regarding market-timing activities and policies).

119. Section 206(4) gives the Commission rulemaking authority to define and proscribe conduct that is fraudulent under Section 206. Investment Advisers Act of 1940, 15 U.S.C. § 80b-6(4)) (2000).

120. Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

121. *Id.* at 881-84.

122. *Id.* at 881.

purposes, the position was completely at odds with that taken by the Commission for more than forty years in commencing enforcement cases under the Section.

Citing its concern that the *Goldstein* decision circumscribed its authority to police fraud involving investment advisers, the Commission proposed in 2006, and in 2007 adopted, Rule 206(4)-8.[123] A stated goal of the Commission was to regain its authority to bring enforcement actions to its pre-*Goldstein* level.[124] By its terms, the Rule prohibits any investment adviser, whether registered under the Advisers Act or exempt from registration, from: making a false or misleading statement to prospective or existing investors in a pooled investment vehicle managed by the adviser; or otherwise defrauding such an investor.

The relative simplicity of Rule 206(4)-8 belies its potential scope. The Rule's reach appears to be virtually unlimited in terms of the written materials prepared by, and conduct engaged in by, advisers that could be prohibited under the Rule. The SEC itself, for example, has cited a wide variety of such materials: fraudulent information in account statements, offering circulars, or responses to requests for proposals, typically known by their acronym "RFPs" in the investment advisory business; fraudulent information regarding an adviser's current or future investment strategy; fraudulent information regarding an adviser's or its employees' experience or credentials; and fraudulent information regarding the risk of investment in a pooled entity, the valuation of the entity's holdings of securities, or the entity's performance.[125] More importantly, the Commission has suggested

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123. *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Investment Advisers Act Release No. 2628, 72 Fed. Reg. 44,756 (July 11, 2007); Press Release, Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n, Statement of Chairman Cox Concerning the Decision of the U.S. Court of Appeals in Phillip Goldstein, et al. v. SEC (Aug. 7, 2006), *available at* http://sec.gov/news/press/2006/2006-135.htm. In adopting the Rule, the Commission relied on this authority under Section 206(4) of the Advisers Act, which as noted above, provides the Commission with rulemaking authority to adopt rules to proscribe fraudulent conduct under Section 206. 15 U.S.C. § 80b-6(4). The Commission explained that its authority under that Section is not limited to proscribing fraudulent conduct by advisers with respect to clients of the advisers. *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Investment Advisers Act Release No. 2628, 72 Fed. Reg. 44,756 (July 11, 2007). As a result, the Section is not, and rules adopted under the Section need not be, limited in the manner reflected in *Goldstein* with respect to Sections 206(1) and 206(2).

124. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756, 44,756 (Aug. 9, 2007) (to be codified at 17 C.F.R. pt. 275).

125. *Id.* at 44,757-58.

that the words "otherwise defrauding such an investor" should not be read as limited in any way.[126]

The scope of the Rule is likely to be made even broader by the way in which the Commission expects to apply it. The Commission has said, much to the dismay of many in and around the advisory business community, that when bringing an enforcement case for a violation of the Rule, the SEC need only show an adviser acted negligently;[127] the SEC believes that it does not need to show that the adviser acted with knowledge or intent to deceive, manipulate, or defraud.[128]

To date, the SEC appears to have relied upon Rule 206(4)-8 only once in instituting an enforcement action against an investment adviser subject to the provision of the Advisers Act.[129] As a result, it is too early to tell the Rule's effects on the investment advisory industry. In light of the breadth of the Rule's terms, the manner in which the Commission expects to apply it, and the goal underlying the Rule's adoption of placing the Commission's enforcement authority on the same plane as it was prior to *Goldstein*, it seems likely that the Commission will rely on the Rule frequently in pursuing investment advisers engaging in conduct the Commission deems questionable. The history of the Commission's enforcement proceedings under Sections 206(1) and 206(2) would suggest that, in so doing, the

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126. *Id.* at 44,759. The unlimited nature of this phrase when proposed was severely criticized by, among others, an American Bar Association sub-committee. Comment Letter from Robert Todd Lang, Chair & Paul N. Roth, Vice Chair, Subcommittee on Private Investment Entities, ABA to Robert E. Plaze, Associate Director & Douglas J. Scheidt, Assoc. Dir. & Chief Counsel, Div. of Inv. Mgmt., SEC (June 23, 2005), http://www.sec.gov/divisions/investment/noaction/aba120805-incoming.pdf (last visited Mar. 10, 2008).

127. In support of its position that it must only show negligence to prove a violation of the Rule, the Commission points to the U.S. Court of Appeal's decision in *SEC vs. Steadman*, 967 F.2d 636, 643 (D.C. Cir. 1992).

128. *Id.*

129. *See* Complaint, SEC v. Rabinovich & Assocs., L.P, No. 07 Civ. 10547 (S.D.N.Y. Nov. 27, 2006). On November 26, 2007 the Commission filed a complaint against Rabinovich & Associates, an unregistered investment company, and two of its employees on allegations of, among other things, violation of Section 206(4) and Rule 206(4)-8 under the Advisers Act. *Id.* The case seems to be a particularly egregious one in which interests in the fund were being sold to "senior citizens and retirees" through advertising that was, according to the SEC, misleading about the past performance of the interests as well as the qualifications of the fund's manager. SEC v. Rabinovich & Assocs., L.P., Litigation Release No. 20,372, (Nov. 27, 2007), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20372.htm. To date, no settlement order has been issued and neither the text of the complaint nor the associated litigation release shed light on the Commission's approach to its application of the Rule.

Commission will continue to set substantive standards for investment advisers.

III. SHORTCOMINGS OF ENFORCEMENT-DEVELOPED RULES

The SEC, by using enforcement actions as a means of establishing rules of conduct for investment advisers, has followed a model it has employed continually in many other areas. The Commission has long set standards for public companies and their officers and directors by bringing actions under various provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.[130] The Commission has sought to enforce compliance with provisions of the same statutes to encourage what it considers appropriate conduct for market professionals such as investment bankers and broker-dealer representatives.[131] The Commission, on a fairly regular basis, commences actions designed to influence or change the behavior of professionals who practice before the Commission—accountants and lawyers.[132]

Setting standards through enforcement proceedings has many potential benefits for the SEC.[133] The Commission, it seems, is always short of resources; bringing a relatively small number of well-publicized enforcement actions in an attempt to police conduct among industry professionals can be an effective use of its scarce resources. Enforcement-action rulemaking can also be undertaken quickly and almost certainly is a faster form of proceeding than traditional rulemaking, which contemplates the Commission's publishing a rule proposal, receiving and responding to public comment, and adopting a final rule. Taking decisive action in an efficient

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130. *See e.g.*, Sky Scientific, Inc., Administrative Proceeding File No. 3-9201, 69 SEC Docket 762-58 (Mar. 5, 1999); M.D.C. Holdings, Inc., Exchange Act Release No. 27,208, 44 SEC Docket 758-331 (Sept. 1, 1989): Norsul Oil & Mining, Ltd., Administrative Proceeding File No. 3-8556, 62 SEC Docket 252-118 (June 5, 1996).

131. *See* Banc of America Securities LLC, Exchange Act Release No. 55,466, SEC Docket (Mar. 14, 2007); Richard J. Puccio, Administrative Proceeding File No. 3-8438, 59 SEC Docket 1985 (July 10, 1995).

132. *See e.g.*, Gregory M. Dearlove, CPA, Administrative Proceeding File No. 3-12064, SEC Docket (July 27, 2006); KPMG PEAT Marwick LLP, Exchange Act Release No. 43,862, 74 SEC Docket 357-4 (Jan. 19, 2001).

133. For insightful commentaries on the benefits and drawbacks of SEC rulemaking versus enforcement, see generally ROBERTA S. KARMEL, PROSECUTION BY REGULATION: THE SECURITIES EXCHANGE COMMISSION VS. CORPORATE AMERICA (1982); James J. Park, *The Competing Paradigms of Securities Regulation*, 57 DUKE L.J. 625 (2007); Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. ON REG. 149 (1990).

and cost-effective manner works well for the Commission's public image as a strong, no-nonsense securities oversight body.

The benefits of enforcement action rulemaking to the SEC need to be balanced against its potential detriments to securities market professionals. The relative ease with which the Commission can bring and settle administrative actions generally results in more, rather than less, regulation on an industry-wide basis, which can in turn discourage companies and professionals, both U.S.-based and those outside the United States, from participating in the U.S. securities markets. Enforcement actions may be brought by the Commission to deal with cases of egregious conduct, and for that reason, the remedies for the conduct set out in settlement orders, which in effect can—and very often do—become industry standards, may be more onerous and less flexible than they might have been had the conduct been less extreme. By virtue of being tied to a specific set of facts, an enforcement proceeding yields rules that may be incomplete or difficult to apply by other market participants.

All of the potential flaws in enforcement-action rulemaking can be seen in the rules effectively developed over time through settlements of cases brought under Section 206 of the Advisers Act. As explained in the discussion above, these rules are often unclear as to their scope and often leave significant practical questions unanswered. Investment advisers and their counsel are left to divine, if not guess, the application in every day business life of basic fiduciary obligations, such as the duty to provide impartial advice, the duty to allocate securities fairly, and the duty to achieve best execution in connection with securities transactions. An adviser that comes to a conclusion as to the application of such a duty that is wrong in the eyes of the SEC or its staff risks an enforcement action for fraud and its negative consequences.

The flaws in the existing body of rules developed by the SEC over time through actions brought under Section 206 are likely to be exacerbated in the future. The number of investment advisers has been generally increasing in recent years. The most compelling characteristic of entities subject to the Advisers Act, however, is not their number but their diversity; advisers today run the gamut from financial planners to separate accounts managers to mutual fund advisers to hedge or other private fund managers.[134] Much, if

134. *See* NAT'L REGULATORY SERVS. & INV. ADVISERS ASS'N, 2007 EVOLUTION-REVOLUTION REPORT 4, *available at* http://www.investmentadviser.org/public/evolution_revolution-2007.pdf (reporting on investment adviser industry demographics).

not most, of the existing body of enforcement-developed Section 206 rules was simply not developed with this variety of advisers in mind.

The sheer number of investment advisers, the increasing diversity of the investment adviser population, and the growing importance of the industry to the American public, taken together, suggest that the time may be right for a comprehensive review to be undertaken of the rules the SEC has developed through enforcement of the Advisers Act. Such a review, which appears never to have been undertaken to date, should have as its goals, among other things: identifying gaps, deficiencies, and inconsistencies in existing rules and interpretations; considering and proposing revisions to existing rules; and identifying positions that have outlived their usefulness.[135] The review could also suggest ways in which compliance with rules applicable to investment advisers operating in the United States could be made less time consuming and more cost efficient for potential participants in the investment advisory business.

CONCLUSION

Over the years, the Investment Advisers Act of 1940 has grown from its humble beginnings as a disclosure-based statute. Through SEC enforcement actions brought principally under the Act's anti-fraud provisions, a substantial number of substantive standards have been developed that are applicable to investment advisers, often whether or not the advisers are subject to registration under the Act. The SEC's recent adoption of an anti-fraud rule under the Advisers Act is likely to further the creation of additional such standards through enforcement proceedings.

Many of the standards set out by the SEC to date under the Advisers Act through enforcement actions are less than clear and leave open significant questions of practical importance to investment advisers. The flaws in those

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135. The SEC has adopted a number of rules pursuant to its authority in Section 206(4). *See, e.g.*, Rule 206(4)-1, 17 C.F.R. 275.206(4)-1 (2007); Rule 206(4)-2, 17 C.F.R. 275.206(4)-2 (2007); Rule 206(4)-7 17 C.F.R. 275.206(4)-7 (2007). Those rules generally set out procedures advisers need to follow in engaging in certain types of conduct. However, the rules do not generally address the types of fiduciary conduct issues dealt with in enforcement cases brought under Section 206. The SEC recently proposed amendments to Part 2 of Form ADV, the form used by an investment adviser to register under the Advisers Act. Amendments to Form ADV, Exchange Act Release No. 57,419, Investment Advisers Act Release No. 2711 (Mar. 3, 2008). Those amendments are intended to enhance disclosure made by investment advisers to their clients. *Id.* Like the Commission's rules under Section 206(4), the Form ADV amendments do not address the matters treated by the Commission's various Section 206 enforcement cases.

statements, particularly when considered in light of the growth in, and great diversity of, investment advisers today suggests the need for a comprehensive review of those standards.