BENDING THE INVESTMENT ADVISERS ACT'S REGULATORY ARC

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"[P]ast performance does not guarantee future results . . ."[1]

ABSTRACT

The Investment Advisers Act of 1940 ("IAA") and its regulatory purview have changed dramatically over the life of the statute. The statute began as a simple registration scheme with barebones conduct integrity prohibitions for wealth managers and purveyors of investment newsletters. Although the statute's original minimalist cast was deficient, the IAA's regulatory scope has undergone a fundamental transformation, both in terms of the expanding class of advisers covered by the statute's substantive provisions and the statute's expansive structural integrity requirements. Over a span of decades, the IAA's focus has been reoriented so that it is directed at least as much, if not more, at institutional asset managers rather than wealth managers who advise retail investors. As matters now stand, the IAA is the primary mechanism for regulating institutional asset managers that manage trillions of dollars in assets while retaining its legacy purpose of enforcing conduct integrity norms in delivering investment advice. This transformation is a product of the regulatory scheme's enhanced reliance on structural integrity safeguards attained through rulemaking.

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1. 17 C.F.R. § 230.482(b)(3)(i) (2003) (mandatory cautionary language required in any Rule 482 mutual fund advertising prospectus that uses performance data). *Cf.* 17 C.F.R. § 275.206(4)-1(a)(2) (2019) (Investment Advisers Act Rule 206(4)-1, which, prior to its amendment in 2020, required that any past recommendations permissibly shared with a client contain the cautionary legend that "it should not be assumed that recommendations made . . . will be profitable [in the future].").

This historical assessment offers useful lessons for crafting successful regulatory strategies in this area, as well as lessons that expose deficiencies in recent SEC initiatives. The SEC's recent efforts to restate a standard of conduct for advisers under the IAA (the "Interpretation") illustrates this point well. The Interpretation was not well-conceived and, if anything, represents a missed regulatory opportunity to rethink existing models of investor protection for retail investors in the investment adviser context. The Interpretation was part of the SEC's multi-part Regulation Best Interest rulemaking initiative (the "Initiative"), which sought to reconcile the standards of conduct governing the two main types of securities professionals serving retail investors: broker-dealers and investment advisers.

Wholly apart from the overall merits of the Initiative, the Interpretation is disappointing both as a matter of law and policy. As a matter of law, the Interpretation is a deeply flawed construction of the IAA because it completely disregards contemporary principles of statutory interpretation. It asserts that the statute mandated a federal fiduciary duty, even though the statute is silent as to any such duty. Moreover, while laudable in its aspirations, the agency's interpretation is meek in substance. The asserted fiduciary duty accomplishes little more than what a natural reading of the statute's text mandates, namely a heightened standard of disclosure (as opposed to the SEC's asserted generalized fiduciary duty). More importantly, the SEC's interpretation is disappointing as a matter of policy; it restates largely undisputed principles of accountability and does not offer any new meaningful benefits in terms of investor protection for average retail investors. If, instead, the SEC had embraced a more ambitious objective to rethink the issue of investor protection for average retail investors under the IAA, it could have more usefully pursued targeted default conduct rules to affirmatively enhance investor protection for average retail investors.

Although the SEC chose not to pursue rulemaking for investment advisers, the elements for such a rulemaking strategy can be sketched out. Such an approach would design conduct rules with a consumer-protection cast. In order to enhance investor protection under the IAA for average retail investors, conduct standards should go beyond mere fiduciary principles and incorporate targeted default rules that offer affirmative investor protection guideposts. Such rules eventually might serve as a template for analogous rules for broker-dealers when providing average retail clients with personalized investment advice on a non-discretionary basis.

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INTRODUCTION

Most statutes have stories of how they came to be, and of their original and enduring significance as pieces of legislation. Frequently, these stories are static, and the said statute reposes within its original conception, not wavering from its pre-ordained purpose. The Investment Advisers Act of 1940 ("IAA")[2] is not such a statute.

The IAA has not exhibited a fixed and unwavering storyline. Rather, its broad contemporary mandate evolved incrementally from its original limited scope. The IAA's original focus was modest oversight of wealth managers and non-managerial investment advisory services. Today, it is the principal source of financial regulation of asset managers (primarily institutional money managers), while it continues to regulate personalized forms of investment advice. Not only is the class of regulated advisers very different today from those covered under the humble IAA of 1940, but so too is the scope of the substantive requirements by which regulation is effected.

Enacted in tandem with the Investment Company Act of 1940 ("ICA"),[3] the IAA has become a full statutory co-partner with the ICA in regulating a vast investment management and advisory industry involving tens of trillions of dollars in securities in the United States alone. In contrast, when enacted, the IAA seemed like a legislative afterthought to the ICA; the IAA's statutory purpose was originally dubbed a form of industry census taking.[4] That reality has long since given way to the modern IAA, which establishes a framework for significant federal regulation of a capacious class of firms known as investment advisers. The category encompasses firms that perform one or more advisory roles, ranging from mere personalized investment recommendations to retail clients, to managing securities portfolios in the billions, and in some cases, aggregating in the trillions of dollars.[5]

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2. 15 U.S.C. § 80b-1.

3. 15 U.S.C. § 80a-1. The two statutes, the ICA and IAA, were enacted on August 22, 1940 and share a single public law number—Pub. L. No. 76-768 (1940). The original ICA is set forth at 54 Stat. 789 and the original IAA is set forth at 54 Stat. 847.

4. *See infra* Section I.A.

5. Although it is difficult to come up with strictly comparable figures on assets under management ("AUM") across different segments of the investment management industry, various sources are sufficiently precise to convey the differences in order of

A. A PRELIMINARY STATEMENT OF THE ARGUMENT

The IAA's regulatory arc has changed dramatically over the statute's relatively short life, affording robust investor protections in a business that has undergone explosive growth and transformational change.[6] This article shows how this outcome was not the result of a single unifying vision at the outset, but rather of a confluence of factors that resulted in a readily adaptable framework to regulate this dynamic segment of the financial services industry. This history not only provides an understanding of how these different factors worked together, often in an unintended fashion, to produce a readily adaptable scheme of regulation, but also provides the basis for an argument with a contemporary focus. Specifically, notwithstanding notable successes, the SEC has also recently missed opportunities to enhance investor protection under the IAA's regulatory scheme.

The shape of the IAA's regulatory arc was not foreordained. Every statute is different, and the circumstances that occasion each statute may be more (or less) amenable to legislative and regulatory amelioration. Though adaptability has been an important feature in the IAA's biography, this feature is a product of the originally spare statutory framework, amended at critical junctures, and the statute's heavy reliance on delegated rulemaking authority to the SEC. This historical

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magnitude across industry segments. The Investment Company Institute ("ICI") compiles the most reliable figures as to registered investment companies, such as mutual funds and exchange-traded funds. As of the end of 2019, it reported roughly $26 trillion for registered funds. *See* INVESTMENT COMPANY INSTITUTE, INVESTMENT COMPANY FACT BOOK 31 (60th ed. 2020) [hereinafter ICI FACT BOOK], https://www.ici.org/pdf/2020_factbook.pdf [https://perma.cc/Y4TA-LXF3]. The SEC's Division of Investment Management compiles AUM figures for private funds, such as hedge funds and private equity funds, showing $9.7 trillion in AUM for the same time period. *See* SEC. & EXCH. COMM'N, ANALYTICS OFFICE, PRIVATE FUNDS STATISTICS (May 14, 2020), https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2019-q3.pdf [https://perma.cc/ES2D-A3X2]. Finally, the SEC reported that registered broker-dealers held approximately $4.3 trillion in AUM in their customer accounts. *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031, 84 Fed. Reg. 33318, 33407 (July 12, 2019). These categories combined double-count assets. Moreover, the figures for the broker-dealer category almost certainly involves some double-counting within the category.

6. This preliminary statement presumes familiarity with basic terminology relevant to the IAA. A roadmap to the terminology follows immediately after this sub-section and may be useful for readers unfamiliar with the IAA's subject matter.

assessment illuminates the regulatory methods and choices available to the SEC.

The IAA's unfolding story has been shaped by three institutional participants: Congress, the SEC, and the Supreme Court. Congress, a somewhat irregular partner, has nevertheless consistently made critical adjustments to the statutory scheme. The SEC has been an indispensable participant in the legislative process (as an advocate of reform) and in its role of administering the regulatory process. In the former role, the agency has been a leading advocate for legislative amendments; in its rulemaking capacity, it has focused on critical structural regulatory objectives that have expanded the scope and robustness of the IAA's regulatory framework. The Supreme Court's contribution has also been significant, yet uneven. Its decisions involving the IAA have tugged in different directions but ultimately have provided the SEC with sufficient flexibility to vindicate investor protection interests.

Historical and economic factors affecting the investment management industry have played an instrumental role in guiding the shape of the IAA's regulatory arc.[7] These factors are themselves independent, or at best, indirectly related to the IAA's regulatory scheme. Thus, many significant factors fueling changes in the regulatory arc are probably non-legal, such as the rising tide of national economic prosperity and the consequent increase in investment savings and assets under management. This article is not focused on an examination of these factors, but this trend nevertheless led to a very different financial industry today relative to the one that existed in 1940. In conjunction with the vast increase in investable wealth, the financial services industry has undergone many changes that have contributed to economic efficiency in managing assets and advising investor accounts. Over the last fifty years, this trend has been especially pronounced with respect to information technologies, finance theory, new financial products (including an explosion of pooled investment products), and capital markets. These economic and financial changes undoubtedly have served as a catalyst for regulatory evolution.

The regulatory scheme (consisting of statute and administrative rules and practice) combines conduct integrity requirements and structural integrity requirements.[8] Over time, the number and mix of

7. *See infra* Section I.A.

8. There is no established definition for these two categories as used in this article. By "conduct integrity requirements," I mean requirements in the nature of

such requirements under the IAA and the rules thereunder (i.e., the IAA's regulatory arc) have changed through timely (and sometimes, overdue) statutory amendments and agency rulemaking. This evolution produced fundamental changes in the IAA's regulatory arc both in terms of the scope of the IAA's coverage (principally expanded coverage of asset managers) and the regulatory scheme's substantive obligations. The regulatory arc slowly shifted from an almost exclusive focus on conduct integrity to a scheme combining conduct and structural integrity requirements, and indeed has become one in which the significance of the structural integrity mandates arguably outweighs that of the conduct integrity mandates. The regulatory arc is no longer limited to a narrow range of practices within a sleepy industry that caters to wealthy retail investors, but rather encompasses an expanding array of institutional asset managers and touches on every aspect of an adviser's operations. The delegation of significant rulemaking discretion to the SEC has allowed the IAA's regulatory arc to adapt to the evolving asset management and financial services landscape through administrative regulation while statutory amendments serve to enlarge and re-order the scope and manner of federal regulation.

While the SEC has routinely pursued strategies to effectuate the IAA's broadening regulatory sphere and has achieved notable success (such as the implementation of a sweeping compliance rule), it has also stumbled at times. Most recently, it has stumbled in failing to advance a regulatory vision under the IAA of existing models of investor protection for retail investors. To some extent, this failure is understandable, since the agency's efforts under the IAA were collateral to a much larger nine-year project to rethink investor protection for

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conduct prohibitions. Such requirements consist of generic antifraud protections and specific proscriptions on conduct, such as trading with a client or acting as an agent with respect to trades among clients. Structural integrity requirements are requirements and obligations that provide assurances of reliability, credibility, validation, and transparency beyond any deterrence effects arising from conduct integrity requirements (such as the fear of the consequences from detection of prohibited conduct). Structural integrity requirements encompass a broad spectrum of protections ranging from record keeping and filing requirements, to requirements that mandate disclosure or impose conditions on business operations (such as custody or compliance obligations). Structural integrity requirements tend to be more complex in substance than conduct integrity requirements and frequently involve congressional grants of rulemaking authority coupled with agency rulemaking. To be sure, the two categories are not airtight and may overlap. These two types of requirements, nevertheless, are distinct building blocks for investor protection.

retail customers of broker-dealers known as the Regulation Best Interest Initiative (the "Regulation BI Initiative" or "Initiative").[9] In the Regulation BI Initiative, the SEC attempted to articulate a grand compromise regarding the standards of conduct when dealing with retail investors that govern the two major categories of retail-facing securities professionals: broker-dealers and investment advisers. Specifically, the Initiative attempted to better harmonize the standards applicable to these two types of securities professionals (broker-dealers under the Exchange Act and investment advisers under the IAA) when broker-dealers and their associated persons provide personalized investment advice that is purely advisory in nature to retail clients.

The SEC benchmarked a standard of conduct for investment advisers in dealing with all clients—retail and institutional—in a 2019 agency interpretation (the "Adviser Conduct Interpretation" or "Interpretation").[10] Leaving aside Regulation BI and the broker-dealer prong of the issues, the Interpretation is itself deeply flawed in articulating (or more accurately, attempting to restate) a standard of conduct. The standard of conduct managed to confuse existing legal standards in this area, and more importantly, offered little that was new in terms of investor protection for average retail investors dealing with investment advisers. Essentially, after a nine-year period in which it considered the relative differences between the conduct standard for broker-dealers and for investment advisers, the SEC largely restated the status quo view for the conduct standard for investment advisers in a more formal framework.

The latter part of this article explores the major deficiencies of the SEC's Adviser Conduct Interpretation, both as a matter of law and

9. The Initiative collectively consisted of four regulatory components. *See infra* note 265 and accompanying explanatory text. Regulation BI itself, the single most significant component of the Initiative's regulatory package, addressed the standard governing the conduct for broker-dealers (and their associated persons) when providing retail customers with personalized advice while, as discussed in the text below, another component of the four-part Initiative addressed the standard of conduct governing investment advisers generally.

10. *See* Commission Interpretation Regarding Standards of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248, 84 Fed. Reg. 33669 (July 12, 2019) [hereinafter Adviser Conduct Interpretation]. The approach to standards of conduct for investment advisers actually sweeps more broadly than Regulation BI in that it encompasses the standard of conduct with respect to *all* advisory clients rather than merely retail clients. *Id.* at 33677.

policy. The agency eschewed rulemaking to achieve its ends, and instead, has sought to secure its objectives by means of statutory construction. The Interpretation, however, is a sandcastle of sorts: A structure erected on an unsound foundation, helpless before the incoming tide of contemporary statutory interpretation jurisprudence. Put more bluntly, as a matter of statutory construction, the interpretation is all but indefensible. The statute's text and the Supreme Court's precedent can reasonably be read to impose a heightened standard of disclosure on investment advisers, but a heightened disclosure standard commensurate to the disclosure obligations of a fiduciary is not the same as an unqualified fiduciary duty. Moreover, by attempting to cover the conduct of all types of advisers under a single fiduciary umbrella, the interpretation creates ambiguity rather than clarity regarding the metes and bounds of any fiduciary duty under the IAA.

Second, while laudable in its aspirations, the Interpretation is meek in substance. Although the SEC's articulation of a standard of conduct for advisers may appear comparatively robust, this appearance is deceptive. The Interpretation mistakenly asserts that the statute imposed an unqualified statutory fiduciary duty on investment advisers.[11] The established heightened standard of disclosure achieves virtually everything accomplished by an independent fiduciary duty (save for a requirement of due care untethered to any disclosure violation). The injection of a novel due care obligation does little more than what is already accomplished by more precise structural integrity requirements relating to adherence to the compliance rule.[12] Moreover, as a matter of SEC practice, the SEC has never sanctioned an investment adviser for fiduciary misconduct, absent deceitful conduct (i.e., statements or omissions that violate the adviser's heightened duty of disclosure).

Of course, the SEC likely has the authority to re-promulgate its interpretive rule as a legislative rule and could, if it chose, establish a stand-alone fiduciary duty, thereby reaching a result similar to the Interpretation (i.e., imposing a fiduciary duty by rule rather than trying to derive such a duty from the IAA's text).[13] But, for the reasons already discussed, this would be ill-advised. Very little would change in terms

11. *See infra* Section IV.A.

12. *See infra* Section III.B.1.

13. Such an approach may have been separately unappealing to a majority of the Commission members because such a rulemaking might trigger rulemaking obligations as to broker-dealers that the Commission wished to avoid. *See* 15 U.S.C. § 80b-8(g) (as amended by the Dodd–Frank Act, discussed in Section I.E. *infra*).

of existing enforcement policy relative to the heightened standard of disclosure imposed on investment advisers, but the approach might open the door to a vague and boundless duty of care. Such issues are best left to more precise structural integrity requirements, such as the compliance rule. More importantly, the entire regulatory project ignores a more pressing need for new conduct integrity rules with a consumer protection orientation—rules that would afford greater investor protection for average retail investors.

Although the Adviser Conduct Interpretation seems to be a missed regulatory opportunity, such a deficiency is remediable. In this respect, the Interpretation could serve as a useful interlude in crafting a more meaningful investor protection initiative. As noted, the SEC has extensive rulemaking authority under the IAA. Such rulemaking authority could be used to adopt targeted rules that provide greater investor protection for average retail investors in particular situations.

While the optimal substance of the rules is not the focus here, rules in the form of rule-based defaults could be an appealing option. Such rules, moreover, could serve as a template for standards governing broker-dealers as well as when acting with respect to clients in a similar capacity. The result of such rulemaking would likely be more consistent with the spirit of the Dodd–Frank Act[14] that directed heightened scrutiny of personalized advice to retail investors. In addition, such rulemaking offers a path to go beyond mere fiduciary principles as a means of enhancing investor protection.[15]

This article is divided into four parts. The first three sections address sequentially the contributions of Congress, the Supreme Court, and the SEC to the regulatory arc of the IAA. Part I analyzes the history of the IAA's structural changes through the amendments that broadened the Act's narrow original focus. Part II addresses the Supreme Court's role in shaping the IAA's regulatory arc, a role that has been fairly muted and uneven. Two of its decisions have been important in shaping the IAA's regulatory arc, while the remaining decision is simply

14. *See infra* Section I.E.

15. This latter point is an important qualification to the undisputed importance of the Act's fiduciary aspirations. Indeed, it suggests a lesson of topical significance: Fiduciary principles alone are not always sufficient. Rather, as argued below, the SEC should evaluate augmenting fiduciary principles in some areas with rules-based standards to achieve investor protection objectives that are not solely grounded in fiduciary duties (e.g., rules with a consumer-protection orientation).

misconceived. Part III focuses on the SEC's role in administering the IAA (as opposed to its contributions as an informal legislative advisor to Congress). The significance of the SEC's administrative role has grown commensurately with its rulemaking and enforcement powers, and the agency has used these powers creatively to create a robust regulatory structure for an industry whose size and scope have dramatically increased. Part IV uses lessons derived from this taxonomic account of the IAA to inform an issue of topical significance under the IAA: investor protection for average retail investors, where the SEC's role has been less successful. It illustrates the deficiencies of the SEC's Interpretation, both as a matter of law and policy. The section concludes with a discussion of how the prevailing IAA antifraud standard (including its heightened standard of disclosure), supplemented by targeted investor protection rules—specifically, rules that elevate the applicable standard of conduct for investment advisers in providing advice to average retail investors—can be used to enhance protection for those investors. Before beginning this analysis however, a brief roadmap on terminology and the industry is provided to make the subsequent exposition easier for the uninitiated reader to follow.

B. A ROADMAP TO TERMINOLOGY

One of the challenges in conceptualizing the IAA's scope is the wide range of different functionally related advisory activities addressed by the statute. Congress was aware of the existing differences when enacting the IAA and dealt with these varied activities under a single regulatory umbrella. This proved feasible because at its inception, the IAA imposed minimal regulatory demands. Over the past 80 years, these different activities have developed along different trajectories, leading to a sharper delineation of the types of services provided by investment advisers. An unfortunate by-product of this history is the proliferation of sometimes confusing and redundant terminology. This terminology can contribute to the confusion of underlying issues because problems and issues characteristic of one type of advisory service are not always relevant to other investment advisers.

In the interest of analytic clarity, a brief review of the terminology is provided, followed by a box diagram that provides a conceptual taxonomy for thinking about different types of advisers and the activities and services associated with each one. Many of the issues discussed in this article assume basic familiarity with a series of dichotomous categories relevant to the fault lines underlying the issues.

A fundamental distinction in the investment adviser space concerns the difference between advice that is purely "advisory" (meaning that the investment adviser merely makes recommendations to a client), and managerial advice where the adviser manages the client's assets (meaning the adviser makes investment decisions with respect to the client's assets on behalf of the client). In the former context, the adviser is acting in a non-discretionary capacity, while in the latter context, the adviser acts in a discretionary capacity with respect to client accounts. Institutional asset managers and wealth managers exemplify two different types of advisers that provide investment management services.

In talking about investment advice, the adviser's advice may be "personalized," meaning that the advice is directed at an individual retail client as opposed to being impersonal in character. Advice may be impersonal in two distinct respects. Advice is impersonal if the same advice is given to many individuals without regard to the recipients' specific financial circumstances. Alternatively, advice may be impersonal when an asset manager makes investment decisions for a pooled investment vehicle where the effect of those decisions will be uniform for all participants.[16] Personalized investment advice is closely linked to retail investors and does not apply to the independent interests of each underlying beneficiary in an institutional investment arrangement.[17]

Finally, there is a fundamental distinction in federal securities law between investment advisers (and their personnel) who either manage client assets or provide securities advice as part of a regular ongoing line of business) and securities advice rendered to a client which is merely incidental to acting in another capacity, such as a broker or dealer.[18]

16. For example, funds, such as mutual funds or exchange-traded funds, are managed by investment advisers on an impersonal basis (i.e., without regard to the personal characteristics of the holders of the fund shares).

17. "Retail investors" refers to investors who are natural persons or investors that are extensions of an investor's personal interests, such as families or personal trusts. *See* 15 U.S.C. § 80b-11(g)(2).

18. *See* 15 U.S.C. § 80b-2(a)(11) (IAA Section 202(a)(11), giving the definition of "investment adviser"). *See generally* Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release No. 1092 (Oct. 16, 1987), https://www.sec.gov/rules/interp/1987/ia-

Broker-dealers (and their personnel), who are primarily regulated under the Securities Exchange Act of 1934 ("Exchange Act"),[19] are particularly problematic because their activities straddle the divide between the Exchange Act and the IAA.[20] Broker-dealer personnel may provide investment advice in two respects, with differing statutory consequences for the broker-dealer. First, personnel of the broker-dealer may provide advice incidental to servicing a brokerage account of a commission-paying customer without the broker-dealer becoming in any respect an investment adviser (i.e., there is no need to register as an investment adviser or conform to the IAA's requirements).[21] In such cases, a broker-dealer and its personnel are governed by the requirements of the Exchange Act and FINRA, the relevant SEC-registered self-regulatory organization for broker-dealers and their associated professionals. In addition, however, broker-dealers (and some associated persons) may undertake a non-incidental investment advisory role; for example, a broker-dealer or an associated person may manage a customer's account. In such circumstances, the broker-dealer must conform both to its regulatory obligations as a broker-dealer, and with respect to such advised accounts, the broker-dealer must also conform to

1092.pdf [https://perma.cc/4D7V-UY4J] (influential, SEC-ratified staff interpretation as to basic features of the definition).

19. *See generally* 15 U.S.C. § 78a.

20. This distinction is at the heart of the Regulation BI Initiative alluded to above and developed below. *See supra* note 10; *infra* Part IV. For competing explanations of the state of affairs with respect to the distinction of investment advisers and broker-dealers around the time of the Dodd–Frank Act's enactment (i.e., pre-Regulation BI), *compare* Arthur B. Laby, *Harmonizing the Regulation of Financial Advisers*, *in* THE MARKET FOR RETIREMENT FINANCIAL ADVICE 275, 276–77 (Olivia S. Mitchell & Kent Smetters, eds. 2013) ("[Under the IAA] an adviser's recommendation must not only be 'suitable' [as in the case of brokers and dealers], it also must be in the clients 'best interests' . . . . The adviser's best interest standard is analogous to a fiduciary best interest standard in other areas . . . and the duty has been called the 'highest known to the law.'" (citations omitted)), *with* James S. Wrona, *The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and a Framework for Enhanced Investor Protection*, 68 BUS. LAW. 1, 3–4 (2012) (describing as a "mischaracterization" the interpretation "that advisers are subject to a stringent fiduciary duty . . . while broker-dealers are subject to a weaker duty that merely requires their recommendations be suitable for their customers").

21. *See* 15 U.S.C. § 80b-2(a)(11) and its broker-dealer exclusion. The technicalities of this particular result are summarized in Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser, Investment Advisers Act Release No. 5249, 84 Fed. Reg. 33681, 33684–85 (July 12, 2019).

the regulatory obligations imposed on investment advisers. Broker-dealers, in this respect, can be so-called "dual registrants," registered as broker-dealers generally and, with respect to any accounts managed for customers, registered as an investment adviser.[22] As will become evident in Section IV, there is enormous legal significance in this distinction (i.e., whether a person acts in the capacity of an investment adviser and is therefore subject to regulation under the IAA, or in the capacity of a broker-dealer subject to regulation under the Exchange Act).

However, at this juncture, it is important to keep in mind the four basic distinctions within the investment adviser category itself: (i) Personalized non-discretionary advice; (ii) personalized discretionary (managerial) advice; (iii) impersonal non-discretionary (purely advisory) advice; and (iv) impersonal (institutional) managerial advice. For ease of reference, the resulting classification is rendered in the box diagram below:

22. Dual registration is a highly detailed topic relating to broker-dealers that first emerged on the SEC's radar screen in the 1940s. Suffice to say, it introduces a concept that overlaps the dividing line between broker-dealers and investment advisers, but is not the focus of this article. *See generally* Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 395, 404 n.68 (2010) [hereinafter *Reforming Regulation*]. This issue figured prominently in the Regulation BI Initiative discussed in Section IV.B and note 265 *infra*.

Table 1: Simplified Taxonomy of Investment Advisory Services

	Personalized	**Impersonal**
Advisory (non-discretionary)	**Box 1** Pure investment advice made to a retail customer. *Ex.*: Financial planners and robo-advisers [*adviser, unless definitional exception, applies (such as broker-dealer exception)*]	**Box 3** Securities research firms, rating agencies, investment newsletters. [*adviser only*]
Managerial (discretionary)	**Box 2** Ability to manage a customer's investment portfolio, such as that of a retail customer (i.e., make investment decisions for individual clients in terms of securities bought and sold). *Ex.*: Wealth managers or financial advisers [*adviser only, including broker-dealer arrangements that involve dual registration*]	**Box 4** Asset managers (or money managers) who manage pooled institutional accounts (or institutional accounts with defined objectives or involving many beneficial owners). *Ex.*: Mutual funds, ETFs and hedge funds, pension funds [*adviser only*]

This simplified taxonomy can be used to more concretely restate the issues addressed in the Preliminary Statement above. First, even though the basic structure of the IAA adequately functioned as an umbrella regulatory scheme in 1940 for the four areas identified in the taxonomy, the changing sweep of the IAA's regulatory arc reflects changes in the relative economic significance of the activities conducted in each box. Initially, Box 4 activities were largely outside the purview of the IAA. In its initial decades of administering the IAA, the SEC most heavily focused on improper advisory activities in Boxes 2 and 3. Over time, especially over the last four decades, the managerial activities in Box 4 have grown tremendously relative to the activities in Box 1 and 2. The SEC has correspondingly recalibrated its activities to give regulatory priority to those issues particularly relevant to Box 4. In addition, however, the SEC has maintained significant attention to the

activities in Box 2 involving advisers (including broker-dealers) who manage the assets of retail customers.

Part IV addresses the relevant standard of conduct for investment advisers. As noted, the SEC's interpretation arose in connection with a different controversy, namely parity in regulatory treatment of advisers and broker-dealers in certain retail contexts. While broker-dealers may engage in activities in Box 2 (i.e., act as a discretionary investment adviser), when they do, they are subject to the same standards as investment advisers. The parity issue solely implicates activities arising in Box 1 where broker-dealers provide non-discretionary personalized advice under a less demanding conduct standard than that applied to investment advisers. This continues to be true even under the recently adopted Regulation BI. The recommendations advanced at the end of Part IV suggest that investment advisers (and by extension, broker-dealers) should be subject to higher default conduct standards (through targeted rules) when dealing with average retail investors.

I. A REVERSAL OF REGULATORY FORTUNES: EXPANDING THE IAA'S SCOPE

As originally conceived, the IAA dealt with a relatively small investment niche, while the more substantial ICA was intended to squarely address abuses which had emerged with respect to the relatively recent development of investment trusts (pooled investment vehicles) sold to the public.[23] The ICA heavily regulated the investment companies, while asset managers of these vehicles were only lightly regulated by the ICA and, in most cases, not at all by the IAA.[24] Over the ensuing years and through subsequent significant changes in the financial services landscape, a different regulatory calculus has given birth to a new statutory reality for the IAA: a statute that directly regulates institutional asset managers (i.e., asset managers who manage pooled investment vehicles or cater to institutions) as well as regulating the more traditional providers of investment advice contemplated in 1940. This new reality does not negate the IAA's legacy as a statute

23. Closed-end funds in particular collapsed spectacularly during the Great Depression. *See* John Morley, *The Regulation of Mutual Fund Debt*, 30 YALE J. REGUL. 343, 358 (2013).

24. *See infra* Section I.C. (describing elimination of the IAA registration exemption for most fund advisers).

about personalized wealth management and advice, or other categories of investment advice providers, but rather indicates the need for a more encompassing view of the IAA and its statutory mandate.

How did a statute conceived to lightly regulate personalized wealth managers and purely advisory services morph into a regulatory scheme that has extended its reach into the much larger realm of institutional asset management, all while still retaining its legacy oversight of personalized wealth managers and non-managerial investment advice? Much of the story derives from the reality that the business of managing pooled investment vehicles has grown at a staggering pace relative to the business of personalized wealth management. The other part of the story is legal, reflecting the cumulative effect of amendments to the IAA over a sixty-year period that transformed the statute's scope and focus, which in turn triggered regulatory changes.

The IAA's transformation has been fueled by two important categories of statutory amendments: first, amendments that have steadily expanded the class of investment advisers required to operate under its purview, and second, amendments that have expanded SEC rulemaking authority, especially in its ability to add structural integrity requirements to the regulatory scheme. Together these amendments enabled the SEC to update and tailor the IAA's regulatory scheme to a rapidly growing and evolving industry. In short, as a result of the statutory amendments discussed in this section, the IAA ended up somewhere very different from where it began.

Remarkably, the transformation of the IAA's scope and focus did not reflect a sustained comprehensive legislative vision granting the Act primacy in oversight of asset managers. Rather, the concomitant effect of changing industry economics and various statutory amendments, scattered over intervals of ten to twenty years combined, produced this serendipitous outcome. Any appearance of an enduring intentional prospective design is, in fact, a figment of hindsight. This section addresses this aspect of the article's broader exploration, namely, the incremental changes to the statutory text that have made the change in the IAA's focus possible.[25]

25. This exposition focuses solely on changes to substantive regulation rather than changes to remedial features of the regulatory scheme, except where those features materially differ from other federal securities statutes. A variety of commentators have traced different aspects of this history of the IAA emphasizing different issues. *See* Roberta S. Karmel, *The Challenge of Fiduciary Regulation: The Investment Advisers Act after Seventy-Five Years*, 10 BROOK. J. CORP. FIN. & COM. L. 405, 407–16 (2016);

A. THE INVESTMENT ADVISERS ACT AS ORIGINALLY ENACTED

The scope of the Investment Advisers Act at its enactment in 1940 was modest.[26] That statute was paired with another piece of legislation, the Investment Company Act,[27] that expressly addressed pooled investment vehicles marketed to the public. Indeed, the original conception of the two acts showed a stark contrast. In the case of the IAA, Congress settled on a minimal regulatory scheme for a broad category of investment advisers: investment counsel (an antiquated term for personal wealth managers), sponsors of investment newsletters, investment professionals who provide only advisory services, and all other professionals that provided investment advice other than on an incidental basis.[28] As to the Investment Company Act, urged on by the SEC, Congress exhibited a far different sensibility. Investment companies had been a source of manifest abuse, especially in the case of highly levered closed-end funds, and Congress mandated a heavy-handed and intrusive form of regulatory discipline for pooled investment vehicles marketed to the public.[29]

The statutes were products of the historical circumstances from which they emerged, taking shape as an outgrowth of a comprehensive study of investment trusts, congressionally mandated in 1935.[30] The Investment Trust Study was four years in the making and involved an unprecedented gathering of information, data, and personal statements

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Harvey Bines & Steve Thel, *The Varieties of Investment Management Law*, 21 FORDHAM J. CORP. & FIN. L. 71, 130–61 (2016). *See generally* Arthur Laby, *SEC and Capital Gains Research Bureau and the Investment Advisers Act of 1940*, 91 B.U. L. REV. 1051 (2011) [hereinafter *SEC, Capital Gains, and the IAA*]. While these pieces are instructive about various themes and are clearly cognizant of the expansion of the IAA, they do not provide a similar integrated account of the statute's evolution.

26. Pub. L. No. 76-768, 54 Stat. 847 (1940).

27. Pub. L. No. 76-768, 54 Stat. 789 (1940).

28. The definition for investment adviser and its enumerated exclusions is found at 15 U.S.C § 80b-2(a)(11).

29. The legislative findings accompanying the ICA are set forth in two paragraphs, the first reciting findings showing that investment companies engage in and affect interstate commerce and the second identifying eight areas identified in the Investment Trust Study where existing activities have "adversely affected" the interests of investors. 15 U.S.C. § 80a-1(a)–(b).

30. *See* Public Utility Holding Company Act of 1935, Pub. L. No. 74-333, 74 Stat. 687, 837 (1935), *repealed by* Energy Policy Act of 2005, Pub. L. No. 109-58, § 1263, 119 Stat. 594, 974.

from industry executives.[31] The portion of the study dealing with investment advisers was a supplemental report (the "Investment Counsel Report").[32] As the SEC staff explained in that report, it was "of limited coverage and comprehensiveness because it does not include all investment counselors, and does not detail their basic problems," a result dictated by the fact that the topic was beyond the agency's jurisdiction to investigate and was only "incidental to its main study."[33] The Investment Trust Study's discussion of investment companies (2801 pages in three parts, followed by a 384-page summary of recommendations)[34] dwarfed the 70-page Investment Counsel Report.

A record of pervasive abuses is conspicuously absent from the Investment Counsel Report, although there is reference to some problems in a brief four-page section. The SEC conceded that "the survey by the Commission did not include a detailed investigation as to the existence of specific abuses and defects of investment counselors."[35] The Investment Counsel Report relied instead on anecdotal statements from a public conference of investment counsel and questionnaires from a small subset of investment counselors. What emerged was a list of potential areas of abuse: (1) "'tipster' services masquerading as bona fide investment organizations";[36] (2) "trading by investment counsellors for their own accounts in securities their clients were interested [in]";[37]

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31. *See generally* SEC. & EXCH. COMM'N, REPORT ON THE STUDY OF INVESTMENT TRUSTS AND INVESTMENT COMPANIES PURSUANT TO § 30 OF THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935 (1938-1942) [hereinafter INVESTMENT TRUST STUDY]. The Investment Trust Study had five parts that were released as follows: H.R. DOC. NO. 707, 75th Cong., 3d Sess. (1938); H.R. DOC. NO. 70, 76th Cong., 1st Sess. (1939); H.R. DOC. NO. 279 ch. 1-6, 76th Cong., 1st Sess. (1939-40); H.R. DOC. NO. 136, ch. 7, 77th Cong., 1st Sess. (1941); and H.R. DOC. NO. 246, 77th Cong., 1st Sess. (1941).

32. SEC. & EXCH. COMM'N, INVESTMENT COUNSEL, INVESTMENT MANAGEMENT, INVESTMENT SUPERVISORY, AND INVESTMENT ADVISORY SERVICES, H.R. Doc. No. 477 (1939) [hereinafter INVESTMENT COUNSEL REPORT]. This supplemental report was the only material that related to the IAA in the Investment Trust Study. There were five other supplemental reports that are not relevant here: H.R. DOC. NO. 380, 76th Cong., 1st Sess. (1939); H.R. DOC. NO. 476, 76th Cong., 2d Sess. (1939); H.R. DOC. NO. 482, 76th Cong., 2d Sess. (1939); H.R. DOC. NO. 567, 76th Cong., 3d Sess. (1940); H.R. DOC. NO. 659, 76th Cong., 3d Sess. (1940).

33. INVESTMENT COUNSEL REPORT, *supra* note 32, at 1.

34. *See generally* INVESTMENT TRUST STUDY, *supra* note 31.

35. INVESTMENT COUNSEL REPORT, *supra* note 32, at 28.

36. *Id.*

37. *Id.* at 29–30. A student comment several years later described this practice in these terms: "Instead of buying and selling in the interest of the client there was frequently a shifting of high quality securities to the adviser's personal account and the

(3) "arrangements for contingent compensation";[38] (4) "custody of clients' securities" without adequate protection for clients;[39] and (5) indirect transfer of the control of client accounts by corporate advisers through change of ownership of the adviser "without the knowledge or consent of the client."[40]

A comparison of the legislative findings and policies that accompanied the two statutes, the ICA (title I) and the IAA (title II), reveals an overall diminished sense of urgency in the case of the IAA.[41] Similarly, the legislative reports were largely devoted to the ICA and the need for robust legislative responses to the alarming problems revealed by the Investment Trust Study.[42] The legislative reports' discussion of the IAA was another matter. Although they noted a need to address isolated abuses, that concern was combined with another articulated reason: the need to preserve the reputation of "honest" investment advisers.[43] In testimony in support of the original draft legislation, the SEC's chief counsel for the Investment Trust Study described the "basic approach" of the IAA: It would implement basic antifraud protections

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placing of his unwanted issues in the client's account." W.T. Mallison Jr., Comment, *The Investment Advisers Act of 1940*, 1 VAND. L. REV. 68, 70 (1947) (citation omitted).

38. INVESTMENT COUNSEL REPORT, *supra* note 32, at 30.

39. *Id.*

40. *Id.*

41. *Compare* 15 U.S.C. § 80a-1(b) (and the discussion of ICA findings *supra* note 29), *with* 15 U.S.C. § 80b-1 (IAA's findings limited to a single paragraph on the interstate nature of investment adviser business without findings of abuse).

42. *See* H.R. REP. NO. 76-2639, at 7 (1940) ("The record of the study and the reports to the Congress of the Securities and Exchange Commission and the testimony taken before the Senate Committee on Banking and Currency contains many examples of abuses in the organization and operation of investment trusts and investment companies. These abuses have been persistent and have occurred and recurred constantly during the last 10 years."); S. REP. NO. 76-1775, at 11 (1940) ("However, the record does indicate that some of the grossest abuses were perpetrated in most recent years, in fact during the very course of the Commission's study. The conclusion is clear that the perpetrations of these misfeasances and the recurrence of these abuses cannot be completely abated nor the deficiencies eliminated without the enactment of adequate Federal legislation regulating these institutions.").

43. H.R. REP. NO. 76-2639, at 28 (1940) ("The essential purpose of title II of the bill [the IAA] is to protect the public from the frauds and misrepresentations of unscrupulous tipsters and touts and to safeguard the honest investment adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful.").

and allow the SEC to gather information that "approximate[d] a compulsory census."[44]

This frequently cited comment regarding a mere census bears closer scrutiny.[45] The legislative record strongly suggests that the description is far from what the agency actually intended as its final legislative goal. The phrase was used by David Schenker, the chief counsel for the agency's Investment Trust Study, at the outset of the congressional hearings, apparently to defuse industry opposition.[46] In one sense, the SEC's description was accurate: The statute's registration and basic antifraud provisions were merely a starting point, while the agency endeavored to learn more about the industry and formulated an

44. *Investment Trusts and Investment Companies: Hearings Before a Subcomm. of the Senate Comm. on Banking & Currency on S. 3580*, 76th Cong. 48, 319 (1940) [hereinafter *Senate Hearings on S. 3580*] (statement of David Schenker, Chief Counsel, Securities and Exchange Commission Investment Trust Study). There was considerable uncertainty at the time regarding the numbers involved in what today would be called the investment advisory business. To complete the Investment Counsel Report, the SEC relied on questionnaires from 394 more substantial investment counsel firms of which 56 were associated with an investment company or an affiliate thereof. *See* INVESTMENT COUNSEL REPORT, *supra* note 32, at 2. Two-thirds were located in four states. *Id.* at 6. The Investment Counsel Report noted an estimate of somewhere between 3,000 and 4,000 investment counsel firms nationally (using a very broad classification). *Id.* at 2 n.6. In the Senate hearings, the SEC's David Schenker estimated that the number of investment adviser firms was anywhere from 6,000 to 10,000. *See Senate Hearings on S. 3580*, *supra*, at 49. This contrasts with the narrow swath of firms that were actually involved in the hearings, principally from the Investment Counsel Association of America ("ICAA") and some major Boston investment counsel firms. The ICAA had been formed in 1937 to promote self-regulatory objectives, such as a code of professional conduct and professional publications. *See Senate Hearings on S. 3580*, *supra*, at 723–42 (statement of Dwight C. Rose, President of the Investment Counsel Association of America (association's membership comprised of 18 firms with 61 professionals with $600 million in assets under managements, a significant sum for the time)). He also estimated that investment counsel as used in the proper sense by well-established investment counsel involved roughly 150 to 200 firms nationally. *Id.* at 736. This sentiment was reinforced by other witnesses. *See, e.g.*, *id.* at 711 (statement of Douglas T. Johnston) ("The definition of 'investment adviser' . . . covers a number of services which are entirely different in their scope and in their methods of operation."); *id.* at 717 (statement of Charles M. O'Hearn) ("We do not deal with the general public. Our clients represent substantial amounts of capital and have adequate means to inform themselves about us through their banking and legal affiliations.").

45. *See, e.g.*, Philip A. Loomis, Jr., *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214, 245 (1959); *Reforming Regulation*, *supra* note 22, at 403; Bines & Thel, *supra* note 25, at 130–31 n.234.

46. *See Senate Hearings on S. 3580*, *supra* note 44, at 48.

appropriate regulatory scheme. However, omitted from that testimony was what the SEC actually proposed in the original S. 3580 bill as introduced in the Senate: rulemaking authority with respect to books and records, the ability to obtain information regarding customers, and an unusually broad mandate to continue public hearings into the industry with full subpoena powers and unfettered rulemaking authority.[47] These additional features, as originally proposed, proved to be a source of contention for investment counselors who participated in the congressional hearings, especially because the SEC seemed to be extending a dragnet with only a thin predicate.[48]

The SEC's position had a logic to it. The Investment Trust Study mandated by Congress had not actually directed a study of investment advisers broadly, or even investment counselors more narrowly.[49] Rather, the staff of the SEC had construed the mandate for the study as extending to investment counselors that advised investment trusts as well (a much smaller sub-class of investment counselors and a mere fraction of the estimated total number of investment advisers).[50] The SEC explained that its initial goal was to gather more information about the industry before devising a regulatory scheme. Broad rulemaking authority would have essentially allowed the SEC to create, by rule, an appropriate regulatory framework once the agency gained a better handle on the industry. Given the significant statutory regulatory scheme

47. *See id.* at 721–22 (statement of Alexander Standish, President, Standish, Racey & McKay, Inc.) (discussing specific language in title II [the IAA portion] some borrowed from title I [the ICA portion] objected to by investment counselors). While the proposed statutory language was eventually jettisoned, the resulting organic process of amendment has restored these structural features (less the ongoing public hearings and unfettered rulemaking authority) to the IAA's regulatory scheme.

48. *Id.* at 712 (statement of Douglas T. Johnston, Johnston & Lagerquist, Inc.) ("Here the cart would seem to be before the horse—a bill is being proposed to include all investment advisers with certain important exceptions, not to correct predetermined abuses, but to discover whether they exist."); *id.* at 718 (statement of Charles M. O'Hearn, Clarke & Sinbaugh & Co.) (urging rejection of title II of the IAA legislation because "the bill gives the Commission power to do anything it wishes."); *id.* at 741 (statement of Dwight C. Rose, President of the Investment Counsel Association) ("[W]e believe the public interest can be better served without imposition of the additional legislation and uncertain and indefinite inquisition and regulation proposed in this bill.").

49. *See id.* at 47–48 (statement of David Schenker); INVESTMENT COUNSEL REPORT, *supra* note 32, at 1.

50. *Senate Hearings on S. 3580*, *supra* note 44, at 51.

that the SEC had proposed in the ICA, the investment counsel community was apprehensive regarding giving the SEC these powers and sought their elimination from the legislation.[51] The final legislation was shorn of the expansive rulemaking and investigative authority sought by the SEC,[52] and representatives for investment counselors were only too happy to give the revised and defanged bill their blessing.[53]

As a result, the IAA, as enacted, was notable for just how little it actually required.[54] The legislation dealt with the issue of registration and four of the five problematic practices initially identified in the Investment Counsel Report.[55] Ironically, a major focus in the original statute has become something of a dead letter in contemporary times – the use of the term "investment counsel." The IAA originally, and still, prohibits use of the moniker "investment counsel" by registered investment advisers unless that is either the adviser's principal business, or a substantial portion of the adviser's business involves "investment supervisory services" (i.e., managing client assets).[56] The term itself, intended to allow investment counsel to distinguish themselves qualitatively, has fallen into disuse with the emergence of other forms of

51. *See supra* note 48 and accompanying text.

52. Shortly after termination of the Senate hearings in April, the SEC engaged with industry representatives from closed-end and mutual funds and with investment counsel, resulting in substantial revision of the legislation's two titles. *See, e.g.*, Walter P. North, *A Brief History of Federal Investment Company Legislation*, 44 NOTRE DAME L. REV. 677, 683–84 (1969).

53. *See Investment Trusts and Investment Companies: Hearings Before a Subcomm. of the Comm. on Interstate & Foreign Com. on H.R. 10056*, 76th Cong. 86 (1940) (statement of James White, representing Scudder, Stevens & Clark) ("My firm is heartily in favor of this bill."); *id.* at 92 (statement of Dwight Rose, representing Investment Counsel Association of America) ("The Investment Counsel of America unqualifiedly endorses the present bill [the ICA and the IAA] . . . [and] urgently hope passage of the bill may be expedited at this session of Congress so the public may have the benefit of the bill and its provisions without further delay."). The unqualified comments of support in the House hearings contrast with the deeply critical statements barely two months before.

54. *See* INVESTMENT TRUST STUDY, *supra* note 31, at 383 ("In addition to its provisions relating to investment companies, the Act contains a title providing for the registration of investment advisers and in a small degree for the regulation of some of their activities."). In contrast, the SEC described the original legislative proposal as to investment companies (pared back before enactment) as "comprehensive in scope." *Id.*

55. The unresolved issue of custody and safeguarding of client assets would await resolution for another 20 years. *See infra* Section III.A.1.

56. 15 U.S.C. § 80b-8.

professional certification and the dominance of large asset managers.[57] Even the Investment Counsel Association of America, so influential in the passage of the IAA, changed its name in 2005 to the Investment Adviser Association.[58] This issue is of note because it shows that the trajectory of the IAA's arc changed not only as the result of regulatory additions, but also because of the declining significance of some issues that were very much part of the IAA when enacted (e.g., allowing investment counsel to differentiate themselves as a class from other investment advisers).[59]

Thus, the IAA as enacted in 1940 was merely a starting point that addressed a very different world of financial services than what it has become in the 21st century. Congress and the SEC were preoccupied by the larger issue of investment companies, and neither body envisioned how integral the interface between the two statutes would become. The most salient feature of the IAA as enacted is that it established a minimal statutory framework with little rulemaking reserve for the SEC. One can speculate on what would have happened had the SEC's original

57. *See generally* Richard Sloan, *Fundamental Analysis Redux*, 94 ACCT. REV. 363 (2019) (presidential scholar remarks before the American Accounting Association) (summarizing history of certified financial analysts' embrace of fundamental analysis and subsequent rise of quantitative methods of financial analysis). In addition, during this period, the Association of Investment Management and Research (AIMR) was formed and established the formal CFA test and guideline standards for financial reporting. AIMR eventually changed its name to the CFA Institute. *See* NANCY REGAN, THE GOLD STANDARD: A FIFTY-YEAR HISTORY OF THE CFA CHARTER 208 (2012).

58. This history is set forth in summaries on the CFA Institute's website. *See Background & Mission*, INV. ADVISER ASS'N, https://www.investmentadviser.org/about/background-mission [https://perma.cc/KU5S-DAQF].

59. Interestingly, an analogous proposal—to reserve use of the name or title of "advisers" to registered investment advisers (thereby, prohibiting its use by non-investment advisers, such as broker-dealers)—was revived in the regulatory proposals for the Regulation BI Initiatives (*see* Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, Exchange Act Release No. 83063, 83 Fed. Reg. 21416, 21459 (May 9, 2018) (to be codified at 17 C.F.R. pts. 240, 249, 275, and 279)), but the SEC declined to adopt this portion of the rule proposal. *See infra* note 265 (discussing Regulation Best Interest and declining to adopt rules that would have restricted broker-dealers and their associated persons from using the terms "adviser" or "advisor" as part of a name or title when communicating with retail investors); *accord* Form CRS Relationship Summary; Amendments to Form ADV, Securities Exchange Act Release No. 86032, 84 Fed. Reg. 33492, 33623 (July 12, 2019) [hereinafter *Form CRS Relationship Summary*].

version of the IAA legislation been enacted, but its inadequacy at inception guaranteed that it would need to be revisited by Congress and the SEC in the future. Indeed, interspersed efforts of Congress and the SEC attempted over time to adapt the regulatory scheme to the ever-changing realities of the world of investment management. The unintended consequence of the statute's inadequacy at the outset paved the way for the flexible development of a structure that has proven responsive, notwithstanding many twists and turns along the way.

B. THE 1960 AMENDMENTS AND THE ACT'S STRUCTURAL INADEQUACY

The inadequacy of the IAA was not lost upon the SEC. Within five years of its enactment, the SEC reported to Congress:

> The Commission, lacking authority under the Investment Advisers Act to inspect the books and records of investment advisers, has no means of ascertaining the correctness of the representations made in connection with registration, and no authority to determine whether a greater percentage have accepted custody of clients' securities and funds or to determine the amounts of funds and securities held by investment advisers. What is also most important, the Commission has no authority to make periodic inspections to determine whether the funds and securities of clients are intact . . . .
>
> The Investment Advisers Act thus deals with a field with respect to which neither the Commission nor any other government agency can do more than set punitive machinery in motion after the public has been defrauded . . . . Prevention is more desirable and valuable.[60]

Nothing came out of these efforts and the SEC continued to advocate for major substantive amendments. On the eve of the initial breakthrough in 1960, an SEC division director (who subsequently became the agency's general counsel and thereafter served as a commissioner) summed up the state of the Act as containing "only" four substantive provisions[61] and noted that "[i]n view of the limited

60. SEC. & EXCH. COMM'N, REPORT ON EMBEZZLEMENT OF CLIENTS' SECURITIES AND FUNDS BY TWO INVESTMENT ADVISERS AND RECOMMENDATION FOR AMENDING THE INVESTMENT ADVISERS ACT OF 1940 1 (1945). The Commission's legislative recommendations were later introduced in a congressional bill by the House sponsor of the original IAA, Representative Clarence F. Lea. *See* H.R. 3691, 79th Cong. (1945).

61. Philip A. Loomis, Jr., *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214, 247 (1959).

prohibitions" of the IAA, "it is not surprising that the number of civil and administrative proceedings under that act is relatively small."[62]

The Act's perceived inadequacy led to the enactment of the IAA Amendments of 1960[63] and was an overriding theme in the accompanying legislative history.[64] Although the 1960 IAA Amendments addressed a number of perceived deficiencies in the statute and its operation, three features bear special note. First, the amendments empowered the Commission to adopt rules requiring advisers to maintain books and records and permitted periodic examinations by the SEC.[65] The industry, as noted, had successfully blocked such a measure in 1940.[66]

Second, the amendments expanded the IAA's and SEC's regulatory focus over investment advisers in two respects. Section 206 of the IAA—the Act's antifraud provision—had originally applied only to registered investment advisers, thereby excluding both exempt and unregistered advisers. This feature of the statute led to a counterintuitive result in the case of unregistered advisers: Advisers who deliberately shirked their obligation to register—precisely the sort of adviser for whom the risk of abuse is great—could not be held to account under the Act's provision directed at fraud and deceit.[67] The amendment fixed this

62. *Id.* at 248. In a speech to the Investment Counsel Association of America in 1960, Commissioner Sargent urged the organization's support for a menu of proposed amendments recommended by the SEC so that "the industry will be able to cleanse itself of any malpractices that now exist." James C. Sargent, Comm'r, Sec. & Exch. Comm'n, The SEC and the Investment Counselor, Address Before the Investment Counsel Association of America, Inc. (May 19, 1960) [hereinafter *Sargent Investment Counsel Address*].

63. Act of Sept. 13, 1960, Pub. L. No. 86-750, 74 Stat. 750 (1960) (codified as amended in scattered sections of Title 15 of the U.S.C.) (the 1960 IAA Amendments).

64. *See* S. REP. NO. 86-1760, at 2 (1960) ("Of the five acts administered by the Securities and Exchange Commission . . . the Investment Advisers Act of 1940 is the most inadequate."); H.R. REP. NO. 86-2179, at 3 (1960) ("Administration of the Investment Advisers Act since its adoption in 1940 has indicated to the Commission that it is inadequate in many respects and does not afford the necessary protection to clients of investment advisers and other members of the investing public.").

65. *See* 74 Stat. at 886 (inserting books and records provision into IAA Section 204).

66. *See Senate Hearings on S. 3580*, *supra* note 44 and accompanying text.

67. See H.R. REP. NO. 86-2179, at 4 (1960) (noting inadequacy of excluding advisers evading registration from the antifraud provisions).

gaping loophole.[68] Moreover, the amendment necessarily also made clear that the antifraud provisions applied to advisers exempt from registration, which in 1960 implicated two significant then-existing exemptions for advisers that have since been repealed: advisers that primarily serviced registered investment trusts,[69] and advisers that served fewer than fifteen clients annually.[70] In other words, prior to 1960, the IAA's antifraud provisions would not necessarily apply to asset managers of registered investment companies or advisers with a limited number of clients, including, potentially, advisers to a limited number of private funds.[71]

Third, and most significantly for purposes of this article, the amendments greatly expanded SEC rulemaking authority under so-called prophylactic antifraud rulemaking. Specifically, Congress gave the SEC the power to promulgate rules "to prescribe means reasonably designed to prevent" fraudulent and deceptive practices.[72] This power enlarged the SEC's rulemaking power to broad areas of conduct, including some not intrinsically fraudulent or deceitful themselves, to encompass measures designed to aid the prevention of fraudulent or deceitful conduct.[73] In describing these changes, then-Commissioner

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68. *See* 74 Stat. at 887 (striking the restrictive clause advisers "registered under section 203").

69. The registration exemption for that category was repealed in 1970. *See* Act of Dec. 14, 1970, Pub. L. No. 91-547, 84 Stat. 1413, 1417–18, 1430 (codified as amended in 15 U.S.C. § 80b-2) (1970). *See infra* Section 1.C.

70. The registration exemption for that category was substantially repealed in 2010. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1571 (2010) (codified as amended at 15 U.S.C. § 80a) (repealing IAA Section 203(b)(3)). *See infra* Section I.E.1 & n.118.

71. The repeal, noted above, of the blanket exemptions for many mutual fund advisers (in 1970) and large private fund advisers (in 2010) applied the 1960 amendment extending Section 206 to unregistered advisers. However, the problem of investment advisers deliberately circumventing their registration obligations would still exist. Moreover, the 1960 amendment also had a future benefit after Congress embraced a bifurcated federal/state registration system in 1996 that relegated smaller advisers (constituting a significant majority of the total) to state registration (*see infra* Section I.D.): It preserved SEC antifraud jurisdiction, whether the adviser was SEC-registered or not.

72. 15 U.S.C. § 80b-6(4).

73. Nearly identical language in Section 14(e) of the Securities Exchange Act has been construed broadly in this fashion. Schreiber v. Burlington N., Inc., 472 U.S. 1, 11 n.11 (1985) (the statute gives the SEC the "latitude to regulate nondeceptive activities as a 'reasonably designed' means of preventing [unlawful] acts."); *accord* United States v. O'Hagan, 521 U.S. 642, 672–73 (1997) ("A prophylactic measure, because its

Sargent alluded to the flexibility of the rulemaking authority,[74] and the abbreviated statements in the House and Senate reports made clear that they were intended to clarify the SEC's authority to regulate beyond the confines of common law fraud and deceit.[75] SEC rulemaking, as discussed in Section III below, would prove a critical factor in recalibrating the statute's regulatory arc.

C. THE 1970 AMENDMENTS EXTEND THE IAA'S SWEEP TO ASSET MANAGERS

The second wave of amendments that moved the IAA toward becoming a full-fledged asset management statute occurred over the next 40 years, from 1970 to 2010. The first step in this process, the Investment Company Act Amendments of 1970,[76] introduced incremental changes that continued reorienting the SEC's focus in the adviser space to deal more effectively with asset managers.

The SEC began to address rulemaking initiatives under the IAA in the aftermath of the 1960 IAA Amendments,[77] but also addressed the IAA and different aspects of the investment adviser industry in three major reports, submitted to Congress prior to or contemporaneously with the 1970 ICA Amendments.[78] The reports themselves are of

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mission is to prevent, typically encompasses more than the core activity prohibited."). The prophylactic rulemaking language was derived from what is currently codified in Securities Exchange Act Section 15(c)(2)(D)—15 U.S.C. § 78o-(c)(2)(D)—and was originally codified in an amendment to Section 15(c)(2) in 1938. *See* Maloney Act of 1938, Pub. L. No. 75-719, 52 Stat. 1070, 1075. The language was incorporated into the new IAA Section 206(4) as part of the IAA Amendments of 1960. Congress used this same language in amending the Williams Act (Pub. L. No. 90-439, 82 Stat. 457) in 1970 and specifically Securities Exchange Act Section 14(e). *See* Act of Dec. 22, 1970 Pub. L. No. 91-567, 84 Stat. 1497, 1497–98.

74. *See Sargent Investment Counsel Address*, *supra* note 62.

75. *See* H.R. REP. NO. 86-2179, at 7–8; S. REP. NO. 86-1760, at 8.

76. *See* Pub. L. No. 91-547, 84 Stat. 1413 (1970).

77. *See infra* Section III.A.

78. *See* SEC. & EXCH. COMM'N, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES EXCHANGE COMMISSION, H.R. DOC. NO. 95, pt. 1 (1963) [hereinafter *Special Study Report*]. *See generally* SEC. & EXCH. COMM'N, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337 (1966) [hereinafter *Public Policy Report*]; SEC. & EXCH. COMM'N, INSTITUTIONAL INVESTOR STUDY REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 92-64, pt. 8 (1971) [hereinafter *Institutional Investor Study*].

varying significance. The Special Study Report focused significant attention on oversight of broker-dealers, but also made specific recommendations touching on investment advice and investment advisers.[79] The Institutional Investor Study grew out of Congress's direction to the SEC of the need to address fundamental informational gaps regarding the role and impact of institutional investors on securities markets. Notably, this study documented the rapid growth of asset managers—from mutual fund advisers, to institutional money managers of separate accounts, to sponsors of hedge funds—and the need for better disclosure relating to risk and performance.[80] Finally, and perhaps most significantly, the Public Policy Report made specific legislative recommendations relating to the IAA and ICA that served as the springboard for the 1970 ICA Amendments. Taken together, the reports nevertheless attest to the fact that the process by which the IAA took shape was uneven and subject to incremental development, rather than a clear path from the outset.

With respect to the IAA, the 1970 ICA Amendments eliminated the IAA's registration exemption for advisers who primarily advised registered investment companies and made the investment advisory contracts subject to the fee limitations found in Section 205. The specific provision had been a recommendation from the SEC in the Public Policy study.[81] As noted, IAA Section 206 had already been amended to encompass unregistered investment advisers, including those exempted. Eliminating the registration exemption meant that mutual fund asset managers would be directly subject to the IAA in all phases of their business, especially in terms of books and records.

Another major concern of the 1970 ICA Amendments was insufficient accountability for the management fees of money managers. Here too, the amendments directly addressed asset managers. However, in this case, the amendments to the ICA, rather than the IAA, were notable. Congress imposed new obligations on advisers with respect to their role as advisers to registered investment companies. Most directly, a new provision, Section 35(b), "deem[ed]" advisers as having "a

79. *See Special Study Report*, *supra* note 78, at 386–87 (recommending enhanced scrutiny of subscription services, investment advice delivered through market letters and similar communications, and the "reckless dissemination of written investment advice," along with the establishment of a self-regulatory organization for investment advisers).

80. *See Institutional Investor Study*, *supra* note 78, at pt. 2 (Chapters IV–IX, and summarized in Part 8 at Chapters XII–XXI).

81. *See Public Policy Report*, *supra* note 78, at 344–45.

fiduciary duty with respect to the receipt of compensation" from a registered investment company.[82] While the provision created an express private right of action in addition to SEC enforcement powers, what is more significant is that it extended the ordinary fiduciary duty of an adviser under state law to a novel federal fiduciary duty with respect to receipt of compensation for such advisers—a provision without any parallel in state law. As a result, a significant and growing segment of asset manager fees (namely, managerial fees for mutual funds and eventually ETF advisers) would become subject to legal scrutiny. Congress made corresponding changes to the statutory requirements relating to the initial approval and subsequent board review and renewal review by requiring advisers "to furnish such information as may reasonably be necessary to evaluate the terms" of the investment advisory agreement.[83] Though lodged in the ICA, these steps established enhanced processes and scrutiny of asset managers of registered investment products.

D. NSMIA'S 1996 AMENDMENTS TO THE IAA, AND BIFURCATING FEDERAL AND STATE REGISTRATION OF ADVISERS

By 1996, nearly a quarter-century after the 1970 ICA Amendments, assets managed by mutual funds had grown exponentially.[84] Not only were the investment assets of U.S. households rapidly growing, but retail securities professionals (including advisers) were instrumental in this process.[85] The differences between large asset managers at one

82. *See* Pub. L. No. 91-547, 84 Stat. 1413, 1428–30 (1970) (codified at 15 U.S.C. § 80a-35(b)).

83. *See* 15 U.S.C. § 80a-15(c).

84. In 1970, there were 361 mutual funds which held $47.6 billion in AUM. By 1996, 6,246 funds managed $3.52 trillion in assets. *See* ICI FACT BOOK, *supra* note 5, at 196.

85. While difficult to document precisely, the pattern of retail penetration is unmistakable from numerous proxies. For example, in 1995, roughly 29% of U.S. households owned mutual funds, while five years later the share had increased to 46%. *See id.* at 140. Brokers had historically been the principal means of selling mutual fund shares since their creation which declined to roughly 36% by 2004. *See* LEE GREMILLION, MUTUAL FUND INDUSTRY HANDBOOK 160, 170 (2005). While a smaller percentage of the distribution channel, this was more than offset by the total asset pie. During this period, the SEC adopted a number of rules under the ICA to enable investment companies to use new types of fee structures to support retail distribution activities. *See generally* John P. Freeman, *The Mutual Fund Distribution Fee Mess*,

extreme, and small financial advisers at the other, exposed weaknesses in allocating federal and state resources in regulating the adviser space.[86] In addition, federally-registered investment companies chafed under parallel systems of uniform federal regulation and balkanized state regulation.[87] Finally, private funds (notably, including hedge funds) had begun to proliferate and sought ways under federal law to expand their means of accumulating assets.[88]

In the National Securities Markets Improvements Act of 1996 ("NSMIA"),[89] Congress responded to these diverse challenges. Most significantly, Congress (and the SEC) sought to rationalize the overlapping schemes of federal and state regulation of advisers. Congress adopted a bifurcated registration scheme that allocated registration obligations between federal and state regulators in terms of asset size and market significance.[90] While intricate and full of exceptions, the bifurcated registration scheme essentially relegates small personalized advisers (both asset managers and small advisory-only advisers) to state registration schemes, while making large asset managers and personalized advisers with interstate networks SEC adviser-registrants.[91] The number of registered advisers is in the tens of

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32 J. CORP. L. 739, 761–67 (2007) (describing these changes and concluding that new fee arrangements between 1980 and 1998 "completely transformed the economic relationship between the fund industry and large brokerage firms"). To be sure, the trend in retail distribution was greatly aided by sharp increases in the fund assets held in IRA and 401K accounts. *See* ICI FACT BOOK, *supra* note 5, at 165 (documenting the growth).

86. *See* S. REP. NO. 104-293, at 2 (1996) (noting relationship between federal and state regulatory regimes is "confusing, conflicting and involves a degree of overlap" that leads to unnecessary costs, and that state and federal regulators are "overwhelmed by the size of the task.").

87. *See* Paul S. Stevens & Craig S. Tyler, *Mutual Funds, Investment Advisers, and the National Securities Markets Improvements Act*, 52 BUS. LAW. 419, 446–51 (1997) (discussing industry perspective that duplicative features of state regulation imposed a burden on mutual funds and other investment companies).

88. *See* H.R. Rep. No. 104-622, at 18 (1996) (describing one purpose of the legislation as "significantly reduc[ing] regulatory restrictions" on private funds in view of "the important role that these pools can play in facilitating capital formation for U.S. companies").

89. Pub. L. No. 104-290, 110 Stat. 3416 (1996).

90. The particulars, as amended, are set forth in IAA Section 203A (codified at 15 U.S.C. § 80b-3a) and the rules thereunder. The provision was amended as part of the Dodd–Frank Act to increase the size of advisers qualifying for the federal registration scheme. *See infra* Section I.E.1.

91. 15 U.S.C. §80b-3a.

thousands, but not all advisers warranted the same level of scrutiny given the vast differences in size and assets under management. The resulting scheme allowed the SEC to allocate its regulatory resources toward large asset manager-advisers by excluding smaller advisers from the federal registration scheme.[92] The congressional scheme carefully preempted some aspects of state regulation of federally-registered advisers, but just as significantly, it preserved other aspects of state concurrent regulation.[93]

NSMIA further consolidated SEC federal power over asset managers indirectly. It broadly preempted state regulatory authority over the securities offering process and disclosure obligations of registered investment companies (the means by which mutual funds and other registered vehicles gather assets) and certain private fund offerings.[94] While not precisely directed at altering regulation of asset managers, these amendments expanded the practical scope of federal regulation of the class of the largest asset managers, since securities offerings are the principal means for such asset managers to gather assets. Here, in contrast to the bifurcated registration scheme, Congress used a broad form of preemption to expressly preempt state law, except with respect to matters involving fraud.

A final aspect of the NSMIA figures in the narrative regarding reorientation of the IAA's focus and scope. The 1996 amendment addressed an obstacle faced by private funds in gathering investor assets. At the time, the number of investors in a private investment fund,

92. In 1996, there were approximately 23,500 SEC-registered advisers. *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Adviser Act Release No. 1633, 62 Fed. Reg. 28112 (1997). The new registration scheme significantly reduced the number of SEC-registered advisers, which can be approximated by the fact that almost 15 years later, in 2011, the SEC estimated the number of SEC-registered advisers after implementing the Dodd–Frank Act registration amendments would be around 11,500, notwithstanding the significant growth in the financial services sector in the intervening period. *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Adviser Act Release No. 3221, 76 Fed. Reg. 42950, 42994 (2011) (estimate reflecting furthering reductions in SEC-registered investment advisers as a result of higher asset thresholds for federal registration coupled with increases resulting from the elimination of certain registration exemptions).

93. *See* 15 U.S.C. § 80b-3a(b) (containing the express preemption and savings clause provision).

94. 15 U.S.C. §§ 77r-(a) & (b)(2).

such as a hedge fund, was effectively capped at 100 investors.[95] NSMIA introduced a new exemption–Section 3(c)(7)–for non-publicly offered funds limited to ownership by qualified purchasers.[96] Under the ICA, such funds could have an unlimited number of qualified purchaser investors, provided that all investors met the qualified purchaser threshold.[97] As noted, this change had negligible immediate effects on the IAA's focus. However, by broadening the scope of exemptions from the ICA for certain pooled investment vehicles, the change spurred the formation of many kinds of private funds, most notably hedge, private equity, and venture capital funds.[98] The funds were managed by asset managers frequently exempt from registration under the IAA. As these entities developed in later years, the question arose whether some type of regulation would be needed to fill the regulatory gap and, if so, whether such regulation should be under the ICA (i.e., private fund regulation) or under the IAA (i.e., regulation of advisers to such funds).[99]

Shortly after the NSMIA, the Gramm-Leach-Bliley Act ("GLB") provided an additional amendment to the IAA that is of note to this narrative.[100] The legislation easily represented the most significant piece of banking legislation in a generation or more, and notably repealed the famous Depression-era banking legislation known as the Glass-Steagall

95. Private funds, such as hedge funds, would ordinarily meet the ICA's threshold definition of investment company, which is found in ICA Section 3(a). *See* SEC. & EXCH. COMM'N, STAFF REPORT TO THE COMM'N: IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 11 (2003) [hereinafter *SEC Staff Hedge Fund Report*]. At the time, the only available exclusion for hedge funds from that definition was for non-publicly offered funds with 100 or fewer investors in ICA Section 3(c)(1). *See* DIV. OF INV. MGMT., SEC. & EXCH. COMM'N, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 105–06 (1992).

96. 15 U.S.C. § 80a-(3)(c)(7)(A).

97. Such funds could trigger Exchange Act reporting requirements that resulted in an informal (but much higher) cap on the number of total investors in such funds. *See SEC Staff Hedge Fund Report*, *supra* note 95, at 13. Nevertheless, the Section 3(c)-7, greatly increased the ability of private funds to gather assets from investors.

98. *See* Registration under the Advisers Act of Certain Hedge Fund Advisers, Investment Adviser Act Release No. 2333, 69 Fed. Reg. 72054, 72054–55 (2004) (noting 260% increase in hedge fund assets over the preceding five years).

99. *See SEC Staff Hedge Fund Report*, *supra* note 95, at 88–96. *See also infra* Section I.E.1.

100. *See generally* Gramm-Leach-Bliley Financial Modernization Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of Titles 12 and 18 of the U.S.C.). As noted below, GLB repealed the Depression-era Glass–Steagall Act (Pub. L. No. 73-66, 48 Stat. 162 (1933)).

Act. Prior to the GLB, banks that provided asset management services were excluded from regulation under the IAA because the IAA's definition of investment adviser expressly excluded banks from that definition. Banks, however, were (and still are) significant players in the asset management field in terms of registered investment companies under the ICA (e.g., advising mutual funds),[101] overseeing pension assets (including collective trusts), common trusts of bank customers, and trust accounts for bank clients. However, banks enjoyed an exclusion from the IAA because they were not deemed investment advisers within the meaning of the IAA. The GLB amended the IAA to redraw the jurisdictional lines for banks. To the extent that a bank or its affiliates advise—or manage the assets of—registered investment companies, the affiliate or designated group of personnel with the bank is deemed to be an investment adviser required to register as such under the IAA.[102] Other asset management by banks or bank affiliates remain outside the realm of the IAA.

Although GLB's contribution appears to be no more than a technical agency jurisdictional issue, the adjustment is noteworthy. The amendment, once again, underscored the reorientation of the IAA's regulatory arc toward a regulatory scheme that prioritizes oversight of asset managers. To be sure, GLB was at best half a loaf. After all, while a significant share of banks' asset management services remained excluded from the IAA, it also sounded the steady drumbeat to bring unregulated asset managers of securities portfolios under the umbrella of the IAA, a theme that reemerged in the Dodd–Frank Act discussed below.

101. Bank access to the registered investment company market was the subject of litigation that found its way to the Supreme Court. Banks were precluded from sponsoring and advising registered funds (*see* Inv. Co. Inst. v. Camp, 401 U.S. 617, 621, 639 (1971)), but successfully circumvented the obstacle by conducting such activities through bank affiliates. *See* Bd. of Governors of Fed. Rsrv. Sys. v. Inv. Co. Inst., 450 U.S. 46, 78 (1981).

102. *See* 15 U.S.C. § 80b-2(a)(11).

E. DODD–FRANK'S 2010 IAA AMENDMENTS: OF ASSET MANAGERS AND FIDUCIARIES

The Financial Crisis of 2008 led to major reforms in the financial sector with respect to banking, derivatives, and financial institutions.[103] Tucked within the massive legislative response, known as the Dodd–Frank Act,[104] were amendments and provisions that touched on the Investment Advisers Act: (i) significantly revising the exemptive scheme for investment adviser registration under the IAA, especially for private funds (the "2010 Registration Amendments");[105] and (ii) expressly recognizing a federal interest in a standard of conduct, including fiduciary standards, to govern not only investment advisers, but also broker-dealers (together, so-called "securities professionals") in delivering personalized investment services to retail clients (the "2010 Conduct Parity Provisions").[106] Interestingly, the motivation for the 2010 Registration Amendments and the 2010 Conduct Parity Provisions was not directly linked to the Financial Crisis.[107] Rather, the genesis for

103. The literature on the 2008 Financial Crisis is enormous. For the official government report, see FINANCIAL CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT (2011) [hereinafter FINANCIAL CRISIS INQUIRY REPORT].

104. Pub. L. No. 111-203, 124 Stat. 1376 (2010) (formally known as the Dodd–Frank Wall Street Reform and Consumer Protection Act) (herein referred to as the "Dodd–Frank Act"); *see also* S. REP. NO. 111-176, at 40 (2010) ("Th[e] devastation [caused by the Financial Crisis] was made possible by a long-standing failure of our regulatory structure to keep pace with the changing financial system and prevent the sort of dangerous risk-taking that led us to this point, propelled by greed, excess, and irresponsibility. The United States' financial regulatory structure, constructed in a piecemeal fashion over many decades, remains hopelessly inadequate to handle the complexities of modern finance.").

105. This is set forth in Article IV of the Dodd–Frank Act. *See* 124 Stat. 1376, 1571–74.

106. These provisions were part of Article IX of the Dodd–Frank Act. *See* 124 Stat. 1376, 1824–30 and specifically Section 913.

107. This is evident since these types of provisions were not addressed in government assessments and recommendations focused specifically on causes of the Financial Crisis. *See generally* FINANCIAL CRISIS INQUIRY REPORT, *supra* note 103 (highlighting role of corporate governance and risk management at systemically important financial institutions, erosion of mortgage-lending standards, shadow banking liquidity practices, over-the-counter derivatives markets and credit-rating agencies, but not regulation of private funds or standards of conduct of securities professionals); U.S. GEN. ACCT. OFFICE, FINANCIAL MARKETS REGULATION: FINANCIAL CRISIS HIGHLIGHTS NEED TO IMPROVE OVERSIGHT OF LEVERAGE AT FINANCIAL INSTITUTIONS AND ACROSS SYSTEM (2009).

the provisions lay in important issues that had emerged and been allowed to dangle in the preceding decade.[108] The dangling issues resonated with Congress when Congress embarked upon a massive legislative response to the Financial Crisis.[109] Nevertheless, the amendments to the IAA pushed the regulatory arc of the IAA in new directions. As discussed below, the 2010 Registration Amendments resolved the fundamental status of private fund asset managers (and indirectly how private funds would be regulated) under the IAA and introduced additional refinements to the bifurcated registration scheme. In the case of private funds, many, if not most, private fund advisers, not previously registered with the SEC, became subject to enhanced oversight under the IAA, along with their activities. In an unrelated vein, in the 2010 Conduct Parity Provisions, Congress expanded SEC rulemaking authority and specifically invited the SEC to expand the standard of conduct of broker-dealers to retail investors, suggesting that the purpose would be to establish fiduciary parity or uniformity with investment advisers under the IAA. Congress, however, did not mandate parity, and somewhat problematically refrained from prescribing the exact scope and nature of investment advisers' fiduciary duties. Each of these initiatives is discussed separately.

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108. *See infra* Section I.E.2.

109. The Obama Administration's blueprint for regulatory reform, reflecting legislative proposals that had already begun to circulate, was set forth in a comprehensive white paper from the Department of Treasury. *See generally* U.S. DEP'T OF TREAS., FINANCIAL REGULATORY REFORM–A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009) [hereinafter TREASURY REFORM REPORT]. While the report was meant as a broad-based response to the Financial Crisis, and the subject matter of the amendments was reflected in the report's recommendations (e.g., registration of advisers, *see id.* at 37, and harmonization of investment adviser and broker-dealer fiduciary standards, *see id.* at 71), it was recognized that those proposals had an origin independent of the Financial Crisis. Regarding private funds, see H.R. REP. NO. 111-686, pt. 1, at 6, which accompanied the Dodd–Frank predecessor bill Private Fund Advisers Registration Act of 2009, H.R. 3818, 111th Cong. (2009–2010) (noting the financial crisis, but then recounting history of the SEC's efforts to extend regulation to hedge fund advisers in the preceding decade). Regarding revisions to the fiduciary standard applicable to securities professionals, see H.R. REP. NO. 111-687, pt. 1, at 49–50 (accompanying a Dodd–Frank predecessor bill, H.R. 3817–the Investor Protection Act of 2009) (noting that the substance of the bill took shape independent of the financial crisis, and tracing interest in fiduciary standards of securities professionals to a study prepared for the SEC by the RAND Corporation (RAND CORP., TECHNICAL REPORT: INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS (2008))).

1. Expanding the IAA to Cover Private Fund Asset Managers

As noted, NSMIA expanded the exemption private funds enjoy from treatment as investment companies, thereby relieving them of obligations arising under the ICA.[110] This may have appeared innocuous in 1996, but after the Long-Term Capital Management debacle in 1998[111] and the rapid growth in assets managed by hedge funds, the SEC became uneasy.[112] While continuing to bring enforcement actions relating to hedge fund abuses,[113] the SEC attempted a rule change–the so-called Hedge Fund Rule—that effectively would have required virtually all hedge fund managers (but not private equity and venture capital managers) to register with the SEC as investment advisers.[114] The rule was challenged and struck down by the D.C. Circuit as beyond the SEC's statutory authority.[115]

The SEC had little recourse from this regulatory defeat, except to bide its time, absent statutory changes. Its maneuvering room was significantly constrained. It retained residual rulemaking power, such as its prophylactic antifraud rulemaking power, to enhance protection of

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110. *See supra* Section I.D.

111. *See* THE PRESIDENT'S WORKING GRP. ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT (1999). *See generally* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2001) (a colorful retelling of the events).

112. *See generally SEC Staff Hedge Fund Report*, *supra* note 95.

113. The SEC Staff Report enumerates some of these proceedings. *See id.* at 72–75 (summarizing civil and criminal proceedings against principals); *see also* Christopher Cox, Chairman, SEC, *Testimony Concerning the Regulation of Hedge Funds Before S. Comm. on Banking, Housing and Urban Affairs* (July 25, 2006) (summarizing then-recent hedge fund enforcement actions in 2006). One particularly famous hedge fund Ponzi scheme that led to an SEC action involved Bayou Management and was estimated to have generated tens of millions of dollars in losses. *See* Samuel Israel III, Investment Advisers Act Release No. 2515, 87 SEC Docket 2864 (May 9, 2006) (order concluding administrative proceeding summarizing successful civil litigation against respondent).

114. The rule related to how clients of hedge fund asset managers were counted for purposes of the then-existing registration exemption for advisers with fewer than 15 clients. The Hedge Fund Rule would have required the asset manager to treat each hedge fund investor as a client of the adviser. The rule had exclusions for private funds that generally barred redemptions of ownership interests in less than 2 years. *See* SEC v. Goldstein, 451 F.3d 873, 874–77 (D.C. Cir. 2006) (summarizing history and features of the rule amendment). These elements, of course, are moot by the court's decision.

115. *Id.*

investors in private funds,[116] and, of course, it retained the ability to bring enforcement actions when necessary.[117]

In response to the Financial Crisis, Congress completed the Dodd–Frank Act, the massive legislation that introduced substantial regulatory reforms to all facets of the financial services industry. The final legislation in the 111th Congress was an amalgamation of a number of component legislative proposals that ultimately found their way into parallel, but not identical, omnibus bills from each house of Congress: the omnibus House bill (the Frank Bill or H.R. 4173) and the omnibus Senate bill (the Dodd Bill or S. 3217). The Dodd–Frank Act, as enacted, was the reconciliation of the two omnibus bills.

The legislative parent of what was to become Article IV regarding amendments to the private fund adviser registration provisions of the IAA was H.R. 3818, known as the Kanjorski bill. It is worth noting that the legislation was independent of any specific SEC advocacy, but the SEC and its staff were favorably disposed to the basic approach. Most significantly, Congress amended the IAA's registration requirements to remove the fewer-than-15-clients exemption that had previously allowed private advisers to avoid registration.[118] This exemption had been utilized by many advisers of private funds (hedge, private equity, and venture capital funds). In its place, Congress adopted a new scheme that requires advisers of private funds to register if AUM of domestic-advised private funds exceeds $150 million,[119] or the adviser exclusively advises venture capital funds.[120] For the first time, the SEC would have reliable means to regulate private funds (i.e., funds exempt from the ICA) indirectly through its regulatory mandate over private fund advisers. In addition, the amendments also made very detailed revisions to the bifurcated federal-state registration scheme to allocate a bigger

116. *See infra* Section III.B.2 (discussing the private fund rule).

117. The reach of Section 206 is not limited to registered investment advisers. *See* 15 U.S.C. § 80b-6.

118. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1571–72 (effectively repealing IAA Section 203(b)(3) and replacing that provision with a narrow exemption for small entirely foreign advisers with fewer than 15 U.S. clients).

119. 15 U.S.C. § 80b-3(m)(1) (IAA Section 203(m)).

120. 15 U.S.C. § 80b-3(I)(1). In addition, Congress required exempt private funds to file reports with the SEC. *See* 15 U.S.C. § 4(b)-5 & 17 C.F.R. § 204-4 (2001) (implementing reporting requirement for Exempt Reporting Advisers).

chunk of the total class of advisers to state registration schemes.[121] The combined effect of these amendments was to further tilt the SEC's resources toward institutional asset management by extending the SEC's oversight of private fund advisers and forcing more small personalized wealth managers to switch from the SEC registration scheme to state oversight.[122] In other words, the SEC could focus its scarce resources on advisers that managed more assets.

2. The Push for Parity and the 2010 Conduct Parity Provisions

The Dodd–Frank Act also introduced another series of provisions relevant to understanding a fundamental thematic feature of the IAA–the standard of conduct applicable to investment advisers. Unlike the 2010 Registration Amendments that addressed the IAA directly, the 2010 Conduct Parity Provisions ("Parity Provisions") implicated the IAA peripherally. The Parity Provisions urged consideration, but seemingly did not mandate adoption of proposals to elevate the standard of conduct for broker-dealers in giving personalized investment advice to retail customers so that the standard was more closely aligned with that applicable to investment advisers in similar circumstances. The Parity Provisions essentially sought to align the standard of conduct applied to broker-dealers and investment advisers competing in Box I of the Simplified Taxonomy set forth at the outset of this article.[123] Some in Congress may have assumed that the applicable IAA standard was a fiduciary one, even though the statutory amendments were silent in that regard.[124]

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121. *See* 15 U.S.C. § 80b-3a(a)(2). This section sets forth the registration treatment of so-called "mid-sized advisers," a new category of advisers that had the effect of raising the AUM thresholds on advisers precluded from registering with the SEC (i.e., advisers to be overseen by state rather than federal regulators). There is no record of SEC participation on this particular issue.

122. The amendments caused the regulatory transfer of more than 2100 investment advisers to the state regime, increasing the number of exclusively state-registered investment advisers from 15,000 in 2010 to over 17,000 by 2013. *See* NAT'L AM. SEC. ADM'RS ASS'N ("NASAA"), THE IAA SWITCH: A SUCCESSFUL COLLABORATION TO ENHANCE INVESTOR PROTECTION 2 (2013). In 2020, NASAA reported 17,533 state-registered investment advisers (by primary state location), 80% of which had two employees or less. NAT'L AM. SEC. ADM'RS ASS'N, NASAA 2020 INVESTMENT ADVISER SECTION ANNUAL REPORT 1, 15 (2020).

123. *See supra* Table 1.

124. *Compare* H.R. REP. NO. 111-687, at 49 (2009) (summarizing testimony regarding fiduciary duty "emanating" from SEC v. Capital Gains Research Bureau,

So, what was the impetus for the 2010 Conduct Parity Provisions? The answer involves a somewhat twisted narrative going back many years.[125] The basic thrust of this story is the steady erosion over time of the retail business model of broker-dealers over several generations. When the IAA was enacted, broker-dealers typically depended on revenue generated from commission-based compensation in their retail business at a time when commissions were fixed.[126] The fixed commission model differed from the business model for investment counsel, a business model that was based on asset-based or fee-based compensation models (i.e., a percentage of the value of client's assets under management or a regular, recurring charge of some sort).[127] The broker-dealer commission-based model had been in decline for years due to numerous factors, most notably the elimination of fixed-rate commissions in 1975.[128] Competition among broker-dealers led to lower (and in the case of discount brokers, sharply lower) brokerage commission rates, and online access to brokers further fueled

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Inc., 375 U.S. 180 (1963)), *and* H.R. REP. NO. 111-687, at 75 (2009) ("The Committee aims to apply the current state of law to brokers and dealers and does not intend to undermine or dilute this fiduciary standard and market practice for investment advisers."), *with* S. REP. NO. 111-176, at 105 (2010) (agnostically noting need for study "whether there are legal or regulatory gaps or overlap in legal or regulatory standards in the protection of retail customers" with respect to brokers-dealers and investment advisers with delegation of rulemaking authority).

125. *See* Laby, *supra* note 20, at 277–87 (providing an extended summary of key aspects of this history). For an insider's perspective on the history of the events that culminated many years later into the Regulation Best Interest Initiative (*see infra* note 265) from a former Director of the SEC's Division of Investment Management, see Andrew J. Donohue, Keynote Remarks at the Conference on Regulation Best Interest at the McCombs School of Business: The Long Road to Regulation Best Interest (Feb. 11, 2020); Andrew J. Donohue, *Best Interest or Fiduciary Duty* (unpublished summary of 2018 SEC proposal on Regulation Best Interest) (on file with author).

126. Fin. Planning Ass'n v. S.E.C., 482 F.3d 481, 485 (D.C. Cir. 2007) (summarizing history relating to brokerage commission model for incidental investment advice); *see also infra* note 265 (discussing the Solely Incidental Interpretation).

127. *Id.* at 485.

128. *See* Certain Broker-Dealers Deemed Not to Be Investment Advisers, Investment Advisers Act Release No. 2376, 70 Fed. Reg. 20424, 20425 (2005) (in adopting the rule that was later struck down in *Financial Planning Association*, the SEC was motivated by "changes in the market place for retail brokerage"); *see also* Laby, *supra* note 20, at 279–81. For an overview of the history relating to the end of fixed commission rates, see JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 481–86 (rev. ed. 1995).

competitive pressure on broker-dealers' commission-based revenue models.[129]

In 1995, the broker-dealer industry with the encouragement of the SEC issued a report–the so-called Tully Report[130]–which formally recommended that broker-dealers diminish the role of commission-based compensation with respect to non-discount retail customers and that broker-dealers move toward asset-based compensation models. This development triggered regulatory uncertainty regarding the treatment of broker-dealer accounts that received non-discretionary advisory services but charged asset-based fees. Under the IAA, broker-dealers who provide investment advice that is "solely incidental" to their acting as a broker are not deemed investment advisers.[131] However, the broker-dealer "solely incidental" exception counts the receipt of commissions as compensation, a disqualifying factor for the exception under the statute, rather than some excluded form of special compensation. Allowing broker-dealers to charge asset-based fees with respect to servicing non-discretionary advisory accounts, without registering as an investment adviser, marked a change.[132]

The SEC adopted a rule that would have permitted brokers to receive asset-based compensation for servicing non-discretionary advisory brokerage accounts, thereby preserving for broker-dealers the regulatory distinction between non-discretionary advisory broker-dealer business (as a broker-dealer) and asset management for clients

129. The effect on eliminating fixed commission rates was immediate for the industry. *See* Aharon R. Ofer & Arie Melnick, *Price Deregulation in the Brokerage Industry: An Empirical Analysis*, 9 BELL J. ECON. 633, 640 (1978) ("As with the breakdown of any cartel, prices did decline significantly."). This process has inexorably led to very low and even zero commissions for retail investors today. *See* Lisa Beilfuss & Alexander Osipovich, *The Race to Zero Commissions*, WALL ST. J. (Oct. 5, 2019); Jason Zweig, *Lessons of May Day 1975 Ring True Today*, WALL ST. J. (April 30, 2015).

130. AD HOC COMMITTEE ON COMPENSATION PRACTICES, REPORT OF THE COMMITTEE ON COMPENSATION PRACTICES (1995). The Committee was formed at the request of SEC Chairman Arthur Levitt, but it was not an official agency advisory committee. The Chair of the *ad hoc* Committee was Daniel P. Tully of Merrill Lynch & Co. Inc.

131. 15 U.S.C. § 80b-2(a)(11). Of course, broker-dealers who actually managed client accounts were treated as investment advisers who had to register as such at least with respect to those client-managed accounts. Broker-dealers in this context operated as dual registrants: registered broker-dealers for purposes of normal brokerage operations and advisory-only accounts, and as registered investment advisers for purposes of who-for purposes.

132. *Id.*

conducted by broker-dealers (as an investment adviser), regardless of how broker-dealers were compensated by customers.[133] However, the SEC rule was challenged by the Financial Planners Association (FPA) and struck down by the D.C. Circuit.[134] The FPA objected to the rule because it allowed broker-dealers to service advisory-only relationships while receiving asset-based fees without registering as investment advisers.[135] From the FPA's perspective, this put financial planners at a competitive disadvantage relative to broker-dealers in servicing advisory-only accounts because financial planners are treated as investment advisers, and therefore, unlike broker-dealers, are subject to higher conduct standards in dealing with clients.[136]

Although the D.C. Circuit struck down the SEC's rule, controversy continued with an SEC-commissioned study completed in 2008 by the RAND Corporation, which found that retail customers with broker-dealer accounts that received incidental investment advice (and therefore were within the ambit of the IAA) did not understand the difference between standards of conduct governing investment advisers and broker-dealers.[137] As noted then, and to a lesser extent now, broker-dealers providing advice (again, in the non-discretionary advisory sense) are subject to a lower (non-fiduciary) standard of conduct, in contrast to the higher standard of conduct applicable to investment advisers in those circumstances.[138] The RAND Report triggered interest by regulators and

133. *See* Fin. Plan. Ass'n v. S.E.C., 482 F.3d 481, 485–86 (D.C. Cir. 2007) (summarizing the SEC rule adopted with the release referenced at note 128 *supra*).

134. *Id.* at 483.

135. *Id.* at 486.

136. *Id.* at 486–87.

137. ANGELA A. HUNG ET AL., RAND CORP., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 117–18 (2008) [hereinafter RAND BROKER-DEALER REPORT].

138. An underlying point of contention that is not specifically relevant to this article concerns whether the standards, although different in formulation, are not all that different in practice. Commentators disagree. *Compare* Laby, *supra* note 20, at 276–77 ("When providing advice to customers, brokers are subject to a 'suitability' standard . . . . The theory behind the suitability rule is that when a broker recommends a security, he is making an implied representation that the security is consistent with the investor's objectives and therefore a suitable investment . . . . Under the Advisers Act, advisers are subject to a higher 'fiduciary' standard of care . . . . [A]n adviser's recommendation must not only be 'suitable,' it also must be in the client's best 'interest.'"), *with* Wrona, *supra* note 20, at 3–4 ("Media reports have repeatedly described the differences between the two standards by stating that advisers are subject

investor advocates in more closely examining the standard of conduct for broker-dealers providing retail customers with investment advice.

The divergence in standards of conduct governing broker-dealers and investment advisers was something considered by Congress in connection with the mammoth Dodd–Frank Act. The 2009 Treasury Report explicitly recommended action on the issue.[139] In turn, this led to competing legislative proposals in Congress that were reconciled in a provision of the Dodd–Frank Act—Section 913.[140]

The solution crafted in the final legislation was intricate. Congress settled on an agency inquiry mandate coupled with intertwined rulemaking provisions. First, Congress charged the SEC with producing a report on the effectiveness of standards of conduct of securities professionals in providing personalized investment advice to retail customers and enumerated numerous factors that it urged the SEC to consider relating to the need for harmonization of the standards of conduct among securities professionals.[141] Second, in Section 913(f), Congress gave the SEC expansive rulemaking authority to address the legal and regulatory "standards of care for brokers, dealers, investment advisers, [and their associated persons in] providing personalized investment advice about securities to . . . retail customers."[142] Third, in Section 913(g), Congress established a separate grant of rulemaking authority to the SEC to mandate a "best interest" standard for broker-

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to a stringent fiduciary duty requiring them to act in their customers' best interests, while broker-dealers are subject to a weaker duty that merely requires their recommendations be suitable for their customers. That interpretation of the fiduciary duty and of the suitability rule has begun to shape, and to a great extent skew, the debate. If the goal of the debate ultimately is to lead to meaningful regulatory reform, this mischaracterization is unhelpful as a starting point.").

139. *See* TREASURY REFORM REPORT, *supra* note 109, at 71–72 (the recommendation, which can be traced back to legislative hearings in the preceding year, was grouped with various consumer and investor protection measures, including establishment of a consumer financial protection agency).

140. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913, 124 Stat. 1376, 1824–30.

141. *See* § 913(b), 124 Stat. at 1824. The staff completed its report in 2011. *See infra* notes 144 & 264. Senate Hearings specifically addressed the possibility of a uniform fiduciary standard for broker-dealers and investment advisers in providing personalized investment advice to retail customers. *See Implementing the Dodd–Frank Wall Street Reform and Consumer Protection Act*, Hearing before the S. Comm. on Banking, Hous. & Urb. Affs., 111th Cong. 55 (2010) (statement of Daniel K. Akaka, Member, Senate Committee on Banking, Housing & Urban Affairs).

142. *See* § 913(f), 124 Stat. at 1827–28 (so-called "913(f)" rulemaking).

dealers and investment advisers "when providing personalized investment advice about securities to retail customers."[143]

The various sub-parts of Section 913 at the very least reflect a congressional inability to reach a bright-line legislative consensus. While it is clear that the statutory language seems to have been designed to encourage the SEC's exercise of its rulemaking authority, in the end the statutory language did not compel rulemaking. What ensued was a delayed and uneven response to the legislative aspirations expressed in the Dodd–Frank Act. The SEC staff issued a report that endorsed significant elements of harmonization with respect to a standard of conduct for securities professionals,[144] but the SEC failed to move forward and ultimately, with more than a few twists and turns in the intervening years,[145] completed a watered-down, multi-part rulemaking (referred to herein as the "Regulation Best Interest Initiative").[146] For purposes here, however, these efforts have yielded an unintended effect: confusion about fiduciary obligations of investment advisers under the IAA. The issue of regulatory confusion in the SEC's approach to fiduciary concepts under the IAA is addressed in Part IV. At this point in the article, however, it is sufficient to point out that Congress reached a new legislative insight in 2010: There is a regulatory logic in making sure that Securities Professionals who engage in advisory-only activities, even if only incidentally to other professional activities, are subjected to fiduciary obligations in order to ensure greater alignment in

143. § 913(g), 124 Stat. at 1828 (so-called "913(g)" rulemaking). The provision amended both the Exchange Act's broker-dealer requirements and the IAA's investment adviser requirements. Specifically, a new sub-section (k) was added to Exchange Act Section 15 to give the SEC the rulemaking power to establish a flexible fiduciary duty for broker-dealers in providing personalized investment advice to retail customers relative to the standard of conduct fixed pursuant to IAA Section 211's rulemaking powers. In addition, Congress amended IAA Section 211, creating a new sub-section (g), to give Congress rulemaking power to provide the standard of conduct for investment advisers and other securities professionals when providing personalized investment advice about securities to retail customers, including a best interest standard. Congress also added parallel companion provisions requiring the SEC to harmonize enforcement efforts under such rules with respect to securities professionals.

144. *See* SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS (2011); *see also* Elisse B. Walter, Comm'r, Sec. & Exch. Comm'n, Keynote Remarks at the Investment Management Institute: A Tale of Two Studies (Feb. 10, 2011).

145. *See infra* note 264.

146. *See infra* note 265.

the relevant standard of conduct applied to the securities professional. In other words, and again as relevant to the limited purview of this article, standards applicable to investment advisers, a category introduced by the IAA, may need to be rationalized relative to standards applicable to other securities professionals, and most notably, broker-dealers and their personnel.

II. THE SUPREME COURT AND THE IAA: MIXED MESSAGES ABOUT FUNCTION AND CONTEXT

The Supreme Court has considered the IAA and its underlying legislative intent in only three decisions. These decisions offer a judicial counterpoint to the narrative regarding Congress's legislative transformation of the IAA. The Supreme Court's three IAA decisions, issued over many years, are incremental stopping points that do not share a common message: *SEC v. Capital Gains Research Bureau, Inc.*[147] in 1963; *Transamerica Mortgage Advisors, Inc. v. Lewis*[148] in 1979; and *Lowe v. SEC*[149] in 1985. Two cases addressed providers of investment advice acting in an impersonal purely advisory capacity, while one concerned an adviser acting in an impersonal managerial capacity. The two decisions concerning purely advisory services are heavily reliant on legislative history to give meaning to the IAA's text. *Capital Gains* exhibits a functional, principles-based approach that advances a remedial and flexible reading of the statute that nevertheless is tethered to text.[150] In contrast, *Lowe* offers a non-textual reading of the statute, relying heavily on a selective reading of the IAA's legislative history to derive a self-limiting statutory purpose that attempts to artificially cabin the Act's scope.[151] The remaining IAA decision, reflecting a sharply-divided court, addressed implied private rights.[152] That issue transcends the confines of the IAA, but *Transamerica* was one of several decisions that foreshadowed the Supreme Court's inexorable movement toward textualist principles of statutory

147. 375 U.S. 180 (1963).
148. 444 U.S. 11 (1979).
149. 472 U.S. 181 (1985).
150. *See infra* Section II.A.
151. *See infra* Section II.B.
152. *See infra* notes 171–180 and accompanying text.

construction generally, as well as in the context of federal securities law.[153]

Supreme Court decisions interpreting a statute are on a different footing from congressional legislation as discussed in Part I. Statutory construction by courts is necessarily reactive to language choice made by Congress and is circumscribed by the way litigants frame issues for judicial review. There is another complicating factor: Judicial interpretations are snapshots in time, and these snapshots can take on a life of their own in subsequent Supreme Court dicta,[154] or may exhibit methods of statutory construction that are less favored in contemporary jurisprudence.[155] These considerations suggest a need for caution in evaluating the role of the Supreme Court in shaping the IAA's regulatory arc.[156]

A. *CAPITAL GAINS*' FUNCTIONAL APPROACH TO DECEIT

Capital Gains addressed the scope of the IAA's antifraud provision (Section 206 and more specifically Sections 206 (1) & (2)).[157] The defendant in an SEC civil proceeding, Capital Gains Research Bureau, made recommendations to subscribers of its newsletter to purchase the stock of various issuers without disclosing the adviser's practice of acquiring modest positions in the recommended issuer in advance of the adviser's recommendation, or the frequent selling of the firm's positions shortly after disseminating recommendations.[158] The strategy, while

153. *See* Jonathan T. Molot, *The Rise and Fall of Textualism*, 106 COLUM. L. REV. 1, 23–43 (2006) (tracing the various strands in the emergence of modern textualism and the consensus regarding core principles). For an excellent detailed historical analysis of these issues in shaping securities law analysis, see A.C. Pritchard & Robert B. Thompson, *Securities Law in the Sixties: The Supreme Court, the Second Circuit and the Triumph of Purpose over Text*, 94 NOTRE DAME L. REV. 371 (2018); *see also infra* Section IV.A.2 (discussing how modern textualist principles undercut the Adviser Conduct Interpretation).

154. Indeed, dicta has played a conflating role in understanding the IAA. *See infra* note 315.

155. *See infra* Section IV.A.2.

156. For example, contemporary theories of statutory interpretation are of great relevance in reaching a proper understanding of the status of fiduciary concepts under the IAA and indeed provide grounds for viewing the SEC's Adviser Conduct Interpretation skeptically. *See infra* Section IV.A.

157. SEC v. Cap. Gains Rsch. Bureau, Inc., 375 U.S. 180, 181 (1963).

158. *Id.* at 182–83.

profitable for the adviser, was a marginal source of profit for the firm.[159] The SEC sought injunctive relief to prevent this practice as fraudulent, or at least deceitful, within the meaning of the Act based on violations of Section 206(1)–which prohibits use of "any device, scheme or artifice to defraud any client"–and Section 206(2)–which prohibits participation in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client."[160] A divided *en banc* appellate court affirmed the district court's denial of an injunction on grounds that the SEC had failed to show an intent consistent with either fraud or deceit in *Capital Gains Bureau*'s actions.[161] The Supreme Court reversed and remanded, holding that proof of an intent to deceive (scienter) was not required, at least under Section 206(2).[162] The Court's holding rested on a disclosure-based rationale, or as the Court described it, liability "encompass[ing] nondisclosure of material facts."[163] In the Court's

159. *See id.* at 202 (Appendix to the Opinion of the Court).

160. The Court's opinion did not explicitly distinguish between Sections 206(1) (i.e., the fraud prohibition) and 206(2) (i.e., the prohibition of practices that operate as a fraud or deceit). However, the language the Court used to justify its holding tracked Section 206(2): "operates . . . as a fraud or deceit upon any client or prospective client." *Id.* at 191 (internal quotations omitted); *accord id.* at 192. The SEC explicitly sought relief under both subsections of Section 206. *See* Brief for Petitioner at 10, SEC v. Cap. Gains Rsch. Bureau, 375 U.S. 180 (1963) (No. 42) (urging Court to hold that "this breach of respondent's fiduciary duty violated sections 206(1) and (2)").

161. SEC v. Cap. Gains Rsch. Bureau, Inc., 306 F.2d 606, 609, 611 (2d Cir. 1962).

162. *See Capital Gains*, 375 U.S. at 201. The Court did not specifically invoke the term scienter, but rather requirements of "intent to injure" and "deliberate dishonesty." *See id.* at 192, 195, 200. The Court's subsequent explanations of similar language in the federal securities laws clarified the holding in terms of scienter. Specifically, the Supreme Court held a decade later that "fraud" under the Securities Exchange Act required scienter (that is, an intent to deceive or a culpable state of mind). *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1977). In a post-*Hochfelder* discussion of language in Section 17 of the Securities Act (language similar to Section 206(2) of the IAA), the Court held that prohibitions of "untrue statements" or practices that operate as a deceit on investors do not require scienter. *See* Aaron v. SEC, 446 U.S. 680, 695–97 (1980). In the Court's view, the plain language found in Section 17 of the Securities Act and Section 206(2) of the IAA (in light of its earlier decision in Capital Gains) made clear that such language does "not require 'a showing [of] deliberate dishonesty as a condition to protecting investors.'" *Id.* at 697 (citing *Capital Gains*, 375 U.S. at 200).

163. *Capital Gains*, 375 U.S. at 186; *see also Hochfelder*, 425 U.S. at 196–97 ("Accordingly, we hold that the Investment Advisers Act of 1940 empowers the courts, upon a showing such as that made here, to require an adviser to make full and frank disclosure of his practice of trading on the effect of his recommendations."). Congress understandably included not only a general fraud prohibition but a "specific

view, Section 206(2) was intended to cause advisers to disclose all material conflicts of interest to clients in connection with advisers' investment recommendations.[164]

The significance of this decision cannot be overstated, as it is easily the most influential judicial decision in the IAA canon. However, its treatment of the fiduciary status of investment advisers, and its meaning, remain a source of continuing uncertainty even today. The Court's purposive interpretation underscored the Act's expansive remedial purposes, but did not wholly depart from the statute's language.[165] Although the Court noted that the legislative history's primary focus was on "personalized counseling to investors," the Act's language was not so limited.[166] In other words, the IAA's plain language should not be given an unduly narrow reading to forestall a result consistent with the statutory purpose ascribed to it by the Court.[167]

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proscription against nondisclosure," given that common law courts contemporaneous with the IAA's enactment were "merging the proscription against non-disclosure into the general proscription against fraud." *Id.* at 198.

164. *See Capital Gains*, 375 U.S. at 191–92 (The IAA reflects "a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously–to render advice which was not disinterested."); *see also id*. at 187 (SEC report urged that "all conflicts of interest between the investment counsel and the client [be] removed").

165. *See id.* at 195 (Congress intended that the IAA should "be construed like other securities legislation . . . not technically and restrictively, but flexibly to effectuate its remedial purpose."). In this respect, Professors Pritchard and Thompson's views are slightly overstated. *See* Pritchard & Thompson, *supra* note 153, at 396 (arguing that Goldberg's majority opinion for the *Capital Gains* Court secured the "ultimate victory" for the dissenters in the Second Circuit over the *en banc* majority opinion that had rejected the claim on the theory that purpose could not trump text). The two authors conclude that the Supreme Court opinion in *Capital Gains* implicitly endorsed a philosophy that "statutory text was no match for the flexible/remedial interpretive canon, fueled by fiduciary duty analysis." *See id.* While Justice Goldberg's opinion admittedly exhibits a strong purposivist orientation, the opinion nevertheless attempted to find a textual foothold for its argument and specifically in the meaning of the elastic statutory phrase of "'practice or course of business which operates as a fraud or deceit' upon any client . . . ." *Capital Gains*, 375 U.S. at 191.

166. *Id.* at 187 n.15.

167. *Id.* at 199–200. The Court separately rejected an argument that the expansive rulemaking authority conferred on the SEC to "prescribe means reasonably designed to prevent . . . fraud[]" in the 1960 Amendments (new authority which was prospectively available to prohibit the conduct of the Capital Gains Research Bureau) did not compel an unduly narrow construction of the original IAA Section 206 from 1940. *Id.* at 199.

The discussion of the fiduciary nature of relation between an adviser and its client in *Capital Gains* is critical to contemporary understandings and misunderstandings of the IAA. *Capital Gains* did not hold, nor did the Court's language state, that the IAA established a broad self-effectuating fiduciary standard for investment advisers. Instead, the Court referred to the fiduciary nature of an adviser's relationship to its client as an operative feature of common law.[168] In other words, the *Capital Gains* Court subscribed to a fiduciary standard of disclosure, as argued for by the SEC at that time.[169] Subsequent isolated Supreme Court dicta have misstated the point, and recent SEC pronouncements have sought to bolster such dicta, a point that is addressed in Part IV below.[170] For now, it is sufficient to note that the opinion's expansive reading of the statute came from reading its textual proscriptions in light of then-emerging common law fiduciary duties, rather than construing the statute as itself establishing an enforceable federal fiduciary duty for investment advisers.

Transamerica, decided a little more than fifteen years after *Capital Gains*, involved an action against a fund asset manager (i.e., a form of impersonal managerial advice, unlike in *Capital Gains*).[171] The underlying private cause of action sought rescission of the adviser's advisory agreement, recovery of management fees, and monetary damages for fiduciary misconduct of the adviser.[172] Substantively, the Court offered general support for the holding in *Capital Gains*, and

168. *See id.* at 191 (The statute "reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship . . . .'"); *id.* at 194 ("Congress recognized the investment adviser to be [a fiduciary] . . . ."); *id.* at 201 ("The statute, in recognition of the adviser's fiduciary relationship to his clients," imposes requirements.).

169. *Id.* at 201:

> To insure [disinterestedness, the IAA] empowers the courts to require disclosure of material facts . . . . [W]hat is required is 'a picture not simply of the show window, but of the entire store . . . not simply truth in the statements volunteered, but disclosure.' . . . Experience has shown that disclosure in such situations, while not onerous to the adviser, is needed to preserve the climate of fair dealing which is so essential to maintain public confidence in the securities industry (internal citations omitted).

(quoting in part Harry Shulman, *Civil Liability and the Securities Act*, 48 YALE L.J. 227, 242 (1933) (discussing a similar philosophy animating the Securities Act of 1933)).

170. *See infra* notes 314–316 and accompanying text.

171. Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 13 (1979).

172. *Id.* at 14.

arguably expanded its scope in dicta.[173] Nevertheless, the only issue before the Court concerned implied rights of action under the IAA. A closely divided court held that while a cause of action for equitable relief could be implied under the language of Section 215,[174] a similar private action could not be implied for monetary damages under Section 206.[175]

The issue of implied rights of action may appear unrelated to the IAA's regulatory arc, but it has had significant unanticipated regulatory consequences. First, foreclosure of implied private actions has served as a check on expansive theories of liability under Section 206 and instead generally confined liability determinations to SEC-initiated proceedings.[176] Second, by foreclosing implied private actions for damages under the IAA, any lack of parity in conduct standards applicable to broker-dealers and investment advisers does not manifest itself in terms of remedies for damages under the federal securities law.[177]

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173. *Id.* at 17 ("As we have previously recognized, § 206 establishes 'federal fiduciary standards' to govern the conduct of investment advisers . . . ." (citations omitted)). Indeed, the Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations."). The dicta is ambiguous in an important respect as discussed in Part IV. One reading is consistent with the interpretation of *Capital Gains* offered above, namely that any fiduciary standard was tethered to (and hence qualified by) practices that operate as a fraud or deceit by a fiduciary (which is referred to herein as the "tethered" theory of fiduciary obligation). The alternative reading is that the *Transamerica* Court construed *Capital Gains* as imposing an untethered generalized fiduciary obligation on investment advisers under the IAA (which is referred to herein as the "untethered" theory of fiduciary obligation).

174. *Id.* at 18–19.

175. *See id.* at 19–24.

176. The Court has at times commented on the expansive effect created by private securities law actions. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 748 (1975); *cf.* Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961, 1006 (1994). In contrast, although the SEC frequently seeks to extend application of liability principles, it does so in ways that tends to be incremental and disciplined. *See id.*

177. The scope of IAA Section 206 is not identical with the antifraud provision of the Securities Exchange Act (Section 10(b) and Rule 10b-5 thereunder). Most clearly, there is no purchase and sale requirement under Section 206. In addition, Section 206(2) does not require scienter. *See supra* note 162**.** While the conduct of advisers involving a purchase or sale of securities could be subject to private actions to the same extent as broker-dealers under Rule 10b-5, the adviser will not face actions for monetary damage liability under Section 206. *Compare* Hennessee Grp. LLC,

The Court's decision is important in another respect. The Court framed the issue of implied private rights of action as one of "statutory construction" under the IAA.[178] While the analysis involving implication of private actions has not always been viewed on the same statutory construction footing as statutory construction in other contexts, *Transamerica* signaled a new sensibility regarding principles of statutory construction.[179] It specifically rejected resorting to statutory purpose in the absence of evidence of statutory intent to achieve the asserted result.[180] Although confined to the seemingly narrow issue of the existence of implied right of action, *Transamerica*'s statutory analysis in fact signaled a more cautious approach to statutory construction generally, including under the IAA. *Transamerica*'s textual analysis of the IAA stands as a harbinger for renewed focus on textual analysis in matters arising under the IAA specifically as well as other statutes generally, an issue that reappears in Section IV.A.2 below.

B. *LOWE* AND CONTEXTUAL DYSFUNCTION

Unlike the Supreme Court's flexible textual reading of the IAA in *Capital Gains* or the more searching textual reading in *Transamerica*, *Lowe*[181] represents a puzzling exploration of the IAA by the Supreme Court. The decision exemplifies an unapologetically purposivist

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Investment Advisers Act Release No. 2871, 2009 WL 1077451, at *11 (Apr. 22, 2009) (finding fraudulent and deceitful conduct under the IAA), *with* S. Cherry St. LLC v. Hennessee Grp. LLC, 573 F.3d 98, 115 (2d Cir. 2009) (affirming dismissal of private investor private action under Rule 10b-5 for failure to allege facts satisfying the relevant scienter pleading requirement).

178. *Transamerica*, 444 U.S. at 15 ("The question whether a statute creates a cause of action, either expressly or by implication, is basically a matter of statutory construction.").

179. *See id.*; *see also* Molot, *supra* note 153, at 20–23 (discussing how implied right of action jurisprudence served as a precursor for the modern shift in Supreme Court case law on statutory interpretation). This shift began with a very malleable textual/purposive approach (*see generally* Cort v. Ash, 422 U.S. 66 (1975)) that has given way to a much more searching textual approach. *See generally* Alexander v. Sandoval, 532 U.S. 275 (2001). *Transamerica*, as well as another securities law case, *Touche Ross & Co. v. Redington*, signaled some discomfort with the Court's *Cort* jurisprudence. 422 U.S. 560 (1979).

180. *Transamerica*, 444 U.S. at 24 ("But the mere fact that the statute was designed to protect advisers' clients does not require the implication of a private cause of action for damages . . . . The dispositive question remains whether Congress intended to create any such remedy." (citations omitted)).

181. 472 U.S. 181 (1985).

approach to interpreting the statute and in this case, an unusually unpersuasive reading of the legislative history and text.[182] Before the Supreme Court, the case concerned the propriety of an injunction against continued publication of an investment newsletter by a former (and therefore unregistered) investment adviser who had been the subject of an administrative order barring him from the industry.[183] The injunction presented a constitutional issue of enjoining continued publication of an investment newsletter (that is, a form of prior restraint of publication).[184]

A threshold issue for the majority turned on the construction of the statutory term "investment adviser" and its exclusion of a publisher of "any bona fide newspaper . . . or financial publication of general and regular circulation"–the so-called publisher exclusion.[185] Writing for the majority, Justice Stevens invoked principles of constitutional avoidance to indicate that construction of the publisher's exclusion should be given the widest possible latitude to either narrow or eliminate any constitutional question.[186] With that, his opinion launched into a consideration of the purposes of the IAA to inform its understanding of the publisher exclusion.[187] After an extensive survey of the legislative history and hearings leading to enactment of the IAA, Justice Stevens concluded that "the Act was designed to apply [only] to those persons . . . who provide personalized advice attuned to a client's concerns,"[188] rather than persons providing communications that "remain entirely impersonal and do not develop into . . . fiduciary,

182. *See infra* notes 322–325 and accompanying text (discussing purposivist approaches to statutory construction).

183. *Id.* at 183. Lowe had previously been sanctioned by the SEC for misconduct in operating an investment advisory firm that he owned and was barred from the industry by an SEC enforcement action. Subsequently, he began to market two different investment newsletters and another publication that provided stock charts. The SEC contended that Lowe was acting as an investment adviser in violation of the injunction barring him from the industry. *See id.* at 184–86.

184. *Id.* at 211, 228–35 (White, J. concurring). For Justice White and two other justices, prior restraint in violation of the First Amendment was the central issue: one which the majority opinion avoided based on its finding that Lowe was not acting as an investment adviser.

185. 15 U.S.C. § 80b-2(a)(11)(D); *see also Lowe*, 472 U.S. at 203.

186. *See Lowe*, 472 U.S. at 189–90.

187. *See id.* at 190–202.

188. *Id.* at 207–08.

person-to-person relationships."[189] Because Lowe came within the publisher's exclusion, the majority opinion concluded he had not acted as an investment adviser.[190] Since he had not violated the original injunction, the Court reinstated the district court's decision that had denied the SEC's request for an injunction prohibiting Lowe from publishing his investment newsletters.[191]

Justice White's concurrence for three justices zeroed in on the problematic features of Justice Stevens' analysis, beginning with the majority's invocation of constitutional avoidance as a justification for its statutory construction.[192] Prior restraint, whether applied to the press or commercial speech, as Justice White observed, is disfavored under well-established constitutional doctrine, and therefore, avoidance principles provided no basis for a contorted reading of the IAA.[193] Instead, Justice White provided a close reading of the statute and legislative history to rebut the idea that the statute enacted by Congress in 1940 was solely limited to personalized advice.[194] Although the legislative history contained multiple references to examples of personalized investment advice (as Justice Stevens noted), this "hodgepodge of materials" showing that Congress was indeed focused on personalized advice in part, could not exclude or narrow the meaning of "investment adviser" given the statute's language and a legislative history that explicitly encompassed impersonal investment advice as well.[195] The statute's text expressly indicated that the statute went beyond personalized advice.[196]

189. *Id.* at 210.

190. *Id.* at 211.

191. *Id.* at 210.

192. *Id.* at 211–36.

193. *See id.* at 212–13, 227. *See generally* Neal Kumar Katyal & Thomas P. Schmidt, *Active Avoidance: The Modern Supreme Court and Legal Change*, 128 HARV. L. REV. 2109 (2015) (discussing how constitutional avoidance frequently functions to mask judicial activism through statutory construction).

194. *See Lowe*, 472 U.S. at 219–23.

195. *Id.* at 221 n.7.

196. *Id.* at 218. The plain language of the investment adviser definition by its own terms is not limited to personalized advice, but rather expressly encompasses impersonal forms of written advice provided by businesses which "issue[] or promulgate[] analyses or reports concerning securities." 15 U.S.C. § 80b-2(a)(11). The concurrence also noted that the Act's narrower term "investment counsel" in Section 208, which in 1940 was regarded primarily as a form of personalized investment management, served as further statutory evidence that the more general term "investment adviser" was broader in scope than merely personalized advice. *Id.* at 221 n.7. Finally, the use of a "bona fide publication" in the exclusion suggested that there

Moreover, the majority's view was at odds with the Court's own prior observations regarding the statute's scope in *Capital Gains*.[197]

Contrary to the majority's straightjacketed version of the statute, the IAA, as enacted in 1940, imposed only modest regulatory burdens. The SEC's original legislative goal in proposing the adviser legislation in 1940 was mainly to gather information in an unsupervised area, which implicitly signaled an open-ended agenda in terms of future initiatives for a more comprehensive regulatory approach.[198]

There is also some irony to the majority's opinion in *Lowe*. As noted, the investment management industry regulates asset managers that provide impersonal asset management services to pooled investment vehicles with respect to assets in the tens of trillions of dollars. Justice Stevens' theory of the statute as exclusively focused on personal investment management advice was anachronistic, even at the time of the *Lowe* decision. Again, as noted, Congress had specifically amended the IAA in 1970 to eliminate the registration exemption for managers that exclusively served registered investment companies, namely asset managers providing impersonal advice.[199] The antiquated view of investment advice as wholly personalized has given way in practice to a brave new world of layered advisory services in which an investor receives overlapping investment services from different sources. For example, retail investors may frequently receive personalized investment advice from a wealth manager who consults research materials prepared by other advisers to select an investment portfolio whose components are investment funds managed by asset managers providing impersonal management services. Thus, the role of the IAA is not, as *Lowe* suggests, to explain one of many layers of investment

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were impersonal publications that would not come within the exclusion. In addition, the majority was silent as to how impersonal forms of asset management (involving pooled investment vehicles) came within the statute, given that, in its view, the statute was exclusively designed to address personalized advice.

197. *See* SEC v. Cap. Gains Rsch. Bureau, 375 U.S. 180, 187 n.15 (1963) ("While the [Investment Trust Study] concentrated on investment advisory services which provide personalized counseling to investors . . . [the relevant Senate Committee] did receive communications from publishers of investment advisory services . . . and the Act specifically covers 'any person who, for compensation, engages in the business of advising others, either directly or through publications or writings.'") (quoting 15 U.S.C. § 80b-2).

198. *See supra* Section I.A.

199. *See supra* Section I.C.

advisory services, but rather an attempt to encompass the many layers of investment advice within a single overarching statutory model.

Finally, *Lowe* needlessly created an unnecessary regulatory loophole for the incipient internet age. The internet enables purveyors of impersonal investment advice to blast (i.e., disseminate) their recommendations to the public, including in targeted form through social media. Is such information personalized if it is part of a targeted social media campaign? Analytically, there is no reason to think such electronically mass disseminated communications (e.g., blast e-mails) are any more personalized than a newsletter disseminated by ordinary mail. If there is no distinction, social media would constitute an apparent expansive loophole created by the *Lowe* Court's reasoning. Notwithstanding the obstacle created by *Lowe* in applying the IAA to advice disseminated over social media, the SEC has successfully worked around the problem.[200]

* * *

What can be said about the Supreme Court's mixed messages? In the end, the legal consequences of the Court's decisions have varied. *Capital Gains* represented a huge stride in understanding the scope of the Act's antifraud provision as encompassing a fiduciary disclosure standard tethered to practices that might operate as a fraud and deceit through a functional interpretation of the statute's language. *Transamerica* underscored the significance of the IAA text in understanding its regulatory arc and indirectly elevated the significance of the SEC by largely sidelining any private actions for damages for clients under the IAA (though not foreclosing private remedies under the Exchange Act). *Lowe* stands out as an unfortunate decision that is difficult to square with the statute's language or regulatory arc. The

200. *See* SEC v. Park, 99 F. Supp. 2d 889, 896 (N.D. Ill. 2000) (distinguishing *Lowe* because blast e-mail created the semblance of personalized communications). In addition, the SEC has sidestepped *Lowe*'s insulation of material arguably covered by the "publisher exclusion" by recourse to the antifraud provisions of the Exchange Act where the content disseminated is actually fraudulent (thus, eliminating the need to show that the malfeasor acted as an investment adviser). *See, e.g.*, SEC v. Pirate Invs. LLC, 580 F.3d 233 (4th Cir. 2009) (affirming judgment against publisher for violating Exchange Act's antifraud provision in connection with its recommendation of an issuer's company that contained false information); SEC Brings Fraud Charges Against Former CBS MarketWatch Columnist Thom Calandra for Illegal Trading Scheme, Litig. Release No. 19028 (Jan. 10, 2005) (TV news commentator touting stocks for personal gain found to have violated Exchange Act's antifraud provisions).

Supreme Court's contribution to the IAA's regulatory arc ultimately stands as a detached and intermittent one, which has shaped the statute's application, but not its direction.

III. THE SEC'S EXPANDING ROLE IN SHAPING THE IAA'S APPLICATION

Unsurprisingly, the SEC has proven an integral force in shaping policy under the IAA. As the agency charged with administering the federal securities laws, including the IAA, the SEC's administration is continuous and ongoing and, therefore, the SEC performs a role unlike the roles performed by either Congress or the Supreme Court. Its role is necessarily subordinate to Congress' statutory role in shaping policy, but the agency has had a more pronounced effect in shaping policy than the Supreme Court (and other courts) which, as noted, have had more of an effect in shaping application rather than policy.[201] The SEC has been influential in shaping policy in three broad respects. As previously discussed in Part I, the SEC has been a key proponent of many legislative initiatives, an SEC role that is not revisited in this section. In its more conventional role of administering the IAA, the agency exercises a direct policy-setting role through its expansive rulemaking powers. Finally, the agency is able to affect standards of conduct and practice through its enforcement and examination powers.

In this section, the article turns toward these latter roles of rulemaking and enforcement and, in particular, how the agency has changed its orientation over time. The first sub-section of this Part provides a synopsis of SEC agency rulemaking and enforcement action prior to 2000 in the IAA context and the second section provides a comparative synopsis of agency action after 2000.

The SEC's role under the IAA has expanded over time with respect to asset management issues relative to its historic emphasis on oversight of personalized investment management. The SEC's role in shaping policy in the asset management sphere has grown significantly for two reasons. First, in conjunction with continuous expansion of the IAA's scope and the SEC's rulemaking, asset management issues have loomed large in presenting more difficult and intricate challenges. Over time, the SEC has exercised its enforcement powers with greater assertiveness,

201. *See supra* Part II.

which two commentators have dubbed "regulation by accretion."[202] In addition, the agency has used its rulemaking powers to enhance structural safeguards where asset managers have garnered increased regulatory attention because of their rapid growth (from something around several billion dollars in assets managed in 1940 to managed assets in the tens of trillions of dollars today).[203]

A. THE SEC'S ACTIONS PRIOR TO 2000

As noted, the statute was originally inadequate through its failure to provide the SEC with the necessary rulemaking authority or an ongoing presence to ensure enforcement. What is most significant in the period prior to 2000 was that the SEC gained the rulemaking power and enforcement resources that enabled it to exercise a significant role in shaping the IAA's regulatory arc.

1. The SEC Flexing Its Rulemaking Muscles

The 1960 IAA Amendments fundamentally altered the SEC's role in administering the IAA by expressly granting rulemaking in two specific areas.[204] The SEC acted first with respect to recordkeeping issues. Congress gave the SEC new rulemaking powers over books and records to accompany the amendment that gave the SEC examination powers.[205] As would be expected, such rules were tightly focused in response to the Congress's rulemaking grant.

The other relevant area of rulemaking authority related to the SEC's prophylactic antifraud rulemaking authority pursuant to IAA Section 206(4). As noted earlier, this grant of rulemaking authority entailed a broader degree of administrative discretion that empowered the SEC to adopt rules which "prescribe means reasonably designed to prevent" fraudulent and deceptive practices.[206] These rules expressly

202. *See generally* Barry P. Barbash & Jai Massari, *The Investment Advisers Act of 1940: Regulation by Accretion*, 39 RUTGERS L.J. 627 (2008).

203. *See supra* note 5 and accompanying text.

204. *See supra* Section I.B.

205. 17 C.F.R. § 275.204-2 (1961). The rule had the desired effect of opening up adviser activity to regulatory review judging by decisions that followed. *See, e.g.*, SEC v. Olsen, 354 F.2d 166, 170 (2d Cir. 1965) (sustaining civil contempt order against investment adviser based on the adviser's withholding of its public business records from the SEC based on a generalized assertion against self-incrimination).

206. *See supra* Section I.B.

encompass practices that are not themselves fraudulent or deceitful (i.e., rules designed to rein in practices that might lead to fraud or deceit) and, therefore, the subject matter of such rules may have a broader scope than fraud and deceit limitations of Sections 206(1) and Section 206(2).[207]

The agency, in short, moved forward with prophylactic rulemakings in two areas which it perceived as having the highest priority in terms of curbing abusive practices. It began with an advertising rule (Rule 206(4)-1)[208] motivated by seemingly obvious investor protection considerations in the form of a conduct integrity rule: Investment advisers are skilled professionals dealing in specialized information in situations, while "prospective clients . . . are frequently unskilled and unsophisticated in investment matters."[209] Such clients are likely to lack the ability to meaningfully assess the quality of the services they receive when rendered. Neither the proposing nor adopting releases identify sources for the rule's proscriptions, but they bear some relationship to those found in the Statement of Policy relating to investment company sales literature that set forth disclosure principles to minimize deceptive practices in connection with the sale of fund shares.[210] Commentators in the immediate wake of the advertising rule's proposal expressed some misgivings as to its potential scope.[211] However, that rule has stood the test of time, and only recently did the

207. *See supra* note 73 and accompanying text.

208. 17 C.F.R. § 275.206(4)-1 (2010).

209. *See* Adoption of Rule 206(4)-1 under the Investment Advisers Act of 1940, Investment Advisor Act Release No. 121., 26 Fed. Reg. 10548 (Nov. 9, 1961); *see also* Investment Advisers Act Notice of Proposed Rulemaking, Investment Advisor Act Release No. 113, 26 Fed. Reg. 3070 (Apr. 11, 1961).

210. At the time, Securities Act Rule 156, regarding investment company sales literature, did not exist. *See* 17 C.F.R. § 230.156. However, a prototype for Rule 156 did exist in the form of a statement of policy. *See* Statement of Policy, Securities Act Release No. 3385, 15 Fed. Reg. 5469 (Aug. 14, 1950) (a statement of policy with respect to the use, form, and content of sales literature and advertising employed by dealers and underwriters in the sale of investment company securities); *see also* Donald C. Cook, Vice Chairman & Comm'r, Sec. & Exch. Comm'n, SEC Policy Regarding Supplemental Literature of Investment Companies (Aug. 29, 1950) (addressing the Mutual Fund Sales Conference).

211. *See generally* Allen E. Throop & Thomas A. O'Boyle, *Developments in Federal Securities Regulation*, 16 BUS. LAW. 828 (1961); Peter A.K. Reese, *Securities Legislation of 1960–Part 1*, 17 BUS. LAW. 412 (1962).

SEC give it a significant facelift in light of changes in the industry and in marketing practices.[212]

The other rule—Rule 206(4)-2, the so-called "custody rule"—addressed custody of client assets managed by advisers, a structural integrity issue.[213] While a similar rule already existed for broker-dealers,[214] that rule was promulgated pursuant to rulemaking authority tailored to the SEC's authority to oversee the financial solvency of broker-dealers.[215] In contrast, the IAA custody rule confers authority to prescribe "means reasonably designed to prevent" fraudulent and deceptive practices.[216] While it is easy to see how custody requirements might deter certain abusive practices and promote integrity, such requirements are less directly related to prevention of fraud and deceit than, for example, rules against deceptive advertising. In other words, from the SEC's perspective, its prophylactic rulemaking authority was capacious indeed, and encompassed preventative measures consistent with cultivating accountability as well as measures targeting business conduct and practices linked to patterns of malfeasance.

Notwithstanding Section 206(4)'s expansive possibilities, the SEC's prophylactic rulemaking authority remained dormant for nearly another 20 years. This is somewhat surprising, because the SEC had advocated for, and indicated an intent to use, the new rulemaking authority more freely.[217] Although the rule regulating use of cash solicitations by advisers in marketing their services through professional solicitors was initially proposed in 1968, it was not adopted until 1979 in a revised form.[218]

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212. *See* Investment Adviser Marketing, Investment Adviser Act Release No. 5653, 86 Fed. Reg. ___ (Dec. 22, 2020) (adopting release).

213. 17 C.F.R. § 275.206(4)-2 (2010).

214. 17 C.F.R. § 240.15c3-3 (2003).

215. 15 U.S.C. § 78o(c)(3)(A) (a far more specific grant of rulemaking authority to "prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers' securities and the carrying and use of customers' deposits or credit balances").

216. *See* 15 U.S.C. § 80b–6.

217. *See Special Study Report*, *supra* note 78, at 386–87.

218. Although a rule regulating use of cash solicitations by advisers in marketing their services through professional solicitors was initially proposed in 1968 (*see* Proposed Rule 206(4)-3, Investment Advisers Act Release No. 231, 33 Fed. Reg. 15669 (Oct. 23, 1968)), a final rule was not adopted until 1979 in a revised form. *See*

Once again, the SEC paused before again seeking to invoke its prophylactic rulemaking powers under the IAA.[219] In 1994, the SEC sought to implement a suitability requirement under the IAA.[220] The rulemaking was an early, ambitious attempt to use the prophylactic rulemaking authority to extend or at least clarify the fiduciary obligations of investment advisers (especially in the area of personalized advice to retail investors) under the IAA.[221] The SEC retreated in the face of opposition, though maintaining that many aspects of its rulemaking were implicit in Sections 206(1) and (2) as reflected in prior enforcement actions. As the century drew to an end, it was fair to say that the SEC chose to refrain from using its prophylactic rulemaking to address personalized investment advice in an assertive fashion, though clearly subsequent rules have imposed requirements affecting both institutional asset managers as well as advisers providing personalized advice.

2. The SEC's Evolving Enforcement Priorities

In the IAA's early years, the SEC's enforcement activity was noticeably low. There were sporadic cases, typically triggered by either egregious conduct or instances where a firm acted as both broker-dealer and investment adviser,[222] presumably because the firm was already on

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Requirements Governing Payments of Cash Referral Fees by Investment Advisers, Investment Advisers Act Release No. 688, 44 Fed. Reg. 42126 (July 18, 1979).

219. In 1987, the SEC did adopt IAA Rule 206(4)-4 which required an investment adviser to disclose to clients material financial and disciplinary information. *See* Financial and Disciplinary Information that Investment Advisers Must Disclose to Clients, Investment Advisers Act Release No. 1083, 52 Fed. Reg. 36915 (Sept. 25, 1987). This requirement was subsequently rescinded and restated as a disclosure requirement in the advisory brochure pursuant to Rule 204-3. *See* 17 C.F.R. § 275.204-3 (1961). In other words, the original (and thoroughly unremarkable) requirement did not really require invocation of the SEC's prophylactic rulemaking powers.

220. *See* Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients, Investment Advisers Act Release No. 1406, 59 Fed. Reg. 13464 (Mar. 22, 1994) [hereinafter *Suitability of Investment Advice Release*].

221. *Id.*

222. For an early example in this regard, see Hughes v. SEC, 174 F.2d 970, 977 (D.C. Cir. 1949) (holding broker-dealer registration was properly revoked when dual registrant's conduct, acting as a fiduciary, violated both Exchange Act and IAA antifraud prohibitions). Another significant case, of somewhat later vintage, applied the

the SEC's regulatory screen. The SEC could also bring actions against investment advisers that advertised publicly, such as impersonal subscription services that provided investment advice.[223] Activity increased somewhat in the retail area after the mid-1960s,[224] but the cases, by contemporary standards, were still relatively few in the institutional asset area.[225]

The SEC did not bring many enforcement actions against asset managers prior to 1990.[226] In the case of registered companies, the SEC sometimes seemingly exercised restraint to avoid cumulative violations under both the ICA and the IAA.[227] This practice began to change in the

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antifraud proscriptions of the Exchange Act and the IAA to a large branch-office broker/dealer-investment adviser firm and found significant supervisory deficiencies in the branch office structure. *See* Shearson, Hammill & Co., Exchange Act Release No. 7743, 1965 WL 87139 (Nov. 12, 1965).

223. *See, e.g.*, SEC v. Cap. Gains Rsch. Bureau, 375 U.S. 180, 284 (1963); SEC v. Blavin, 760 F.2d 706, 710 (1985) (imposing sanctions where investment newsletter violated the IAA in failing to register as an investment adviser). Subscription services were an area of focus in the Special Study. *See Special Study Report*, *supra* note 78, at 359–69 (describing abusive practices in which subscription service produced reports that could be used by broker-dealers to tout security).

224. *See* Suitability of Investment Advice Release, *supra* note 220, at n.5.

225. *See, e.g.*, Kidder, Peabody & Co., Inc., Investment Advisor Act Release No. 232 (Oct. 16, 1968) (sanctioning firm and associated person in settled administrative proceeding for trading activities in a unit (Special Investment Advisory Service) dealing with either institutional asset managers or very wealthy clients). Part of the explanation for the lack of activity before 1960 can be attributed to the lack of books and records requirements and examination authority until 1960. *See* Requirement to Maintain Specified Books and Records, Investment Advisor Act Release No. 111, 26 Fed. Reg. 987 (Feb. 1, 1961) (adopting release).

226. There are some rare examples. *See, e.g.*, E.F. Hutton & Co., Inc., Investment Company Act Release No. 14773 (Oct. 29, 1985) (finding adviser violations of the ICA and antifraud provisions of the IAA relating to purchases and redemptions of fund series shares at incorrect prices, which in turn resulted in miscalculation of investor share holdings and fees); Steadman v. SEC, 450 U.S. 91, 92–94 (1981) (in addressing relevant standard for burden of proof, noting that case had arisen from a proceeding which alleged violations by the petitioner of the IAA and ICA).

227. *See, e.g.*, Fred Alger Mgmt., Inc., Investment Company Act Release No. 17358, 45 SEC Docket 790 (Feb. 26, 1990) (finding adviser aided and abetted misstatements in a registered investment company registration statement regarding adviser's performance record with advisory accounts (without any IAA antifraud finding), but compelling, as a condition of settlement, that the adviser employ a compliance officer); Stein Roe & Farnham, Inc., Investment Company Act Release No. 17316, 45 SEC Docket 502 (Jan. 22, 1990) (finding ICA violation of affiliate compensation prohibition relating to fund brokerage allocation practices but silent as to

1990s,[228] and was all but abandoned in the 21st century in the face of the Late Trading and Market Timing scandal and the adoption of new rules.[229] While this difference may seem largely technical, combined ICA and IAA actions have the effect of framing the adviser as a primary violator in connection with ICA violations. As seen below, the IAA can no longer be viewed as focused solely on enforcement against advisers who serve retail clients. Rather, it is the primary statute for accountability under the federal securities laws of investment advisers of all stripes, whether retail advisers or asset management firms.

B. ENHANCED SEC ENGAGEMENT AFTER 2000

The 21st century did not begin auspiciously for the SEC on the advisory regulatory front.[230] In 2003, the mutual fund industry experienced the massive Late Trading and Market Timing scandal (the "LTMT Scandal").[231] In relatively short order, it suffered two significant

possible IAA antifraud violations). The SEC's failure to assert cumulative ICA and IAA violations was not compelled by statute, but rather was a matter of self-imposed restraint. The Supreme Court had previously established that violations under federal securities statutes are cumulative. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 386 (1983) ("A cumulative construction of the securities laws . . . furthers their broad remedial purposes.").

228. *See, e.g.*, Strong/Corneliuson Cap. Mgmt, Inc., Investment Advisers Act Release No. 1425, Investment Company Act Release No. 20394, 1994 WL 361971 (June 12, 1994) (finding violations by adviser of the principal transaction prohibition of the ICA and IAA antifraud provision in connection with cross-trades between private fund and registered investment companies managed by the adviser); Van Kampen Inv. Advisory Corp. & Alan Sachtleben, Investment Advisers Act Release No. 1819, Investment Company Act Release No. 23996, 70 SEC Docket 1213 (Sept. 8, 1999) (finding both ICA and IAA antifraud violations by adviser and its personnel in connection with dissemination of performance figures in sales literature that was misleading in failing to alert investors that figures were based on *sui generis* gains that could never be realized in the future).

229. *See infra* notes 237 & 240.

230. Independent of advisory regulatory issues, Congress and the SEC responded separately to massive public company accounting scandals in 2001 and 2002 that led to Congress's enactment of the Sarbanes-Oxley Act (Sarbanes-Oxley Act, Pub. L. No. 107–204, 116 Stat. 745 (2002)) and a corresponding intensive round of rulemaking and enforcement by the SEC.

231. For a description of the scandals, see Tamar Frankel & Lawrence A. Cunningham, *The Mysterious Ways of Mutual Funds Market Timing*, 25 ANN. REV. BANKING & FIN. L. 235 (2006); Mercer Bullard, *The Mutual Fund as a Firm: Fund*

IAA rulemaking defeats in the D.C. Circuit,[232] not to mention the revelation of a massive Ponzi scheme where the SEC appeared to have failed to pursue red flags.[233] Nevertheless, robust regulatory responses, aided in part by post-Financial Crisis congressional action, emerged from these temporary setbacks and ultimately left the SEC with a more robust regulatory arsenal than where it had started in 2000. As noted, the SEC responded aggressively to trading scandals and in other areas as well. This subsection focuses on two rules adopted during this period that greatly expanded its regulatory focus with respect to institutional asset managers and, concomitantly, its enforcement arsenal: the IAA's compliance rule and the private funds antifraud rule.[234] In the case of institutional asset managers, these rules illustrate the indispensable value of the SEC's prophylactic antifraud rulemaking authority to effect both structural and conduct integrity objectives.

1. The Compliance Rule and Its Enforcement

The SEC adoption of separate compliance rules under the IAA and ICA represented both its first and most powerful rulemaking response.

Arbitrage, Frequent Trading and the SEC's Response to the Mutual Fund Scandal, 42 HOUSTON L. REV. 1271 (2006).

232. *See* Fin. Plan. Ass'n v. SEC, 482 F.3d 481, 485 (D.C. Cir. 2007) (striking down a rule than excluded broker-dealers charging asset-based fees from the definition of investment adviser and therefore as beyond the scope of the IAA); SEC v. Goldstein, 451 F.3d 873, 884 (D.C. Cir. 2006) (striking down an SEC rule that had the practical effect of requiring hedge fund advisers to register under the IAA (the rule itself related to the method of counting clients for purposes of the then-existing Section 203(b)(3) registration exemption for advisers with less than 15 clients)).

233. *See* OFF. OF INVESTIGATIONS (INSPECTOR GENERAL), SEC. & EXCH. COMM'N, REP. NO. OIG-509, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME (2009) (Public Version); *see also* Donald C. Langevoort, *The SEC and the Madoff Scandal: Three Narratives in Search of a Story*, 2009 MICH. STATE L. REV. 899, 900–01 (2009).

234. See 17 C.F.R. §§ 275.206(4)-7 and 206(4)-8, respectively. Other rules adopted pursuant to § 206(4) had similar, but more specialized, consequences for institutional asset managers in particular. *See* 17 C.F.R. § 275.206(4)-5 (prohibiting the provision of investment advisory services to government entity clients when the investment advisor or affiliated personnel make time proximate political contributions to a related government official of the prospective client) (adopted 75 Fed. Reg. 41069 (July 14, 2010); *see also* 17 C.F.R. § 275.206(4)-6 (Rule 206(4)-6) (prohibiting an adviser from exercising proxy voting authority on behalf of client with respect to the client's securities, absent safeguards to ensure proper exercise of authority and information to client regarding the exercise of such authority).

Although the Compliance Rule, Rule 206(4)-7, was adopted in the wake of the LTMT Scandal,[235] the Rule had actually been proposed before the scandal revelations.[236] Revelation of the scandals added urgency to the adoption of that rule and others.[237] The Compliance Rule imposes three critical affirmative obligations on advisers:

> (1) Adoption and implementation of written policies and procedures reasonably designed to prevent securities law violations;
>
> (2) Annual reviews of the policies and procedures for adequacy and effectiveness; and
>
> (3) Designation of a chief compliance officer (CCO) to administer the policies (in other words, there must be someone who is legally answerable for ensuring adherence to the compliance rule).

The Compliance Rule was adopted pursuant to the agency's prophylactic antifraud rulemaking authority and, like the Custody Rule, is a notable application of that rulemaking authority. These rules are not directed at a specific type of conduct that typically entails misconduct. Rather the rules enable the SEC to effectuate structural regulatory requirements to ensure integrity and accountability generally (while no doubt preventing specific incidents of abuse). The Compliance Rule specifically mandates a self-policing infrastructure for investment advisers. The requirements apply equally to large and small advisers, but the mandate necessarily scales to the asset management firm's operating risk. In other words, the more complex the advisory firm, the more demanding the obligation to provide "policies and procedures reasonably designed to prevent violations" (i.e., the more sophisticated

235. Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299, 68 Fed. Reg. 74714 (Dec. 24, 2003) (adopting release).

236. Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 25925, 68 Fed. Reg. 7038 (Feb. 5, 2003) (proposing release).

237. The adopting release focused on the timing scandals in the first three of four paragraphs of the release, even though it had not figured in the proposing release. *See* Investment Advisers Act Release No. 25925, *supra* note 236, at 74714–15. The LTMT Scandal was also instrumental in the Adviser Code of Ethics Rule. *See* Rule 204A-1 (17 C.F.R. § 275.204A-1 (2004)) (mandating adviser obligations to adopt Code of Ethics and minimum requirements therefor) (adopted in Investment Advisers Codes of Ethics, Investment Company Act Release No. 2256, 69 Fed. Reg. 41696 (July 2, 2004)).

and far-flung the asset management firm, the more sophisticated the requisite policies and procedures for the firm).[238] Moreover, the fact that the obligation contains an ongoing annual review requirement ensures that existing policies and procedures must be regularly updated to keep abreast of evolving best practices.

The Rule's requirements were arguably novel, and the SEC announced reassuringly that its initial application of the rule would be collaborative and deferential to industry judgment.[239] Early enforcement proceedings involved basic violations of the Compliance Rule where an adviser either lacked, or had patently inadequate, written compliance policies and procedures.[240] The rule applies equally to all investment advisers, whether small or large, or whether retail or institutional. Over time, administrative proceedings finding violation of the Compliance Rule have become voluminous. Examples of the Compliance Rule's application to the increasing complexity of institutional asset managers operations show how it functions to address subtle forms of misconduct as well as enable a form of fluid regulatory oversight.[241] For example, the SEC determined that advisers had failed to meet their compliance obligations when:

- A firm (i) failed to detect coding errors in complex computer program used to implement quantitative investment portfolio strategy, (ii) failed to detect discrepancies in the performance of

238. 17 C.F.R. §§ 275.6(4)-7(a). The result follows from the rule's language. The policies and procedures must be reasonably designed to prevent violations and, for more complex advisory firms, what is "reasonable" in terms of policies and procedures will scale up to align with the complexity of the organization's business.

239. *See, e.g.*, Chairman William H. Donaldson, Sec. & Exch. Comm'n, Remarks before the Mutual Fund and Investment Management Conference (March 14, 2005) (describing new SEC "CCOutreach Program" designed "to communicate with CCOs, answer their questions, and give them the information and support they need from the Commission to perform their critical oversight function").

240. *See, e.g.*, Omni Inv. Advisors, Investment Advisers Act Release No. 3323, 102 SEC Docket 1878 (Nov. 28, 2011) (sanctioning a firm that lacked a compliance program for two years and thereafter named as CCO an executive located much of the time in a foreign country).

241. As discussed *infra* in note 338 and the accompanying text, the Compliance Rule serves to fill in a gap in the antifraud protection afforded by Section 206(2) with respect to the duty of care of advisers. As argued there and in Section IV.A.2., Section 206(2) addresses only duty of care violations involving deceit and does not encompass a duty of care generally. The Compliance Rule provides a structural integrity rule that makes it possible to address duty of care issues indirectly through a duty to have adequate policies and procedures to prevent violations of the IAA and rules thereunder.

> the model portfolio over a two year period; and (iii) lacked adequate quality control over development, testing and alteration in model by the portfolio manager.[242]
>
> • An adviser to registered funds and institutional accounts failed to identify misstatements made by a sub-adviser (a separate asset management firm) regarding historical performance of a quantitative sector rotation strategy managed by the sub-adviser that in turn caused the adviser to make misstatements to its own clients in reliance on the sub-adviser's misstatements (i.e., the adviser failed to maintain adequate oversight of the integrity of the sub-adviser it retained to provide portfolio management services).[243]

Findings of pervasive or egregious substantive violations of the IAA are typically coupled with a finding of a Compliance Rule violation.[244] The logic of this pattern is straightforward: A substantive violation is circumstantial evidence of the absence of policies and procedures, or lack of enforcement of such policies or procedures, reasonably designed to prevent the violation that actually occurred. Firms with "adequate" policies and procedures should not have violations, at least according to this type of logic.[245] However, if applied

242. *See* AXA Rosenberg Grp. LLC, Investment Advisers Act Release No. 3149, 100 SEC Docket 1126 (Feb. 3, 2011); *see also* Barr M. Rosenberg, Investment Advisers Act Release No. 3285, 101 SEC Docket 4053 (Sept. 22, 2011) (related proceeding involving the portfolio manager responsible for quantitative model whose violations went undetected by the parent firm's compliance program).

243. *See* Virtus Inv. Advisers, Inc., Investment Advisers Act Release No. 4266, 112 SEC Docket 5581 (Nov. 16, 2015); *see also* F-Squared Investments, Investment Advisers Act Release No. 3988, 110 SEC Docket 2953 (Dec. 22, 2014) (related proceeding involving substantive violations of the sub-adviser).

244. Barclays Cap., Inc., Investment Advisers Act Release No. 3929, 109 SEC Docket 5029 (Sept. 23, 2014) (finding compliance violation when dually-registered adviser with significant compliance resources had numerous substantive violations in newly acquired advisory business from another investment bank which went undetected because the compliance program had not completed its integration of the new unit).

245. An exception to this pattern is found in the Matter of Paradigm Capital Management, Inc., Investment Advisers Act Release No. 3857, 109 SEC Docket 430 (June 16, 2014), but even there the adviser agreed, as part of its sanction, to retain the services of an independent compliance consultant (a common feature in administrative settlements.

too stringently, such logic has perverse effects because it creates a form of strict liability for compliance officers and compliance programs.[246]

A more aggressive consequence in application of the Compliance Rule has been compliance violations in situations involving substantive violations arising in intricate or highly specialized areas of operation,[247] or failure to follow existing policies and procedures in seemingly novel and *sui generis* contexts.[248] In another variation of the Compliance Rule's application, the existence of suspicious circumstances without a showing of a substantive violation led to a finding of deficient compliance procedures, though the insufficient policies and procedures meant that there was no evidence to show whether the suspicious activity actually involved misconduct.[249] Such a regulatory approach flips the typical pattern of policies and procedures that would have prevented a violation from happening. In effect, the adviser must have effective policies and procedures that enable the regulator to determine

246. For one compliance officer's lament, see Court E. Golumbic, *The Big Chill: Personal Liability and the Targeting of Financial Sector Compliance Officers*, 69 HASTINGS L.J. 45 (2017).

247. *See, e.g.*, Lockwood Advisors, Inc., Investment Advisers Act Release No. 4984, 2018 WL 3854609 (Aug. 14, 2018) (the advisor's violation was limited to the Compliance Rule based on other parties' possible substantive violations). In that matter, the adviser, a sponsor of a significant wrap fee program (an investment program that matches individual advisory clients with an investment strategy, then groups together clients in a particular strategy whose accounts are managed by a sub-adviser portfolio manager) with hundreds of sub-advisers, failed to have policies and procedures that would allow the adviser to monitor the routing of client brokerage transactions by sub-advisers to brokers outside the purview of the wrap-fee program.

248. *See* Ares Mgmt. LLC, Investment Advisers Act Release No. 5510, 2020 WL 2743940 (May 26, 2020). In that matter, an investment adviser which had internal policies governing the handling of material non-public information failed to fully adhere to the letter of those policies when an investment committee of the adviser authorized purchases of restricted securities under the adviser's policies (in this case, a portfolio company's equity securities) because an employee of the adviser sat on the portfolio company's board, a circumstance which should have triggered additional precautionary steps by the adviser's compliance staff.

249. *See* Structured Portfolio Mgmt., LLC, Investment Advisers Act Release No. 3906, 109 SEC Docket 3803 (Aug. 28, 2014) (inadequate procedures to oversee allocation of trades among accounts by head trader, but no showing of actual misconduct); *see also* First W. Cap. Mgmt. Co., Investment Advisers Act Release No. 5543, 2020 WL 4038959 (July 16, 2020) (finding a violation of the Compliance Rule where adviser did not have policies and procedures to prevent allocation of Securities Act Rule 144A securities to ineligible client accounts, even though no substantive violation of the IAA was found).

whether violations have in fact occurred. Finally, the SEC has increased the pressure on compliance officers themselves through prosecution of conduct that appeared erroneous and deficient in hindsight, even though the compliance officer may have made careful and deliberate judgments as events unfolded that later prove indefensible.[250]

As noted, the Compliance Rule involved a use of the SEC's prophylactic antifraud rulemaking authority to achieve structural self-policing regulatory objectives on enhanced integrity and accountability. Undoubtedly, it has increased adherence to regulatory requirements by investment advisers of all sorts in all phases of their operations. Nevertheless, it has proven particularly valuable in enabling the SEC to use its regulatory resources effectively in its oversight of institutional asset managers.

2. The Private Funds Advisers Rule and its Enforcement

The post-2000 period has also witnessed a major push by the SEC in its oversight of private funds, both in terms of information collection and conduct integrity oversight. This development has undoubtedly contributed to greater accountability among hitherto large asset managers. The SEC's enhanced oversight in the context of private funds resulted from two contributing factors under the IAA that by themselves hardly signaled a material reorientation.

The first factor arose from the failure of the Hedge Fund Rule.[251] The D.C. Court of Appeals analysis cast into doubt the actionability of private fund adviser misconduct that harmed investors in private funds.[252] The SEC, rather than seeking further review of the Hedge Fund Rule, instead opted to promulgate a rule under its prophylactic antifraud rulemaking authority: Rule 208(4)-8, the Private Fund Fraud Rule.[253] The rule prohibits material misstatements and all fraudulent and

250. *See, e.g.*, BlackRock Advisors, LLC, Investment Advisers Act Release No. 4065, 111 SEC Docket 1721 (April 20, 2015) (sanctioning a chief compliance officer who failed to alert fund board of possible conflicts of interest vetted by the CCO).

251. *See supra* Section I.E.1 (discussing SEC efforts to regulate hedge fund advisers in the early 2000s).

252. *See* SEC v. Goldstein, 451 F.3d 873, 884 (D.C. Cir. 2006).

253. 17 C.F.R. § 275.6(4)-8 (2011) (captioned "Pooled investment vehicles").

deceptive acts, practices, or courses of conduct by registered advisers that harm investors or potential investors in private funds.[254]

The second factor was the Dodd–Frank Act's expansion of the registration requirements relating to advisers to private funds and additional reporting requirements for unregistered investment advisers.[255] As a result, most, if not all large, private fund advisers were required to register as investment advisers under the IAA and fell within the SEC examination purview. This result greatly expanded the SEC's ability to gather information about private funds and their advisers. In other words, private advisers and their businesses were more visible to regulators.

These two factors in tandem allowed the SEC to marshal regulatory resources to afford closer scrutiny beginning in 2012 of industry practices, especially by means of examination.[256] This increased presence in turn enabled the SEC to conclude administrative proceedings and impose sanctions on some of the biggest private equity advisers in the United States (such as Kohlberg Kravis, Roberts & Co., LP,[257] Blackstone Management Partners, LLC,[258] and Fenway Partners, LLC).[259] Such actions have revealed undisclosed conflicts of interest (discovered through examination of operating agreements and financial records) touching on, according to one practitioner summary, undisclosed fees and expenses, misallocation of expenses, undisclosed loans and investments, undisclosed relationships with third parties, and

254. *Id.* The rule refers to "pooled investment vehicles," defined as funds that would come within the ICA's definition of investment company but for the exclusions from that definition found in ICA Section 3(c)(1) or (7), which was subsequently adopted as the statutory definition of private funds under the IAA.

255. *See supra* Section I.E.2 (discussing amendments to the IAA's registration provisions relating to private funds in the Dodd–Frank Act).

256. *See* Marc Wyatt, Acting Dir., Off. of Compliance & Inspections, Sec. & Exch. Comm'n, Private Equity: A Look Back and a Glimpse Ahead (March 13, 2015) (summarizing early activities of SEC examination office with examinations and noting enhanced expertise gained with experience in private equity).

257. Kohlberg Kravis Roberts & Co., LP, Investment Adviser Act Release No. 4131, 111 SEC Docket 4904 (June 29, 2015).

258. Blackstone Mgmt. Partners, LLC, Investment Adviser Act Release No. 4219, 112 SEC Docket 3484 (Oct. 7, 2015).

259. Fenway Partners, LLC, Investment Adviser Act Release No. 4253, 112 SEC Docket 4868 (Nov. 3, 2015).

undisclosed discounts for service providers.[260] According to one SEC official, these enforcement actions have affected practices in the private equity industry by "increas[ing] the level of transparency into fees, expenses, and conflicts of interest," and in other cases causing sponsors to rethink those very practices.[261]

While SEC findings in these matters have addressed conduct violations of IAA Rule 208(4)-8 as well as IAA Section 206(2), these matters have also frequently involved findings of violations of the Compliance Rule.[262] While findings of conduct violations serve to put private funds on notice of what the SEC finds substantively problematic, the compliance policy and procedures enlists all firms' self-policing infrastructure prospectively as well. In short, the combination of statutory and regulatory changes in the post-Financial Crisis environment have significantly extended the SEC's purview over asset managers in the private fund space, thereby more completely regulating under the IAA the universe of investment asset managers.

IV. THE FIDUCIARY CONUNDRUM IN THE IAA'S REGULATORY ARC

The IAA's evolving regulatory arc has seen substantive statutory and regulatory changes that have altered its structural scope precisely at a time when the industry, especially in terms of institutional asset managers, has experienced staggering growth. This account of the statute and its application provides a deeper understanding of the resulting regulatory scheme, but also reveals deficiencies in certain regulatory initiatives. This Part delves into one such misconceived

260. *See* Eva Ciko et al., *SEC Enforcement against Private Equity: A Practical Guide for Private Funds*, *in* THE SECURITIES LITIGATION REVIEW 1 (William Savitt ed., 5th ed. 2019).

261. *See* Andrew Ceresney, Dir., Div. of Enf't, Sec. & Exch. Comm'n, Private Equity Enforcement (May 12, 2016) (keynote address to the Securities Enforcement Forum).

262. *See, e.g.*, First Reserve, LP, Investment Advisers Act Release No. 4529, 114 SEC Docket 6593 (Sept. 14, 2016) (finding Compliance Rule violation where adviser lacked written policy and procedures with respect to the allocation of expenses between the adviser and the funds it managed); TPG Cap. Advisors, LLC, Investment Advisers Act Release No. 4830, 118 SEC Docket 2189 (Dec. 21, 2017) (finding Compliance Rule violation where adviser lacked written policy and procedures regarding necessary disclosure prior to fund investors' commitment of capital regarding conflicts of interest associated with the receipt of accelerated monitoring fees).

initiative that reveals dissonance with the preceding exposition and stems directly from a misunderstanding of the trajectory of the IAA's regulatory arc.

Over the last ten years, the SEC has been vexed by the task of reconciling the standard of conduct for investment advisers (and their associated persons) relative to the standard for broker-dealers (and their associated persons) when providing personalized investment advice to retail customers. The source of this challenge, as described earlier, lay in the Dodd–Frank Act, in which Congress urged agency action on this issue without mandating the terms of any solution.[263] Following a very twisted path of developments after the Dodd–Frank Act,[264] the SEC recently concluded an extensive multi-part rulemaking that attempted to resolve the issues that the Dodd–Frank Act had urged for reconsideration within the bounds of the IAA, in terms of the obligations of investment advisers; and the Exchange Act, in terms of the obligations of broker-dealers. The multi-part rulemaking commonly referred to as the Regulation BI Initiative actually consisted of a package of four different final agency actions.[265] While there are many

263. *See supra* Section I.E.2.

264. After enactment of the Dodd–Frank Act, the SEC consideration took a circuitous nine-year path involving the issuance of an SEC Staff Report in 2011, an SEC Advisory Committee Report in 2014, and the Department of Labor's adoption of a Uniform Fiduciary Rule in 2016 to apply to ERISA-qualified retirement accounts, which was later struck down by a court of appeals decision. For a summary of this protracted narrative, see Regulation Best Interest, Exchange Act Release No. 83062, 83 Fed. Reg. 21574, 21576–83 (May 9, 2018) (proposing release).

265. The four elements of the package were as follows: (i) rules governing the standard of conduct of broker-dealers when providing recommendations to retail customers (Regulation BI); (ii) promulgation of a new customer disclosure form applicable to broker-dealers and advisers regarding their professional obligations with respect to relationships with the particular client or customer (the Relationship Summary Disclosure Document); (iii) an interpretation that set forth the standard of conduct of advisers to their clients (the Adviser Conduct Interpretation); and (iv) an interpretation regarding the "solely incidental prong" of the definition of an investment adviser so that broker-dealer could determine when their advisory activities came within the IAA and subjected the broker-dealer to the conduct standards of investment advisers (the "Solely Incidental Interpretation"). The four initiatives were adopted on June 19, 2019 and appear consecutively in the Federal Register: Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031, 84 Fed. Reg. 33318 (July 12, 2019) [hereinafter Regulation BI Standard of Conduct]; Form CRS Relationship Summary; Amendments to Form ADV, Exchange Act Release No. 86032, 84 Fed. Reg. 33492 (July 12, 2019); Commission Interpretation Regarding Standards of Conduct for Investment Advisers, Investment Advisers Act Release No.

issues presented by the entire Regulation BI Initiative (especially as they relate to broker-dealers' obligations to their customers), that are not relevant to this article, one component of the initiative is.

In the Adviser Conduct Interpretation, the SEC offered an extended exposition of the fiduciary obligations of investment advisers that can be analyzed separately from the Regulation BI Initiative as the latest iteration in the changing shape of the IAA's regulatory arc. As discussed in Section II.A., the IAA's antifraud section, Section 206, entails fiduciary concepts, at minimum, in terms of its application. This aspect of the IAA has produced conceptual confusion that goes to the core of the statute and its mandate: Does the statute itself mandate a self-effectuating federal fiduciary duty? The SEC's Interpretation answers this question in the affirmative. While undoubtedly well-meaning and unobjectionable in many respects, the SEC's Interpretation is patently incorrect as a matter of statutory construction, and more importantly, as argued here, deficient as a matter of policy.[266] If the SEC reverted to a more defensible statutory interpretation, namely the view that the IAA imposes a heightened standard of disclosure on investment advisers commensurate to the disclosure obligations of a fiduciary (what is referred to herein as a "fiduciary disclosure" standard), the resulting standard would have greater clarity than a stand-alone fiduciary duty that lacks any textual grounding. More importantly, abandoning its questionable interpretation would enable the SEC to pursue a more assertive investor protection agenda that seeks to supplement the existing fiduciary disclosure standard with targeted bright-line rules to enhance investor protection for average retail investors.

5248, 84 Fed. Reg. 33669 (July 12, 2019); Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser, Investment Advisers Act Release No. 5249, 84 Fed. Reg. 33681 (July 12, 2019). The SEC explicitly noted the relationship between the Advisers Conduct Interpretation and Regulation BI. *See* Adviser Conduct Interpretation, *supra* note 10, at 33669 & n.3.

266. Although the Adviser Conduct Interpretation was promulgated as part of the larger Regulation BI Initiative, the legal merits of other components of the Regulation BI Initiative are independent of the legal merits of the Advisers Conduct Interpretation. Regulation BI was unsuccessfully challenged in XY Plan. Network, LLC v. SEC, 963 F.3d 244, 253 (2d Cir. 2020) (sustaining SEC's Regulation BI rulemaking authority under the Dodd–Frank Act § 913(f)).

A. THE SEC'S FIDUCIARY CONFUSION

The SEC's interpretation rests on a mistaken premise that "[t]he Advisers Act establishes a federal fiduciary duty on investment advisers."[267] This assertion stands or falls as a matter of statutory construction, and perhaps the most salient feature of IAA is that the statute is silent on the fiduciary obligation of investment advisers. That fact, given the importance and breadth of fiduciary obligations, should give any student of contemporary statutory construction jurisprudence pause, even if the substance of the interpretation itself provides prudent guidance for investment advisers. As noted below, much of the Interpretation's substance remains enforceable under the alternative, and more persuasive, fiduciary disclosure standard.

1. The SEC's Case for a Statutory Fiduciary Duty

When the Dodd–Frank Act was enacted, some, but not all, members of Congress appeared to assume that investment advisers are bound by a federal fiduciary obligation.[268] In Section 913(g) of the Act, Congress specifically authorized the SEC to adopt a fiduciary standard for broker-dealers and such other rules of conduct for investment advisers providing that the duty of such securities professionals "shall be to act in the best interest of the customer without regard to the financial or other interest of" the relevant securities professional in providing personalized retail advice.[269] Instead, in Regulation BI, the SEC fixed, and arguably elevated the standard of conduct for broker-dealers in some cases pursuant to Dodd–Frank Section 913(f).[270] However, the final Regulation BI standard for broker-dealers fell below the standard of conduct applicable to investment advisers either under a putative

267. Adviser Conduct Interpretation, *supra* note 10, at 33670.

268. While it is commonly assumed that Congress collectively concluded that the IAA imposed a federal fiduciary standard in connection with the Dodd–Frank Act, the legislative record is mixed. The strongest evidence in this regard is the House report that served as the basis for the House bill's investor protection measure. *See generally* H.R. REP. NO. 111-687 pt. 1, at 49 (2009). Both the Senate Report (S. REP. NO. 111-176, at 105 (2010)) and the Conference Committee Report (H.R. REP. NO. 111-517, at 870 (2010)) appear deliberately non-committal on the existence of a federal fiduciary duty.

269. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1828–29 (2010).

270. *See* XY Plan. Network, 963 F.3d at 249–50 (summarizing the record that led to Regulation BI's adoption).

federal fiduciary duty (as articulated in the Adviser Conduct Interpretation) or, as discussed below, a federal fiduciary disclosure standard. Accordingly, in its Interpretation, the SEC sought to provide guidance regarding what the agency perceived as the standard of conduct for investment advisers,[271] and specifically "reaffirm[]—and in some cases clarif[y]—certain aspects of the fiduciary duty" under the IAA.[272]

As the SEC itself concedes, the fiduciary principle applicable to investment advisers is "not generally set forth in" the IAA, nor is the "fiduciary duty to which advisers are subject . . . specifically defined."[273] The SEC nevertheless implied a federal statutory fiduciary duty and framed it in terms of the familiar common law constructs of duty of loyalty and duty of care.[274] The Interpretation's discussion of a federally enforceable duty of loyalty is easiest to square with the fraud and deceit prohibitions found in the IAA. Breaches of the duty of loyalty will generally go hand in hand with conduct evidencing fraud or deceit.[275]

The more difficult challenge for the SEC's position is to locate the duty of care component of the fiduciary duty in terms of fraud or deceit. Although breach of a duty of care can entail deceit, a breach need not involve such conduct.[276] Unlike a duty of loyalty where breaches will generally implicate fraudulent or deceitful conduct, the duty of care is only weakly associated with fraud or deceit and may turn upon

271. Adviser Conduct Interpretation, *supra* note 10, at 33669.

272. *Id.* at 33670. Unlike the standard of conduct in the case of Regulation BI, the fiduciary duty found in the interpretation extends beyond providing advice to retail investors, and encompasses obligations applicable to a broad spectrum of investment clients and advisory services. *Id.* at 33671.

273. *Id.* at 33670.

274. *See generally* Robert H. Sitkoff, *The Fiduciary Obligations of Financial Advisors under the Law of Agency*, 27 J. FIN. PLAN. 42 (2014).

275. *Cf.* RESTATEMENT (THIRD) OF TRUSTS: DUTY OF LOYALTY § 78.3 (AM. LAW INST. 2007) ("Whether acting in a fiduciary or personal capacity, a trustee has a duty in dealing with a beneficiary to deal fairly and to communicate to the beneficiary all material facts the trustee knows or should know in connection with this matter.").

276. For example, suitability when viewed as an antifraud principle (which requires some form of deception) requires much more than a general suitability duty imposed by self-regulatory rule. *See generally* Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557 (1999) (distinguishing between the old NASD (now FINRA) self-regulatory approach and the more demanding standard to state a substantive suitability claim under Securities Exchange Act Section 10 and Rule 10b-5 thereunder).

negligence or inadequate diligence.[277] The Interpretation describes the duty as consisting of three components: (i) A duty to provide advice that is suitable for and in the best interests of the client based on reasonable inquiry relating to client objectives;[278] (ii) a duty to seek best execution for the client;[279] and (iii) a duty to provide continuing advice and oversight over the course of the client relationship.[280] However, while undoubtedly a violation of any of these independent duties could involve conduct that operates as a fraud or deceit, no attempt is made to show that a failure to satisfy such duties necessarily operates as a fraud or deceit under federal law.

According to the SEC, an adviser's "obligation to act in the best interest of its client is an overarching principle that encompasses both the duty of care and the duty of loyalty."[281] It is unclear whether the SEC means that the fiduciary duty is equivalent to a best interest standard, or merely that a best interest standard is a guiding principle.[282] The "best interest" language figured prominently in the debate about parity in conduct standards,[283] but it is better known and more firmly established

277. To be sure, a breach of the duty of care can implicate issues of fraud or deceit, such as situations where the fiduciary misrepresents to the principal the nature of its activities undertaken on behalf of the principal. *See infra* note 338. But just as surely, duty of care deficiencies may implicate conduct that is merely negligent and does not involve or operate as a deceit.

278. Adviser Conduct Interpretation, *supra* note 10, at 33672–74. As previously discussed, the SEC had attempted a rulemaking under its prophylactic antifraud rulemaking authority, a rulemaking that was abandoned. *See supra* note 219; Adviser Conduct Interpretation, *supra* note 10, at 33362 n.34 (noting the history of the abandoned suitability proposal).

279. Adviser Conduct Interpretation, *supra* note 10, at 33674–75. The duty of best execution is something that the SEC has referenced, especially in the context of the prohibitions and exclusions for principal trades with clients, or cross-agency transactions among clients, and undoubtedly inheres in the common law notion of fiduciary duty. However, the enforcement proceedings cited by the SEC are limited to situations also implicating a breach of the duty of loyalty where a conflicted adviser deliberately arranges for an inferior trade execution for its own gain.

280. *Id.* at 33675.

281. *Id.* at 33671.

282. Best interest in the securities law context is not a defined term. As one commentator noted prior to Regulation BI, "[t]here is . . . precedent defining a best interest standard as it pertains to broker-dealers." Nicholas S. Di Lorenzo, Note, *Defining a New Punctilio of an Honor: The Best Interest Standard for Broker-Dealers*, 92 B.U. L. REV. 291, 313 (2012).

283. The phrase acquired some currency in the debates that led to the Dodd–Frank Act, where it was codified in IAA Section 211(g) (15 U.S.C. § 80b-11(g)) (Dodd–Frank

in the trust law fiduciary context.[284] Although the SEC has now mandated a best interest standard for broker-dealers by virtue of Regulation BI, that rule provides a significant safe harbor.[285]

For purposes here, it is unnecessary to go through the Interpretation's substance in detail since, as will be argued, its fundamental flaw is in its very premise, which presupposes the existence of a stand-alone federal fiduciary duty. In addition, however, the putative federal fiduciary duty raises other interpretive problems that may lead to confusion. The problem presented by "informed consent" is the most obvious. At common law, liability for breach of a fiduciary duty can be avoided by informed consent, a necessary fiduciary principle that the SEC acknowledges.[286] Moreover, as noted by the SEC, informed consent can be express or implicit.[287] The SEC, however, mistakenly suggests that full and fair disclosure alone that puts a client in "a position to be able to . . . provide informed consent" is sufficient to find implied consent, which is not the case.[288] As described by the SEC, implied consent is no longer a volitional act of the client, but rather nothing more than the failure to object when the client was in a position

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Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913(g), 124 Stat. 1376, 1828–29 (2010)). In that context, the genesis appears to have been the RAND BROKER-DEALER REPORT, *supra* note 137, at 89–90. It is found in isolated IAA case law involving conflicts of interest situations rather than pure due care situations. *See* Adviser Conduct Interpretation, *supra* note 10, at 33671 n.23 (quoting language from two cases).

284. *See, e.g.*, John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929, 980–82 & nn.265–66 (2005) (advocating a best interest defense for a breach of loyalty by a trustee based on existing authority in the area of trust law).

285. *See* 17 C.F.R. § 240.15l-1 (2019) (creating a safe harbor for persons subject to the rule where specified obligations of disclosure, care, conflict of interest management, and compliance are satisfied). If, as it appears, one would not satisfy the SEC's IAA fiduciary standard merely by satisfying the broker-dealer standard, then it would follow that the SEC seemingly believes a best interest standard operates differently in the two contexts. This is most clear from the fact that the broker-dealer standard applies only to broker-dealers providing personalized advice to retail investors whereas an adviser's fiduciary obligation under the IAA extends to any advice provided to any client.

286. Adviser Conduct Interpretation, *supra* note 10, at 33677, 33680–81 (and sources cited therein); *see also* RESTATEMENT (THIRD) OF TRUSTS: EFFECT OF CONSENT, RATIFICATION OR RELEASE § 97 (AM. LAW INST. 2012).

287. Adviser Conduct Interpretation, *supra* note 10, at 33677.

288. *Id.*

to object.[289] In contrast, and as noted below, a failure to object after full and fair disclosure may be sufficient to rebut a finding of fraud or deceit (i.e., overcome the fiduciary disclosure standard).[290]

Another problem created by the Interpretation relates to the scope of the putative federal duty. According to the SEC, the fiduciary duty should be viewed contextually in terms of the "agreed-upon scope of the relationship between the adviser and the client."[291] The application of fiduciary principles will vary depending on the nature and scope of the relationship.[292] Significantly, however, the Interpretation notes that under federal law there are circumstances where, contrary to common law, a client cannot waive enforceable duties by virtue of IAA's anti-waiver prohibition.[293] An obvious problem is that the "agreed-upon scope" qualification could in practice serve to waive fiduciary obligations in some contexts. The "agreed-upon scope" caveat is vague and imprecise, and lacking a textual foundation.

A final lurking and unresolved issue in the SEC's Interpretation concerns the relationship between federal and state conduct standards, and specifically, whether the IAA or SEC rules might preempt elevated state fiduciary or other conduct standards in the investment adviser area.[294] Although the Interpretation did not address preemption of enhanced state conduct standards relating to investment advisers, the issue was explicitly raised as to broker-dealer regulation in connection

289. *Id.*

290. *See* RESTATEMENT (THIRD) OF TRUSTS: EFFECT OF BENEFICIARY CONSENT, RATIFICATION OR RELEASE § 97 (AM. LAW INST. 2012) (Comment (a): "Consent or ratification ordinarily requires more than mere failure of the beneficiary to object to conduct that the beneficiary was aware would or did constitute a breach of trust . . . the consent or ratification is normally expressly communicated to the trustee, orally or by delivery of a writing, although the consent or ratification may be implied by the beneficiary's conduct in some circumstances."); *see also* RESTATEMENT(THIRD) OF AGENCY: GENERAL FIDUCIARY PRINCIPLE § 8.01 (AM. LAW INST. 2006).

291. Adviser Conduct Interpretation, *supra* note 10, at 33671.

292. *Id.*

293. *Id.* at 33672. The sum of these three features—(i) the overarching fiduciary principle, (ii) viewed contextually in light of agreed-upon scope, (iii) subject to the proviso that any agreed-upon scope limitations do not violate anti-waiver constraints–yield the SEC's principles-based federal fiduciary duty.

294. *See generally* JOHN E. NOWAK & RONALD D. ROTUNDA, CONSTITUTIONAL LAWS §§ 9.1, 9.2 (8th ed. 2010) (discussing conflict preemption (the most relevant form in this situation) because of the impossibility of complying both with state and federal law, or because a state requirement stands as an obstacle to the accomplishment of the purposes or objectives of federal law).

with Regulation BI.[295] The IAA arguably implicates parallel concerns. As to preemption under the IAA, however, the statute, if anything, supports an inference that Congress intended a cooperative federal-state scheme under the IAA with respect to investment advisers (i.e., one preserving state law conduct requirements).[296] The savings provisions generally preserve state law requirements from preemption, except in cases of actual conflict.[297] There does not appear to be any conflict between the objectives of federal regulation of investment adviser

295. *Compare* Regulation BI Standard of Conduct, *supra* note 265, at 33327 ("We note that the preemptive effect of Regulation Best Interest on any state law governing the relationship between regulated entities and their customers would be determined in future judicial proceedings based on the specific language and effect of that state law."), *with* Robert J. Jackson Jr., SEC Comm'r, Sec. & Exch. Comm'n, Statement on Final Rules Governing Investment Advice (June 5, 2019), https://www.sec.gov/news/public-statement/statement-jackson-060519-iabd [https://perma.cc/N58E-PFK7] (criticizing the Commission's ambivalence as to preemption and stating: "We can and should say unequivocally that today's release sets a federal floor, not a ceiling, for investor protection. Our failure to do so invites extensive and expensive litigation over the scope of the rule—and its effects on nascent state regulation." (emphasis added)). For an example of a state regulation that imposes on broker-dealers a higher conduct standard than federal law, see 950 MASS CODE REGS § 207 (2020).

296. The bifurcated registration scheme codified in Section 203A (15 U.S.C. § 80b–3a) mandates shared responsibility with respect to registration of investment advisers. As noted, most investment advisers (generally the smaller ones who manage only a small fraction of assets under management) are prohibited from registering with the SEC if state registration (and in some cases, examination) is available. In addition, the IAA contains explicit savings clauses: Sections 203A(b)(2) (15 U.S.C. § 80b–3a(b)(2)) and 222 (15 U.S.C. § 80b–18a). Of these, Section 203A(b)(2) is the more straightforward: It indicates that state securities commissions will retain jurisdiction to investigate and enforce matters relating to fraud or deceit whether the relevant adviser is state or federally registered. Section 222, captioned "State regulation of investment advisers," is more in the nature of a traffic control provision between conflicting state and federal non-conduct provisions and conflicting non-conduct provisions among the states.

297. *Cf.* Burks v. Lasker, 441 U.S. 471, 479 (1979) (noting the ICA and IAA generally "do not require that federal law displace state laws [with respect to fund governance issues] unless the state laws permit action prohibited by the Acts, or unless 'their application would be inconsistent with the federal policy underlying the cause of action . . . .'" (citations omitted)); 15 U.S.C. §§ 78o(i)(1) & 78bb(a) (two provisions under the Exchange Act, with the former effecting field preemption as to select non-conduct requirements relating to broker-dealers and the latter providing a savings clause for other requirements (including broker-dealer conduct standards) except in instances of actual conflict).

conduct and the possibility of more stringent state law conduct standards. Indeed, as discussed in *Capital Gains*, federal conduct standards in this area stand on the shoulders of underlying state conduct regulation.[298]

Notwithstanding these problems, there is a more fundamental problem in the SEC's position: It cannot withstand textual scrutiny.

2. The SEC's Fiduciary Textual Deficit

The statutory construction problem can be stated plainly: The IAA's textual silence as to an investment adviser's fiduciary duty is a fatal flaw in the SEC's theory and stands as an insurmountable obstacle to finding a freestanding federal fiduciary statutory mandate. For at least thirty years, the Supreme Court has been at pains to address competing theories of statutory construction.[299] Most obviously, the SEC's

298. Rulemaking by the SEC represents a final avenue for arguably preempting enhanced state conduct standards, but agency preemption stands on weaker grounds and cannot supervene Congress' statutory design. *See, e.g.*, Watters v. Wachovia Bank, N.A., 550 U.S. 1, 22 (2007) (savings clause did not preclude an agency rule that was consistent with the overarching preemptive sweep of the National Bank Act). Agency preemption nevertheless stands on shakier ground and has elicited a fair amount of scholarly commentary. *Compare, e.g.*, Nina A. Mendelson, *A Presumption Against Agency Preemption*, 102 NW. U. L. REV. 695 (2008) (arguing for a judicial presumption against agency preemption, absent clearly delegated statutory authority), *with* Brian Galle & Mark Seidenfeld, *Administrative Law Federalism: Preemption, Delegation, and Agencies*, 57 DUKE L.J. 1933, 1934 (2008) (arguing "for a more nuanced set of rules that would permit agencies in many instances to preempt or regulate without the need for express congressional approval).

299. The literature in this regard is truly voluminous. While this article offers neither the occasion nor space to rehash the in-and-outs of the debate or even to canvas its many unresolved nuances, it is sufficient for purposes here to emphasize a broad consensus now exists that statutory text must occupy a primary role in resolving issues of statutory construction. *See, e.g.*, Molot, *supra* note 153, at 43 (2006) ("Textualism seems to have been so successful–indeed, far more successful that its defenders or detractors care to admit–that we are all textualists in an important sense."); Jonathan R. Seigel, *Textualism and Contextualism in Administrative Law*, 78 B.U. L. REV. 1023, 1057 (1998) ("In a significant sense, we are all textualists now."). Purposivism, the main competing interpretive doctrinal strand, itself has accordingly moved in a direction that affirms the importance of text in statutory construction. *See* John Manning, *The New Purposivism*, 2011 SUP. CT. REV. 113, 119 (2011) ("This article argues that the Court's modern approach to letter and spirit, although commonly justified as an aspect of textualism, fits equally well with the most fundamental premises of purposivism, properly understood."). *See generally* Richard Fallon, *Three Symmetries between Textualist and Purposivist Theories of Statutory Interpretation*–

interpretation is entirely non-textual; the IAA nowhere provides any textual support for finding that Congress created a federal fiduciary duty for advisers. The omission of the term "fiduciary" in Section 206 (i.e., what Congress did not say) counts against assuming such a missing term should be included within the statute.[300] Federal securities law is not an exception to the trend toward textual-based statutory construction as demonstrated by the Supreme Court's pithy admonition of petitioners in *Cyan, Inc. v. Beaver County Employees Retirement Fund*: "The statute says what it says, or perhaps better put here, does not say what it does not say."[301] The *Cyan* admonition cuts to the heart of the position

and the Irreducible Roles of Values of Judgment with Both, 99 CORNELL L. REV. 685 (2014).

300. *See, e.g.*, Park 'N Fly v. Dollar Park & Fly, 469 U.S. 189, 194 (1985) ("Statutory construction must begin with the language employed by Congress and the assumption that the ordinary meaning of that language accurately expresses the legislative purpose"); Conn. Nat'l Bank v. Germain, 503 U.S. 249, 253–54 (1989) ("We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there."); Bostock v. Clayton Cnty., 140 S. Ct. 1731, 1749 (2020) ("[P]eople are entitled to rely on the law as written, without fearing that courts might disregard its plain terms based on some extratextual consideration."). Of course, Supreme Court decisions make clear that modern textualist approaches should not be conflated with simple literalism per se; still, statutory context matters. *See, e.g.*, Yates v. United States, 574 U.S. 528, 546 (2015) (holding fish was not a "tangible" object whose concealment was intended to impede a federal investigation as contemplated by the Sarbanes–Oxley Act, such as tangible objects used to record or preserve information). Such cases show what is not at issue here, namely that language actually used must nevertheless be read in light of the statute's structure and revealed intent. In other words, textualism does not compel literalism, but does preclude augmenting Congress's language with new terms.

301. 138 S. Ct. 1061, 1069 (2018) (construing provisions of the Securities Litigation Uniform Standards Act of 1998 (SLUSA) intended to conform SLUSA's operative provisions with the Securities Act of 1933); *see also* Digit. Realty v. Somers, 138 S. Ct. 767, 782 (2018) ("Because 'Congress has directly spoken to the precise question at issue,' we do not accord deference to the contrary view advanced by the SEC in Rule 21F–2. The statute's unambiguous whistleblower definition, in short, precludes the Commission from more expansively interpreting that term." (citations omitted)) (rejecting an SEC non-textual interpretation of the Dodd–Frank Act securities law whistleblower definition that equated the definition with a related but differently-worded whistleblower definition in the Sarbanes-Oxley Act); Lawson v. FMR LLC, 571 U.S. 429, 440–41 (2014) ("In determining the meaning of a statutory provision, 'we look first to its language, giving the words used their ordinary meaning.' . . . Absent any textual qualification, we presume the operative language means what it

advanced in the Interpretation: Section 206, and, in particular, Section 206(2) do not say anything about a "fiduciary" duty or advisers as "fiduciaries."

The dispositive significance of the textual omission of "fiduciary" in the IAA is only bolstered by corroborating contextual factors, including the legislative history relating to the IAA's drafting. In that regard, Professor Arthur Laby's able summary of the IAA's legislative history notes that the enacted version of the IAA expunged an explicit reference to "fiduciary obligations" of advisers that had been contained in the original legislation as proposed.[302] Moreover, in contrast to the IAA, the term "fiduciary" was used expressly by Congress in the ICA, the IAA's companion statute which was enacted in the same public law as the IAA.[303] This sequence was repeated in 1970, when Congress added Section 36(b) to the ICA,[304] a provision which expressly creates a limited "fiduciary" duty for advisers with respect to the receipt of compensation. Yet in those very same amendments, Congress enacted amendments to the IAA without including any express language recognizing an enforceable federal fiduciary duty under the IAA.[305] The fact that Congress did not show any reticence in imposing specific fiduciary obligations in the ICA, at the very time it either enacted or amended the IAA's text, argues against finding any intent to create such obligations in the IAA.[306]

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appears to mean . . . ." (citation omitted)) (holding that whistleblower provisions of Sarbanes-Oxley Act encompass employees of a contractor for public company).

302. *See SEC, Capital Gains, and the IAA*, *supra* note 25, at 1069–70 (2011) (setting forth legislative history).

303. The ICA's original Section 36 (now codified as Section 36(a) (15 U.S.C. § 80a-35)) codified the fiduciary duties of registered investment companies' directors and officers and the role of the SEC in enforcing such duties.

304. 15 U.S.C. § 80-36(b) (augmenting the statutory federal fiduciary duty found in sub-section (a) by further providing "the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation . . . . paid by such investment company."). As the Supreme Court guardedly noted in construing that statutory duty, "[t]he meaning of § 36(b)'s reference to 'a fiduciary duty with respect to the receipt of compensation for services' is hardly pellucid . . . ." Jones v. Harris Assocs. LP, 559 U.S. 335, 345 (2010). This guarded approach to fiduciary duties expressly provided by Congress argues for caution in implying such duties where not provided by statute.

305. *See supra* Section I.C.

306. The treatment of fiduciary obligations under other federal statutes similarly undercuts implying the existence of an implied broad-based fiduciary duty under the IAA. For example, a later enacted statute, the Employee Retirement Income Security

Moreover, the SEC must contort the fiduciary duty found in the statute to make it fit. As previously noted, the SEC-found fiduciary duty in Section 206(2) duty does not operate like fiduciary duties generally. For example, the SEC agrees that, under 206(2), *Capital Gains* requires no more than disclosure of conflicts of interest between the adviser and its client.[307] Such a principle does not accord with common law notions of fiduciary duty, where a fiduciary satisfies its duty to disclose conflicts of interest only if the principal both receives notice and consents to the conflict.[308] In other words, disclosure makes no sense as a sufficient remedy, if in fact the investment adviser is subject to an asserted fiduciary duty under federal law.

This point is underscored by the text of Section 206(3), which immediately follows Section 206(2). For that provision and that provision only, an adviser who acts as a principal for his own account, or as an agent for another client's account, is prohibited from trading with its client "without disclosing to such client in writing before the completion of such transaction the capacity in which [the adviser] is acting and obtaining the consent of the client to such transaction."[309] Unlike Section 206(2), Section 206(3) expressly articulates a high, fiduciary-like standard of conduct, requiring the customary means for obtaining a client's consent to cure potential fiduciary misconduct.[310] Congress's establishment of an explicit federal fiduciary-like prohibition

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Act of 1974 ("ERISA"), 29 U.S.C. § 1001 *et seq.*, addresses fiduciary requirements, but unlike the IAA, the statute expressly refers to "fiduciaries." *See, e.g.*, 29 U.S.C. § 1109(a) ("Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach . . . ."). Not surprisingly, the Supreme Court has had no difficulty in concluding that Congress imposed fiduciary obligations on such persons. *See* LaRue v. DeWolff, Boberg, & Assocs., Inc., 552 U.S. 248, 253 (2008) (discussing § 1109). Recognition of a federal fiduciary absent a statutory mandate lacks precedent, except in bankruptcy where federal judicial powers in equity are extensive. *See, e.g.*, Pepper v. Litton, 308 U.S. 295, 306 (1939) (disallowing claim under federal bankruptcy statute based on inherent equitable powers finding a breach of fiduciary duty by controlling stockholder).

307. *See* Adviser Conduct Interpretation, *supra* note 10, at 33671.

308. *See supra* note 290.

309. 15 U.S.C. § 80b-6(3).

310. *Id.*

in 206(3) weighs against implying a mini-fiduciary principle in Section 206(2) in the face of the statute's silence.[311]

Similarly, the SEC's Interpretation sits uneasily with Congress's 1960 IAA amendments that granted the SEC prophylactic antifraud rulemaking authority to adopt "means reasonably designed to prevent" acts, practices, or courses of conduct that are fraudulent or deceptive.[312] The need to expand the SEC's rulemaking authority in this way would not have been nearly as urgent if the statute had already imposed a generalized fiduciary duty on investment advisers. The amendment's purpose was addressed by the Supreme Court's decision in *Capital Gains*, where the Court acknowledged that such rulemaking could be used to address fiduciary conduct of investment advisers, but concluded that rulemaking was not necessary to address deceitful conduct by investment advisers acting in a fiduciary capacity under Section 206(2).[313] The seemingly sharp distinction in *Capital Gains* between deceitful conduct by a fiduciary, actionable under Section 206(2), and the authority conferred by Section 206(4) to address non-deceitful conduct by rule, is largely inexplicable if the SEC's Interpretation is correct.

Against these overwhelming contextual considerations, the SEC's position basically rests on two arguments. First, the Interpretation relies on dicta from dated Supreme Court decisions suggestive of an unarticulated (but nevertheless intended) fiduciary duty.[314] Supreme

311. As noted, the Interpretation does not explain why disclosure alone is sufficient to discharge the putative fiduciary duty found in Section 206(2). As discussed in the next section, the fiduciary standard of disclosure approach to Section 206(2), the alternative to the SEC's Interpretation, explains the result: The duty is merely one of disclosure and thus full and accurate disclosure discharges the duty. *See infra* Section IV.B.

312. 15 U.S.C. § 80b-6(4). *See supra* Section I.A.

313. *See* SEC v. Cap. Gains Rsch. Bureau, Inc., 375 U.S. 180, 199 (1963).

314. *See* Adviser Conduct Interpretation, *supra* note 10, at 33670 n.15 (citing Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979), which stated that "§ 206 establishes federal fiduciary standards to govern the conduct of investment advisers"; Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 471 & n.11 (1977) (*Capital Gains* was "premised on its recognition that Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers")); *id.* at 33670 n.16 (citing *Capital Gains*, 375 U.S. at 194 in which the Court noted that in drafting the Advisers Act, Congress was influenced by developments in the common law of fraud which had begun to change with respect to actions brought against a fiduciary, "which Congress recognized the investment adviser to be"); *id.* at 33671 n.20 (citing

Court dicta must be rejected as a basis for interpretation when unsupported by statutory text.[315] In a detailed analysis of the Supreme Court dicta in *Capital Gains* (the very dicta relied on by the SEC in its interpretation), Professor Laby rejected those dicta and concluded: "A careful reading of the Act and its legislative history . . . demonstrates that, although Congress recognized certain advisers to be fiduciaries, it did not create or impose a fiduciary duty on advisers."[316]

The SEC could seek to defend its Interpretation (in the parlance of the APA, an interpretive rule)[317] under administrative deference principles grounded in the *Chevron* doctrine.[318] Although *Chevron* deference principles command judicial deference to reasonable agency constructions of ambiguous statutory language, *Chevron* requires in the first instance genuine statutory ambiguity.[319] Although the parameters of

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Transamerica, 444 U.S. at 18, which states: "[T]he Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations.").

315. The Supreme Court has rejected ill-considered prior Court dicta in matters of statutory interpretation. *See, e.g.*, 14 Penn Plaza LLC v. Pyett, 556 U.S. 247, 257–60 (2009) (rejecting dicta in a prior Court decision based on judicial policy which sought to introduce a qualification to a statute where Congress had not so provided). In one federal securities law case, SEC v. Edwards, 540 U.S. 389, 396 (2004), the Court curtly dismissed dicta from two prior Court decisions. *See id.* at 396 ("[W]e will not bind ourselves unnecessarily to passing dictum that would frustrate Congress' intent . . . ."); *cf.* Jeffrey Lipshaw, *The False Dichotomy of Corporate Governance Platitudes*, 46 J. CORP. L. 345, 366 n.94 (forthcoming 2021) (illustrating the unreliability and malleability of dicta in Delaware corporate law decisions).

316. *SEC, Capital Gains, and the IAA*, *supra* note 25, at 1103.

317. "[I]nterpretive rules . . . are 'issued by an agency to advise the public of the agency's construction of the statutes and rules which it administers.'" Perez v. Mortg. Bankers Ass'n, 575 U.S. 92, 97 (2015) (quoting Shalala v. Guernsey Mem'l Hosp., 514 U.S. 87, 99 (1995)).

318. *See generally* Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837 (1984). Like the debate on textualism and purposivism in statutory interpretation, Chevron's meaning and justification elicits much debate. *See generally* Michael Herz, *Chevron is Dead, Long Live Chevron*, 115 COLUM. L. REV. 1867 (2015).

319. See, for example:

> Even under *Chevron*, we owe an agency's interpretation of the law no deference unless, after "employing traditional tools of statutory construction," we find ourselves unable to discern Congress's meaning . . . There is no room in this scheme for a wholly unmentioned [statutory device implied by the agency] . . . [W]e [may not] defer to an agency official's preferences because we imagine some "hypothetical reasonable legislator" would have favored that approach. Our duty is to give effect to the text that 535 *actual* legislators (plus one President) enacted into law.

the statutory phrase "operates as a fraud and deceit" on a client may not be precise, that alone does not render the provision ambiguous. A statutory prohibition of conduct that operates as a fraud or deceit, by definition, cannot encompass a non-deceitful breach of a fiduciary obligation.[320] Thus, even if the scope of fraud and deceit were deemed ambiguous, any attempt to read into those terms a fiduciary mandate beyond what is fraudulent or deceitful would be rejected as arbitrary and capricious.[321]

*** * ***

In the end, what can explain the SEC's misconceived efforts at statutory construction in the Interpretation? Quite simply, the SEC employed an outdated approach to statutory construction relative to contemporary standards.[322] The SEC's reading of the IAA should be viewed as a purposivist reading of the statute: an interpretation that accords controlling weight to policy considerations that may have informed legislators in enacting the statute. Even in a purposivist approach, "a statute's language almost invariably furnishes the best

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SAS Inst. Inc. v. Iancu, 138 S. Ct. 1348, 1358–59 (2018) (citations omitted).

320. This is the *ratio decidendi* of the Court's holding in *Santa Fe Industries*. *See infra* note 334 (discussing the Court's holding in *Santa Fe Industries*).

321. Where a statue speaks clearly to an issue, the Court need not even determine whether the agency's interpretation is arbitrary and capricious since the statute itself controls. *See* Milner v. Dep't of the Navy, 562 U.S. 562, 569–73 (2011) (rejecting a Defense Department interpretation of FOIA Exemption 2 where the interpretation had no connection to the exemption's text and notwithstanding longstanding appellate court precedent supporting the interpretation); Brown v. Gardner, 513 U.S. 115, 119–21 (1994) (rejecting 60 year old VA regulatory policy requiring claimants seeking compensation from the VA to prove that disability resulted from negligence in treatment where fault-based standard found no support in the relevant statute's language, and notwithstanding repeated amendment by Congress of the statute without expressing disapproval of the agency's policy). In addition, both of these cases show that the Supreme Court's fidelity to unambiguous statutory text is not altered merely because of the purported longstanding nature of the agency's interpretation when that interpretation does not comport with the statutory text. By the same token, the Adviser Conduct Interpretation's reliance on earlier SEC releases does not provide any authority for the SEC's demonstrably mistaken statutory construction, but merely evidences the consistency of the SEC's mistake.

322. *See supra* notes 299 & 300; *see also* Pritchard & Thompson, *supra* note 153, at 430 (after describing how purposive methodology shaped securities law decisions of the Supreme Court and the Second Circuit in the 1960s, concluding that Supreme Court decisions in the latter 1960s "marked the end of the purposive era for securities law in the Supreme Court").

evidence" of purpose.[323] The Supreme Court shows little appetite for non-textual purposive approaches to statutory construction (as discussed above) and the federal securities laws are no exception.[324] The argument for a generalized fiduciary duty may well be stronger today than in yesteryear given intervening changes in the investment management industry. Even if true, the agency's construction of the IAA cannot be motivated by counterfactual speculation: Had Congress then only known what we know today, then surely they would have opted to impose a fiduciary duty in the IAA.[325]

B. AN ANSWER TO THE IAA'S FIDUCIARY CONUNDRUM: THE FIDUCIARY DISCLOSURE STANDARD

Though unpersuasive, the SEC's reading of Section 206(2) is appealing in one respect: Investment advisers, because of their fiduciary status under state law, should be held to a higher standard of conduct under federal law in dealing with clients. How can this intuition be squared with the idea that an adviser is not a fiduciary under federal law? Although an adviser's state common law duty is not directly enforceable under the IAA, the common law fiduciary status of investment advisers determines how the IAA's antifraud disclosure obligations apply: Advisers, because of their state-law fiduciary status, have a heightened disclosure obligation under federal law. This approach, as previously noted, is referred to in this article as a fiduciary disclosure standard.

A fiduciary disclosure standard comports with the text of Section 206(2) and fully captures the Supreme Court's holding and rationale in *Capital Gains*. Specifically, it represents a more natural reading of Section 206(2). The IAA proscribes fraud as well as "any transaction, practice or courses of business that operates as a fraud or deceit upon any client."[326] The common law fiduciary status of an adviser is critical

323. Fallon, *supra* note 299, at 705.

324. *See* Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247, 270 (2010) (stating, in rejecting the Solicitor General's purposive construction of Section 28 of the Exchange Act on behalf of the SEC: "It is our function to give the statute the effect its language suggests, however modest that may be; not to extend it to admirable purposes it might be used to achieve."); *see also supra* note 165 and accompanying text.

325. The Supreme Court's admonition, quoted *supra* note 319, rings especially true in this regard.

326. 15 U.S.C. § 80b-6(2).

in applying Section 206(2)'s disclosure standard. An adviser's conduct may operate as a deceit in contexts where an adviser's common law fiduciary status triggers a heightened disclosure obligation. This natural reading of the statute is bolstered by the legislative history, which made reference to the fiduciary character of investment advisers and investment counsel, while modestly providing for registration of advisers and tools to deal with so-called "rogue" professionals who use fraudulent and deceitful practices.[327]

The fiduciary disclosure standard reading of Section 206(2) also conforms to *Capital Gains* as well as existing SEC administrative practice. The Supreme Court's decision emphasized that the violation followed from the adviser's failure "to make full and frank disclosure of [its] practice of trading on the effect of [its] recommendations" to customers (i.e., in advance of client trading that typically increased the price of the recommended security).[328] One particularly revealing passage rhetorically juxtaposed so-called technical constructions of fraud and deceit with construction of those terms in light of adviser's fiduciary status: "Congress codified the common law 'remedially' . . . to the prevention of fraudulent securities transactions by 'fiduciaries,' not 'technically' as it has traditionally been applied in damages suits between parties to arm's-length transactions involving land and ordinary chattels."[329]

How can the IAA impose a federal fiduciary disclosure standard if the statute itself does not make advisers fiduciaries under federal law? In effect, a fiduciary disclosure standard presupposes that investment advisers have a common law fiduciary duty under state law. While the common law provides ample support for such a premise, it does not follow that all states subscribe to a uniform fiduciary standard with respect to all types of investment advisers classified as such under federal law. Moreover, if the IAA's fraud and deceit prohibition is based on state common law fiduciary obligations, does that mean its application will necessarily require a state-by-state analysis of state law

327. *See supra* note 43.

328. SEC v. Cap. Gains Rsch. Bureau, Inc., 375 U.S. 180, 197 (1963).

329. *Id.* at 195. In other words, where undisclosed conflicts of interest exist, a fiduciary standard of disclosure creates an affirmative duty to disclose on the part of fiduciaries such as investment advisers analogous to the "disclosure or abstain" obligation that underpins federal insider trading law. A further passage articulates this standard as follows: "The statute, in recognition of an adviser's fiduciary relationship to his clients, requires that his advice be disinterested. To insure this, it empowers the courts to require disclosure of material facts." *Id.* at 201.

fiduciary obligations to determine whether a particular adviser is a fiduciary in the state where challenged conduct occurs? If so, the IAA's prohibition of fraud and deceit arguably would not apply uniformly across the United States.

The *Capital Gains* Court did not address this issue, but there is a clear solution. Under federal law, federal courts are empowered to fashion uniform federal common law where application of federal law requires legal concepts or principles not set forth expressly in federal law.[330] Resort to federal common law standards under the securities laws is illustrated in a Supreme Court securities law decision issued after *Capital Gains*, *Reves v. Ernst & Young*.[331] *Reves* dictates that, where federal law requires uniformity, federal courts should fashion a uniform federal rule of law, derived from available non-uniform state law principles, consistent with the federal statute's remedial purposes.[332]

Such an approach provides a compelling explanation for *Capital Gains*' holding. Courts should apply a fiduciary disclosure standard under Section 206(2) because, when enacted, it was commonly recognized that investment advisers were common law fiduciaries in many state jurisdictions.[333] Courts and the SEC need not give effect to the fiduciary standards of each of the fifty states in applying the IAA. Rather, courts should apply a uniform federal standard for deceit that presumes that an adviser under the IAA is acting in a fiduciary capacity,

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330. The topic of federal common law is beyond the bounds of this article, but it is invoked here in its most general sense. *See generally*, Martha A. Field, *Sources of Law: The Scope of Federal Common Law*, 99 HARV. L. REV. 881, 890 (1986) (Federal common law "refer[s] to any rule of federal law created by a court (usually but not invariably a federal court) when the substance of that rule is not clearly suggested by federal enactments–constitutional or congressional."); Thomas W. Merrill, *The Common Law Powers of Federal Courts*, 52 UNIV. CHI. L. REV. 1, 5 (1985) ("'Federal common law' . . . means any federal rule of decision that is not mandated on the face of some authoritative federal text–whether or not that rule can be described as the product of 'interpretation' in either a conventional or unconventional sense.").

331. 494 U.S. 56 (1990). In *Reves*, the Supreme Court addressed, in part, whether demand notes fell within an exclusion from the definition of security in the Exchange Act known as the short-term paper exclusion. *Id.* at 72–73. When a demand note is deemed to have matured is a matter of state law that varies from state to state. *Id.* at 72. In fashioning a uniform federal standard, the Court looked to the standard of the states whose principles were most consistent with the underlying purposes of federal law. *Id.* at 72–73.

332. *Id.*

333. *See supra* note 168.

a result that entails heightened disclosure obligations. Thus, even though the IAA does not make investment advisers fiduciaries under federal law (and all that entails), advisers do face heightened disclosure obligations commensurate with a fiduciary disclosure standard.

The fiduciary disclosure standard offers a more persuasive reading of Section 206 in another respect. As noted, Section 206(2) claims are foreclosed by disclosure to the client, a point recognized by the Supreme Court in *Capital Gains*.[334] But as previously noted, notice alone does not waive or constitute consent to a fiduciary's breach of its duties. For example, clients must consent to any conflict,[335] something that is actually required in Section 206(3).[336] However, under a fiduciary standard of disclosure, the significance of full and fair disclosure makes perfect sense. Full and fair disclosure fully satisfies the Section 206(2) requirement because such disclosure satisfies the heightened disclosure requirement and not because it necessarily discharges any fiduciary duty.

Ironically, notwithstanding the Interpretation, the fiduciary disclosure standard gloss on Section 206(2) most closely tracks agency practice in administrative proceedings. As noted, fiduciary breach involving conflicts of interest typically will be conjoined with acts of

334. *See supra* notes 328 & 329 and accompanying text. This point is also made emphatically in *Santa Fe Industries, Inc. v. Green*, one of the Supreme Court's decisions on whose dictum the SEC sought to rely in its Interpretation. *See* 430 U.S. 462, 471 n.11 (1977). While noting *Capital Gains* had been premised on the belief that Congress had established federal fiduciary standards for investment advisers, the *Santa Fe* Court more importantly underscored the fact that *Capital Gains* involved actionable "non-disclosure" under the statute's antifraud provisions (i.e., for purposes here, involved a breach of the fiduciary disclosure standard). *Id.* Moreover, *Santa Fe*'s actual holding undermines the SEC's generalized fiduciary duty theory. The Court held a claim for fraud under the antifraud rules of the Exchange Act could not lie where plaintiffs solely alleged a breach of fiduciary duty but did not complain of disclosure failures. *Id.* at 471. To hold otherwise, would "add a gloss to the operative language of the statute quite different from its commonly accepted meaning." *Id.* at 472 (citation omitted). *But cf.* Robert B. Thompson, *Federal Corporate Law: Torts and Fiduciary Duty*, 31 J. CORP. L. 877, 882 (2006) (describing *Santa Fe* as "usher[ing] in a new era of restrictive" application of securities law antifraud standards when challenging corporate mismanagement).

335. As noted earlier, the relevant requirement under trust law to discharge a fiduciary obligation is informed consent that entails more than a mere failure to object. *See supra* note 289.

336. 15 U.S.C. § 80b-6(3) (imposing specific requirements for conflicts involving trading with a client or acting as the agent in trades among clients). *See supra* notes 309 & 310 and accompanying text.

fraud or deceit.[337] Thus, it is no surprise that such administrative actions necessarily involve fraud or deceit that only further evidence self-dealing or other forms of disloyalty. What is more revealing about agency practice, however, are the administrative proceedings based on negligence or even gross negligence arising from a breach of the duty of care. In the relatively small group of proceedings arising out of such situations, the SEC's administrative orders invariably recite misstatements and other acts of deception to tether the alleged violation to Section 206(2).[338] The absence of any "pure" duty of care in SEC proceedings, which is to say cases in which deceit is absent, strongly implies that the SEC harbors doubts about the legal validity of actions based solely on a breach of fiduciary duty, absent deceit. In short, the Interpretation's fiduciary analysis conflates a federal fiduciary duty with a federal fiduciary disclosure standard.

In addition, the Interpretation's fiduciary duty analysis creates imprecision in the case of duty of care, which is avoided under a fiduciary disclosure standard approach. It can be difficult for securities professionals to decipher the contours of duty of care from the broad standards invoked by the Interpretation. Moreover, the SEC's view of that duty makes mere negligence the relevant legal threshold for liability,[339] an approach inconsistent with corporate law duty of care analysis where gross negligence is the relevant threshold for duty of care breach.[340]

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337. *See supra* note 275.

338. *See* Hennessee Grp., LLC, Investment Advisers Act Release No. 2871, 2009 WL 1077451, at *9 (2009) (finding that respondents "owed fiduciary duties to their clients to not misrepresent the services that they were providing [namely, due diligence on prospective hedge fund investments] and to disclose all material departures from the representations [of due diligence] that they made to their clients"); Charter Cap. Mgmt., LLC, Investment Advisors Act Release No. 5226, 2019 WL 1773512, at ¶¶ 15–17 (2019) (finding investment adviser negligently breached its fiduciary duties to private funds managed and its investors, but also noting adviser failed to disclose conflicts of interest and made affirmative misrepresentations relating to adviser's level of due diligence and "buy-in" of outside professionals in connection with the investment); Pennant Mgmt., Inc., Investment Advisers Act Release No. 5061, 2018 WL 5814398, at ¶ 1 (2018) (finding violations of IAA Section 206(2) based on finding that the adviser "negligently failed to perform adequate due diligence and monitoring of certain investments contrary to representations" made to clients and in its advisory brochure).

339. Adviser Conduct Interpretation, *supra* note 10, at 33671 n.20.

340. *Cf.* Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985).

C. INVESTOR PROTECTION RULEMAKING UNDER THE IAA: THE ROAD FORWARD

The Interpretation is a move out of sync with the IAA's regulatory arc. What should the SEC do to correct this misstep? This section will discuss three possibilities: (i) Do nothing and go on as before; (ii) attempt to salvage the Interpretation's substance through legislative rulemaking; or (iii) begin to think seriously about ways to supplement the existing fiduciary disclosure standard with targeted rules to augment investor protection for average retail investors.

1. Do Nothing

The SEC's adherence to the Interpretation's fiduciary duty theory could be justified on a "no harm, no foul" rationale: Even if it is wrong—as it almost surely is—there is no harm in pretending it is right. After all, the Interpretation is not subject to direct judicial challenge as in the case of challenges to a rule adoption.[341] However, the future of sticking to a mistaken legal theory is not free of legal consequences in terms of coherence or collateral legal challenges. Most directly, the SEC would face uncertainty should it bring administrative or civil actions based on the Interpretation's theory of actionable non-disclosure fiduciary breaches. If, as argued here, the merits of such claims are dubious at best, such proceedings would afford an avenue to challenge the Interpretation's theory. Fortunately, as noted above, most Section 206(2) actions are fully consistent with a fiduciary disclosure standard. Moreover, proceedings settled prior to adjudication involving a non-disclosure based fiduciary claim will not entail litigation risk, and most SEC administrative proceedings are settled. Thus, the SEC may be able to continue to assert enforcement positions consistent with the Interpretation, even if it is invalid in some respects.

The most likely legal challenge, however, would arise in actions against associated persons of individual advisers, as primary or

341. As noted, the SEC's Interpretation would be classified as an interpretive rule rather than a legislative rule. *See supra* note 317**.** Legislative (or substantive) rules are subject to direct judicial challenge while interpretive rules are not. *See, e.g.*, Azar v. Allina Health Servs., 139 S. Ct. 1804, 1813–14 (2019) (distinguishing the difference between interpretive and legislative rules for purposes of judicial review). For an example of a successful legislative rule challenge, see Financial Planning Ass'n v. SEC, 482 F.3d 481 (D.C. Cir. 2007). In the case of legislative rules under the IAA, direct judicial review can be obtained from a U.S. Court of Appeals. 15 U.S.C. § 80b-13.

secondary violators (e.g., as a "cause" of an investment adviser's violation or as an aider and abettor).[342] Individuals face a different reputational calculation in deciding whether to settle than firms, and therefore, are more likely to refuse to settle. If so, the SEC will need to be cautious in charging ancillary individuals who cannot be tied to actual disclosure misconduct when bringing a non-disclosure fiduciary claim against an asset management firm.[343]

In order to avoid significant litigation uncertainty in "pure" non-disclosure fiduciary actions, the SEC will likely avoid actions against individuals associated with advisers in "pure" non-disclosure fiduciary claims, such as duty of care actions. In other words, defects in the Interpretation's theory could affect the SEC's enforcement strategy in non-disclosure fiduciary actions. In effect, the controversial aspects of the Interpretation's fiduciary position will stand as a sermon from a bully pulpit rather than enforceable regulatory policy.[344]

2. Salvage the Interpretation's Fiduciary Standard of Conduct Through Legislative Rulemaking

An entirely different approach to salvaging the Interpretation would be for the SEC to use delegated rulemaking authority to impose a fiduciary duty on investment advisers pursuant to Section 206(4), a course of action that it expressly declined to do in the Interpretation.[345] While such an explicit rule would go beyond simple fraud or deceit, it almost surely comes with the ambit of means reasonably prescribed to

342. *See, e.g.*, 15 U.S.C § 80b-3(k).

343. *Compare* State St. Bank and Tr. Co., Securities Act Release No. 9107, 97 SEC Docket 2425, at ¶ 33 (2010) (bank liable for misrepresentations made to asset management clients), *with* Flannery v. SEC, 810 F.3d 1, 14 (1st Cir. 2015) (senior State Street bank executive could not be held liable on similar theory where the executive's precise role in causing the misrepresentations was unclear). For technical reasons, the action was premised on violations of the Securities Act antifraud provisions rather than the IAA.

344. To the extent that the SEC wishes to pursue non-disclosure based duty of care claims against individuals, a more defensible position would be to allege that the individuals' lack of due care caused a breach of a compliance policy or procedures under the Compliance Rule. Although there is no private litigation that will be affected by the SEC's overbroad interpretation, it could provide fodder for an equitable action for recovery of advisory fees. *See supra* notes 176–179 and accompanying text.

345. *See* Adviser Conduct Interpretation, *supra* note 10, at 33670 & n.14 (rejecting comment letters favoring rulemaking).

prevent practices that operate as a fraud or deceit, the touchstone for a Section 206(4) rulemaking.[346]

Rulemaking appears to be an approach favored by Congress under a different IAA rulemaking grant. As part of the Dodd–Frank Act, Congress amended IAA Section 211(g) to provide that investment advisers, and other securities professionals, "shall . . . act in the best interests of the customer without regard to the financial or other interest of the broker, dealer, or investment advisor providing the advice" when "providing personalized investment advice about securities" to retail customers.[347] The amendment, in part, delegated to the SEC rulemaking discretion to fix standards of conduct for investment advisers and others in advising retail investors. Although the formulation of Section 211(g) may be opaque, the more important point is that Congress believed that such a process should be calibrated through agency rulemaking.

One might ask why the SEC opted for a statutory interpretation rather than a straightforward rulemaking. This is a matter for speculation, and may have reflected nothing more than an inability to get a consensus at the Commission level on a rulemaking approach. Rulemaking could easily raise concerns. First, a rulemaking would have been subject to judicial challenge upon adoption. Second, rulemaking might have been viewed as triggering additional burdens under IAA Section 211(g).[348] This complex provision arguably would have required a rule that imposed commensurate fiduciary burdens for broker-dealers in at least in some respects, a result that a majority of the Commission may have opposed.[349] Thus, although the SEC could have accomplished much, if not most, of what it hoped to have accomplished in the Interpretation through rulemaking, it deliberately decided to foreswear rulemaking in this context.

This article has no strong view on the desirability of an IAA fiduciary rule because, as noted, it largely overlaps with the fiduciary disclosure standard provided in Section 206(2). Moreover, any rule would have to achieve greater precision than the Interpretation in order to be workable. However, at a policy level, exclusive reliance on a

346. *See supra* note 73.

347. 15 U.S.C. § 80b-11(g).

348. *See* 15 U.S.C § 80b-11(g). Through this provision, Congress arguably was more concerned with elevating the standard of conduct for broker-dealers than investment advisers and that may well have been a sticking point.

349. This echoes the issue that was considered by the Second Circuit's recent *XY Planning* decision (*see supra* note 266), which turned on the difference between rulemaking under Sections 913(f) and 913(g) of the Dodd–Frank Act.

fiduciary-only standard would likely achieve very little in the way of new substantive protection for average retail investors, unless supplemented by targeted rules-based standards. Thus, the issue of a legislative rule fiduciary-only standard is the sufficiency of such an approach in addressing investor protection for average retail investors.

There are both practical and philosophic reasons to question the sufficiency of a fiduciary standard-only approach to investor protection for average retail investors. A fiduciary duty-only approach may offer only a relatively low bar for adviser conduct in some cases. For example, the Interpretation addressed an adviser's fiduciary obligation to recommend the lowest-cost comparable investment product, or fund, to its client, explaining that it is not the case because any recommendation is inherently conditioned on many different facts and circumstances.[350] The Interpretation further emphasized that "an adviser would not satisfy its fiduciary duty to provide advice that is in the client's best interest by simply advising its client to invest in the lowest cost (to the client) or least remunerative (to the investment adviser) investment product . . ."[351] While it is true that all investment recommendations must reflect a balancing of various facts and circumstances, this sort of temporizing is not very useful in affording protection to average retail investors. The SEC's emphatic explanation of this point sounds more like a rationalization than a call to a higher standard of conduct. The very same point, with a more forceful investor protection focus, could have been offered by emphasizing that advisers should select the least expensive fund among funds of similar objectives, strategies, and styles, unless the adviser has affirmative reasons to believe that less expensive funds will be less desirable in some respect for the investor than a recommended fund that is more expensive.

The latter approach places the onus on the adviser to justify recommendations that result in greater investment costs, especially where funds have very similar investment strategies and styles (e.g., actively managed broad-based large cap equity funds with sharply

350. *See* Adviser Conduct Interpretation, *supra* note 10, at 33674 (noting factors "such as an investment product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon, and cost of exit").

351. *Id.*

different costs). The larger point, however, is that a vague general federal fiduciary duty alone potentially de-emphasizes investor protection considerations relative to a fiduciary standard supplemented by rules targeted to provide an investor or consumer protection orientation for average retail investors.[352]

The Interpretation's fiduciary standard-only approach also rests on a dubious policy assumption, namely that an exclusively principles-based approach is more desirable than any other approach, such as the one advocated here (supplementing a fiduciary disclosure standard with targeted rules-based standards). The SEC described the purported IAA fiduciary duty as an inherently "principles-based"[353] approach that properly provides "sufficient flexibility to serve as an effective standard of conduct for investment advisers, regardless of the services they provide or the types of clients they serve."[354] In its endorsement of the sufficiency of an exclusively principles-based and common-law-inspired fiduciary duty for purposes of investor protection, the SEC rejected (as noted above) any need for augmentation of retail investor protection pursuant to rulemaking authority.[355]

The economic and legal literature on rules-based and principles-based standards is vast, and makes clear that the choice of one approach over the other, depends on the nature of the problem that is being

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352. *See generally* Joseph A. Franco, *A Consumer Protection Approach to Mutual Fund Disclosure and the Limits of Simplification*, 15 STAN. J.L. BUS. & FIN. 1 (2009) [hereinafter *A Consumer Protection Approach*] (discussing consumer protection principles and the underlying financial economics literature).

353. *See* Adviser Conduct Interpretation, *supra* note 10, at 33670–71 (repeated in various formulations).

354. *Id.* at 33671.

355. *Id.* at 33670 ("In our view, adopting a rule text is not necessary to achieve our goal in the Final Interpretation of reaffirming and in some cases clarifying certain aspect of the fiduciary duty."). The SEC identified several comment letters that advocated adoption of a fiduciary duty by rule as would be permitted by IAA Section 206(4) or possibly Section 211. *See id* at 33670 n.14.

Similarly, in Regulation BI, the SEC argued that investor choice supported a principles-based rulemaking approach with respect to the standard of conduct for broker-dealers: Affording investment clients choice allows advisers and clients to shape legal obligations in a way that is mutually beneficial. *See* Regulation BI Standard of Conduct, *supra* note 265, at 33332 (stating that imposing a fiduciary duty on broker-dealers in providing advice to retail investors "would significantly reduce retail investor access to differing types of investment services and products, reduce retail investor choice in how to pay for those products and services, and increase costs for retail investors of obtaining investment recommendations").

addressed by the standard.[356] The SEC's conclusion oversimplifies this issue by assuming that choice of rules-based and principles-based standards is an either-or situation. On that assumption, the SEC is probably correct that highly variegated facts and circumstances are intrinsically relevant to understanding fiduciary obligation of advisers. However, that does not mean that an exclusively principles-based approach to a conduct standard for advisers will always be superior. A rules-based standard may serve to supplement principles-based standards in specific circumstances to strengthen investor protection (e.g., rules in dealing with small retail investors).[357]

Unvarnished investor choice rationales should be viewed skeptically in the context of the IAA for two reasons. First, the underlying assumption of the IAA's investor protection scheme is that investors are seeking help from professionals because the investors frequently lack the same knowledge and expertise to make investment decisions on their own. Investor choice is not irrelevant to the IAA's

356. *See* Joseph A. Franco, *Of Complicity and Compliance: A Rules-Based Anti-Complicity Strategy under Federal Securities Law*, 14 UNIV. PA. J. BUS. L. 1, 27–31 (2011) (discussing the debate on the utility of legal norms couched as standards or rules); Thomas Lee Hazen, *Are Existing Stock Broker Standards Sufficient? Principles, Rules and Fiduciary Duties*, 2010 COLUM. BUS. L. REV. 710, 721 ("[T]here is no one-size-fits-all answer to the appropriate balance between specific rules and more generalized standards and principles."). Speed limits are classic examples of laws that take the form of rules whereas the negligence standard in tort law exemplifies a standard. The standards (principles)-versus-rules debate is well-known in the legal literature. The SEC employs "principles" as a synonym for "standards" in the Interpretation. *See* James J. Park, *Rules, Principles, and the Competition to Enforce the Securities Laws*, 100 CAL. L. REV. 115, 130–42 (2012) (discussing enforcement policy implications and distinguishing between rule-based and principles-based legal prohibitions).

357. The SEC itself seems to have conceded this point in its recent proposal to revise the IAA advertising rule, Rule 206(4)-1 (17 C.F.R. § 275.206(4)-1 (1997)). There, although generally endorsing a principles-based methodology for its revisions of the rule, the SEC conceded that a purely principles-based approach would jeopardize investor protection in the case of testimonials, endorsements, and third-party ratings. *See* Investment Adviser Advertisements; Compensation for Solicitations, Investment Advisers Act Release No. 5407, 84 Fed. Reg. 67518, 67520–21, 67537–38 (2019). This approach is reflected, but with some modification, in the adopting release for the final rule. *See* Investment Adviser Marketing, *supra* note 212, at 66–67 n.205, 86 F.R. ___ n.205 ("[T]he amount and type of information that may need to be included in an advertisement directed at retail investors may differ from the information that may need to be included in an advertisement directed at sophisticated institutional investors.").

regulatory scheme, but neither should automatically override other factors shaping investor protection. Rather, only where investor choice is consistent with a belief that investors are well-informed and likely to make rational decisions under conditions of full information should regulation give heavy value to investor choice.

Herein lies the second reason for skepticism regarding opposition to rules-based standards as creating an obstacle to investor choice. As a practical matter, the evidence of fully-informed and rational investor choice among average retail investors is not supported by a wealth of legal and financial literature.[358] Accordingly, investor choice should be given only modest weight when addressing the needs of average retail investors. Instead, policy should focus on ways to enhance average investors' ability to make informed decisions and receive fair treatment by making investment professionals accountable for the guidance they render.

To be sure, broad fiduciary mandates serve a purpose in providing sufficiently flexible standards that can be applied to address countless situations. However, the cost of generality is that such a standard is less likely to yield a meaningfully constraining standard of conduct. Supplementing a broad fiduciary standard with rules-based standards that are narrowly targeted would likely result in a more robust form of investor protection. Rules-based standards can delineate between different classes of investors and accounts (e.g., small retail investors, retirement accounts, and institutional investors) as well as an assortment of advisory contexts (impersonal asset managers, personalized money managers, and personalized advice to retail investors).

3. Targeted Investor Protection Rulemaking to Supplement the Fiduciary Disclosure Standard

As noted, Congress gave the SEC wide-ranging rulemaking authority both in Section 206(4), to adopt means reasonably designed to prevent fraud, and in Section 211(g), to prescribe an appropriate standard of conduct with respect to retail investors. This untapped

358. *See A Consumer Protection Approach*, *supra* note 352, at 42–48 (discussing research showing factors that lead to irrational investor behavior in the context of mutual fund selection); Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Market*, 95 VA. L. REV. 1025, 1045 (2009) (noting that behavioral economics literature "support[s] the idea that investors act less than fully rationally with enough frequency to cause concern.").

reservoir of rulemaking authority is sufficiently robust to allow the SEC to create and shape standards of conduct for an adviser that go beyond mere fiduciary obligations in order to advance investor protection objectives. As discussed below, a hybrid approach to rulemaking–one that relies on well-defined fiduciary floors for conduct and rules that are specifically tailored through rulemaking to target patterns of problematic practices and irrational investor behavior–is more likely to achieve a higher degree of investor protection than an aspirational common law fiduciary mandate alone (exemplified by the SEC's Interpretation).[359]

The merits of any particular example of targeted investor protection rules for average retail investors are beyond the scope of this article. However, some possible examples are offered to illustrate how rulemaking itself can be targeted in ways that are more likely to help average investors achieve cost-effective investment strategies without foreclosing investor choice.

The hypothetical investor protection rules discussed share three general features. First, the rules are formulated either as default norms or disclosure rules to establish prudential guardrails rather than as mandatory rules.[360] This approach would minimize intrusiveness on

359. An incidental benefit of a targeted rules approach (supplementing a basic fiduciary disclosure standard) is that it would prove helpful in making sense of the Dodd–Frank Act's attempt to bring about conduct standard parity between broker-dealers and investment among securities professionals providing advice to retail customers. The effort to bring about greater alignment among the standard of conduct of securities professionals and a meaningful enhancement of investor protection for retail investors has failed in part because the range of clients and functions discharged by these two types of securities professionals made a single all-encompassing conduct rule impractical. A targeted rulemaking approach to standards of conduct for investment advisers dealing with average retail investors could offer a path for reconciling standards of conduct among these two types of professionals in selected areas. Rather than trying to devise a grand common standard to govern both sets of securities professionals, parallel targeted rules-based standards in select areas may provide a basis for reaching consensus on a conduct standard in limited areas (e.g., should variable annuities be marketed differently by investment advisers as opposed to broker-dealers?). In other words, it may be easier to achieve parity in conduct standards by specifically limiting the scope of the areas where parity is sought.

360. *Cf.* Daniel Clarry, *Mandatory and Default Rule in Fiduciary Rules*, *in* THE OXFORD HANDBOOK OF FIDUCIARY LAW 435, 438 (Evan J. Criddle et al. eds., 2019) ("A 'default rule' applies absent a binding expression of party intention that the rule ought not to apply or that it is to be modified.").

investor choice; an investor is able to choose to disregard the guardrails in place.

Second, investor protection rules can be targeted at specific classes of investors, such as an average retail investor, rather than all retail investors, regardless of wealth or sophistication. The financial situation and objectives of investment adviser clients are varied. The Interpretation is expressly framed in terms of principles applicable to all retail clients, leaving it to advisers to make appropriate distinctions based on facts and circumstances, and permits reasonable restrictions in the agreed-upon scope of the relationship between any adviser and its client.[361] In contrast, targeted default rules are better suited to address a large class of average retail investors with limited financial sophistication, modest resources and well-defined objectives (saving for retirement).[362] In this group especially, tailored rulemaking could be used to establish heightened default standards of conduct depending on the nature of the investment product and the financial circumstances of those retail customers.

Third, targeted rules can be used to ensure presentation of meaningful comparative information for evaluating personalized recommendations in context. The rules discussed are weighted to facilitate comparisons by retail investors between actively-managed and passively-managed investment strategies. While advisers are free to offer whatever advice they believe is appropriate, targeted rules can be used to ensure greater accountability in recommendations by requiring that advice be contextualized with respect to comparable generic passively-managed strategies.

Here are three examples of what personalized targeted investor protection rules might look like.

> (a) *A simple targeted rule with respect to recommendations of active over a comparable passive fund*. Such a rule would obligate an adviser to supplement its disclosure in providing personalized advice recommending an actively-managed fund when a comparable

361. *See* Adviser Conduct Interpretation, *supra* note 10, at 33671.

362. As to limitations faced by average retail investors, see Lisa M. Fairfax, *The Securities Law Implications of Financial Illiteracy*, 104 VA. L. REV. 1065, 1077 (2018) (noting that "studies uniformly conclude that Americans are not financially literate"); Jill E. Fisch & Tess Wilkinson-Ryan, *Why Do Retail Investors Make Costly Mistakes? An Experiment on Mutual Fund Choice*, 162 U. PA. L. REV. 605, 6112014) (noting the "relative lack of sophistication" among average mutual fund investors); *see also supra* note 358.

> passively-managed fund is also available to average retail investors. In such circumstances, the adviser would be required to: (i) alert the average retail investor of the existence of comparable lower cost funds, (ii) state reasons for recommending the actively-managed fund, and (iii) provide comparative standardized performance information regarding the active and managed funds in a consolidated format.
>
> (b) *A targeted rule relating for recommendations relating to personalized portfolio-wide strategies* (for example, a retirement portfolio). Such a rule might obligate an adviser to maintain documentation when providing personalized advice to an average retail investor where the amount of portfolio assets held in actively-managed funds exceeds a percentage threshold (such as 30-40%). In such circumstances, an adviser would be required to maintain written records of an assessment regarding the cost effectiveness of the chosen portfolio relative to a passively-managed portfolio (with assets allocated similarly across asset classes) from a portfolio-wide perspective.
>
> (c) *A targeted rule to increase the disclosure obligations of fund advisers when selling classes of fund shares marketed by personalized investment advisers or broker-dealers*. This type of rule would seek to impose additional disclosure obligations on asset managers of funds where such funds' shares are sold to average retail investors by personalized advisers. Specifically, in the case of actively-managed funds, the asset manager would be required to provide enhanced disclosure regarding the types of portfolio strategies for which the fund is not suitable—disclosure that advisers would need to take into account when providing personalized advice to average retail investors. As discussed below, such a rule would seek to target a common issue in two-tiered advisory arrangements: the potential disconnect between the product strategies of asset managers and the recommendations of personalized advisers.

These examples of targeted rules are admittedly impressionistic and would require significant work to tailor them for general application.[363]

363. The illustrative rules employed rely heavily on the potential misuse of actively-managed funds in a retail investor portfolio. This is not meant to suggest that actively-managed funds are in any way inherently undesirable for retail investors. *See generally* K.J. Martijn Cremers, Jon A. Fulkerson & Timothy B. Riley, *Challenging the Conventional Wisdom on Active Management: A Review of the Past 20 Years of Academic Literature on Actively Managed Mutual Funds*, 75 FIN. ANALYSTS J. 4, 8–9 (2019) ("Our review of the literature suggests that the conventional wisdom judges active management too negatively.").

Nevertheless, they illustrate how targeted rules might be fashioned to implement basic investment rules-of-thumb, a form of prudential guardrails, as default norms. Rules of this sort would function differently than traditional fiduciary-only standard and might better serve the needs of average retail investors. Targeted rules could encourage investment behavior that the SEC determines offers lower risks and lower costs for average retail investors without necessarily foreclosing alternative more aggressive investment strategies for those investors. In contrast, a fiduciary-only standard gives wider berth to any adviser's advice provided it is arguably reasonable (i.e., cannot be shown to be unreasonable) under the given facts and circumstances.

The rules discussed above represent a means to address two specific problems not well addressed by fiduciary principles alone: the problem of evaluating advice relating to portfolio strategies for average retail investors, and the problem of gaps and misalignment of strategies created by two-tiered investment arrangements. As to the first of these problems, there is only limited oversight of portfolio strategies under conventional fiduciary principles beyond mere diversification axioms. For example, an adviser rendering personalized advice who recommends that a client diversify his portfolio by holding many fund investments may not be pursuing diversification principles in a sound manner. A diversification strategy that uses many actively-managed funds (e.g., funds with relatively large management fees that have overlapping investment strategies within a given asset class) may not be a sound diversification strategy. Combining actively-managed strategies within an asset class only serves to render an investor's combined portfolio more correlated with the market as a whole (i.e., more similar to a broad-based passive strategy), and less likely to benefit from the active management of any one manager. Such a portfolio and its performance can typically be replicated at lower cost by holding a passively-managed fund.[364]

364. *See generally* K.J. Martijn Cremers & Quinn Curtis, *Do Mutual Funds Get What They Pay For? Securities Law and Closet Index Funds*, 11 VA. L. & BUS. REV. 31 (2016). It should be noted that Cremers and Curtis focus on potential rules of liability for active funds that closet index, but their logic suggests that portfolios that combine many actively managed equity mutual funds raise the same concerns about closet indexing. Is this the fault of the adviser giving personalized advice, or the individual fund asset managers? Admittedly, the adviser giving personalized advice arguably is committing advisory malpractice. However, explicit disclosure from fund asset managers could provide clear guidance on the potential inefficiency of combining many similarly managed actively-managed funds in a single portfolio.

The potential for gaps or misalignment in advisory strategies in two-tiered investment arrangements can also be a source of problems that is difficult to attack with fiduciary principles alone. Average retail investors increasingly participate in investment strategies that involve dual advisory relationships: personalized advice from an adviser regarding investment products, such as different funds, where each particular fund is overseen by an asset manager, itself another adviser. The asset manager is technically advising the fund that it manages and not the fund's individual investors regarding their investment portfolio, while the personalized advice from an investment adviser makes recommendations as to which funds the individual should include in the individual's investment portfolio.

Under federal law, the obligations of the fund, and indirectly, the adviser, with respect to retail investors are primarily twofold: full and fair disclosure, and ensuring the fund's financial and operational integrity. The fund manager is subject to the IAA and its rules but, as noted, the adviser's client is the fund itself. In this type of investment arrangement, the relationship of the asset manager and the investor is almost wholly disclosure-based, and an investor's recourse against the asset manager is largely limited to disclosure-based remedies. No assessment about suitability or appropriateness is made by the asset manager for the investor other than the impersonal information conveyed by means of public disclosure.

The investor, however, may rely on advice from an investor adviser providing personalized investment recommendations regarding selection of fund investments. A personalized adviser has considerable discretion in formulating personalized investment recommendations. The constraints on the investment adviser's judgment are few, and the adviser's judgement cannot be easily challenged if it is not unreasonable.[365] The risk of misalignment in advisory strategies arises to the extent that a particular fund is not well-suited for the personalized adviser's strategy for a client.

365. The two tiers result in in fees to retail investors, whether direct or indirect, to compensate the two levels of advisers. The fund manager charges an asset-based management fee based on the fund's strategy and style that holders of fund shares absorb indirectly when the fund pays the management fee out of fund assets. The fund investor may also incur fees, directly or indirectly, to compensate the investor's personalized adviser. A fund asset manager, of course, has no way of knowing what funds are in an individual fund shareholder's total investment portfolio.

Generally, misalignment in advisory strategies between an asset manager in managing a fund and the way a personalized adviser might envision the fund fitting within a retail investor's portfolio is not subject to regulatory oversight, except in unusual circumstances. For example, the SEC has challenged conduct of securities professionals for causing the client account to rack up unnecessary transaction fees involving mutual funds, and these cases could be viewed as attempts to police some aspects of two-tiered intermediation abuses.[366] The SEC also recently brought a new type of case that might be dubbed a platform case in which it found that an investment adviser breached its fiduciary duties of disclosure in maintaining certain funds on the investment adviser's approved fund platform that was used by registered investment advisers relying on the screening decisions performed by the platform-sponsoring adviser.[367] However, what is common to these approaches is that the personalized adviser bears the entire responsibility to avoid any situation arising from misalignment as long as the fund adviser has caused the fund to fairly disclose its principal objectives and strategies. A targeted rule of the sort described in example (c) above would afford greater protection for average retail investors in a world where two-tiered advisory intermediation is present by forcing asset managers to be clear about how a fund product should be used in an average retail investor's portfolio. Personalized advisers would need to consider such guidance in making recommendations with respect to a retail investor's portfolio.

366. For example, the SEC has recently concluded a massive enforcement initiative, involving the imposition of administrative sanctions on investment advisers that improperly recommended unnecessarily expensive share classes for investors without disclosing their own conflicts of interest in such recommendations. *See* DIV. OF ENF'T, SEC. & EXCH. COMM'N, SHARE CLASS SELECTION DISCLOSURE INITIATIVE (May 1, 2018) (summarizing cases brought and terms of settlement that would be imposed on advisers that self-report violations); *see also* Press Release, SEC, SEC Share Class Initiative Returning More than $125 Million to Investors (Mar. 11, 2019) (announcing settlement against 79 self-reporting investment advisers for share selection misconduct). Subsequent cases involving self-reporting were also completed. The SEC also subsequently brought administrative actions against broker-dealers and investment advisers that failed to self-report under the SEC's program. *See, e.g.*, VALIC Fin. Advisors, Inc., Investment Advisers Act Release Nos. 5550 & 5551 (Jul. 28, 2020) (ordering a combined $20,000,000 civil penalty for violations of a variety of IAA and other securities law provisions).

367. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc., Investment Advisers Act Release No. 4989, 2018 WL 3970539 (Aug. 20, 2018).

CONCLUSION

The Advisers Act is eighty years young. It started as something very different from what it has become, but its mandate has evolved through legislative amendment, financial and economic realities of the business of investment management, and regulatory adaptation of the mandate. Congress has been an active, although not necessarily a fully cognizant agent, in recasting the IAA mandate. However, the changes have been sufficient to allow the IAA to evolve with the times, especially by enabling the SEC to use administrative powers to respond to a rapidly changing environment. For the most part, the SEC has been successful, even though it probably has not always executed such a vision flawlessly or coherently. Its recent Adviser Conduct Interpretation is a disappointment in this regard, as it purports to find an explicit fiduciary duty in the text of the IAA, where none reasonably exists. As a result, the agency convinced itself to do nothing more in terms of investor protection than what it asserts inheres in the statute. The position is both wrong as a matter of law and policy. This missed regulatory opportunity by the SEC shows that, notwithstanding a regulatory arc that has overcome many obstacles, many obstacles remain until the IAA's full promise as a robust source for investor protection is fulfilled.