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Observations on Judicial Approaches to Discerning Investment Adviser Status under the Investment Advisers Act of 1940

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Abstract: *This article analyzes judicial approaches to interpreting the definition of an investment adviser under the Investment Advisers Act of 1940, the United States federal statute governing investment advisers. It starts by noting the role of investment advisers in the United States financial services industry and introduces the statutory definition of an investment adviser and each element of this definition. It explains briefly why adviser status is important and touches on the relationship between investment adviser status and registration as an investment adviser with the United States Securities & Exchange Commission. Based on cases initiated by the United States Securities & Exchange Commission, the United States Department of Justice and investment adviser clients alleging investment adviser violations of the Investment Advisers Act of 1940, the article discusses key judicial interpretations of the elements of the definition of investment adviser. Along the way, the author shares his observations about these judicial approaches to interpreting the definition of an investment adviser by, among other things, evaluating some of the strengths and weaknesses reflected in these judicial approaches.*

Keywords: *investment adviser; investment advice; investment management; Section 202(a)(11); Investment Advisers Act.*

I. Introduction

Under United States federal securities law, the definition of an investment adviser under Section 202(a)(11) of the Investment Advisers Act of 1940 ("Advisers Act") covers services provided by thousands of investment management professionals ranging from portfolio managers advising private investment funds, such as hedge funds, to certain types of personal financial advisers and financial planners,[1] collectively overseeing trillions of dollars in investment assets.[2] The most signifi-

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1 *See* SEC. AND EXCH. COMM'N, STUDY ON ENHANCING INVESTMENT ADVISER EXAMINATIONS 1, 32 (Jan. 2011) (discussing diversity of investment advisory industry as "ranging from small, locally-operated financial planning firms to money managers that are part of global financial institutions […]").

2 *See id.* at 10 (noting that as of Sept. 30, 2010, registered investment advisers managed $ 38.3 trillion in assets); *see also* SEC. AND EXCH. COMM'N, DODD-FRANK ACT CHANGES TO INVESTMENT ADVISER REGISTRATION REQUIREMENTS 5 (Jan. 13, 2013) ("There are 10,754 advisers registered with the Commission with total assets under management of $ 49.66 trillion.").

Fundstelle: *Carroll*, Observations on Judicial Approaches to Discerning Investment Adviser Status under the Investment Advisers Act of 1940, ALJ 1/2015, 99–126 (http://alj.uni-graz.at/index.php/alj/article/view/39).

cant part of Section § 202(a)(11) defines an investment adviser as one who "for compensation, engages in the business of advising others [...] as to the value of securities or as to the advisability of investing in, purchasing, or selling securities [...]."[3] While much of the work of these and other financial professionals falls clearly under this definition, investment adviser status is not always obvious, particularly when dealing with newly created financial services and products.

This article examines how courts approach the elements of this definition and some of the challenges they face. It starts by noting briefly why investment adviser status is important. It then reviews the complete statutory definition of an investment adviser and touches on the relationship between investment adviser status and investment adviser registration with the U.S. Securities & Exchange Commission ("Commission"), a federal agency charged with administering the Advisers Act. Next, the article identifies the types of cases that may implicate this definition. Finally, it outlines key judicial approaches to interpreting this definition while sharing some observations about these approaches.

II. Investment Adviser: Definition, Exceptions and an Exemption

Investment adviser status is important because it carries with it certain responsibilities and opportunities. At the very least, an adviser that meets this definition owes a fiduciary duty to its clients[4] and is subject to the Commission's authority to investigate and prosecute in civil proceedings investment adviser fraud under provisions of § 206,[5] regardless of whether or not an investment adviser is required to register with the Commission.[6] Similarly, an investment adviser is designated by law as a potential whistleblower target under § 21F[7] of the Securities Exchange Act of 1934 ("Exchange Act").[8] On the other hand, registered investment advisers may participate as a

3 Investment Advisers Act of 1940 ("Advisers Act"), § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (1940). Hereafter references to sections of Advisers Act and rules promulgated thereunder will not be identified as part of the Advisers Act, but simply by section number and rule number.

4 Sec. & Exch. Comm'n v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963) (citations omitted) ("The Investment Advisers Act of 1940 thus reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship."); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 n.11 (1977) ("[...] Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers." (citations omitted); Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979) ("[T]he [Advisers] Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations.").

5 *See* § 206(1)-(2), Prohibited Transactions by Investment Advisers, 15 U.S.C. § 80b-6(1-2), ("It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly – (1) to employ any device, scheme, or artifice to defraud any client or prospective client; (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client [...].").

6 *See* § 206, Prohibited Transactions by Investment Advisers, 15 U.S.C. § 80b-6; Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 n.6 (1979) (When amending Section 206 by adding Section 206(4), "[...] Congress also extended the provision of § 206 to all investment advisers, whether or not such advisers were required to register under § 203 of the [Advisers] Act, 15 U.S.C. § 80b-3. 74 Stat. 887."); *see also* "Investment Adviser Status and Investment Adviser Registration with the Commission" in this article.

7 § 21F Securities Exchange Act of 1934 ("Exchange Act"), Securities Whistleblower Incentives and Protection, 15 U.S.C. § 78u-6*; see* Securities Whistleblower Incentives and Protections, Securities Exchange Act Release No. 64545 (May 25, 2011) 3, 76 FR 34300 (June 13, 2011) (adopting rule release) ("Section 21F directs that the Commission pay awards, subject to certain limitations and conditions, to whistleblowers who voluntarily provide the Commission with original information about a violation of the securities laws that leads to the successful enforcement of an action brought by the Commission that results in monetary sanctions exceeding $ 1,000,000."); *see also* Exchange Act § 3(a)(47), 15 U.S.C. 78c(47) ("The term 'securities laws' means [...] the Investment Advisers Act of 1940 [...].").

8 15 U.S.C. § 78a et seq.

qualified institutional buyer in the private resale of certain securities pursuant to Rule 144A[9] of the Securities Act of 1933 ("Securities Act").[10] Under United States federal securities laws, other consequences flow from investment adviser status.[11]

Section 202(a)(11) defines an investment adviser and provides eight exceptions[12] to this definition. Section 202(a)(11), in its complete form, defines an investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities."[13] Some of the terms appearing in this definition are defined further by the Advisers Act.[14]

By parsing the language of § 202(a)(11), three categories of investment adviser emerge. The first category, which was identified at the beginning of this article, covers persons who are engaged in the business of providing advice to others on investment in or the value of securities for compensation. Those meeting this definitional language are referred to in this article simply as investment advisers. The second category of investment adviser covers persons who provide investment advice through publications or writings, and are referred to in this article as "Publication Advisers."[15] The third category includes those who, for compensation, are in the regular business of issuing analyses or reports on securities, and are referred to as "Report

9 *See* Securities Act of 1933 ("Securities Act") § 5(d), 15 U.S.C. § 77e(d); Securities Act Rule 144A, Private Resale of Securities to Institutions, 17 C.F.R. § 144A (defining a qualified institutional buyer as "[a]ny investment adviser registered under the Investment Advisers Act."); *see also* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Investment Advisers Act Release No. 3524 (July 10, 2013) 3, 78 FR 44771 (July 24, 2013) (adopting rule release) (footnote omitted) ("The term 'Rule 144A offering' in this release refers to a primary offering of securities by an issuer to one or more financial intermediaries – commonly known as the 'initial purchasers' – in a transaction that is exempt from registration pursuant to § 4(a)(2) or Regulation S under the Securities Act, followed by the resale of those securities by the initial purchasers to QIBs [qualified institutional buyers] in reliance on Rule 144A.").

10 15 U.S.C. § 77a et seq.

11 *See*, *e.g.*, Selective Disclosure and Insider Trading, Exchange Act Release No. 43154 (Aug. 15, 2000) 1, 65 FR 56,716 (Aug. 24, 2000) (adopting rule release) ("Regulation FD (Fair Disclosure) is a new issuer disclosure rule that addresses selective disclosure. The regulation provides that when an issuer, or person acting on its behalf, discloses material nonpublic information to certain enumerated persons (in general, securities market professionals and holders of the issuer's securities who may well trade on the basis of the information), it must make public disclosure of that information."); Regulation FD, 17 C.F.R. § 243.100(b)(1)(iii) (identifying investment advisers as defined under § 202(a)(11) as a member of a class of recipients of material nonpublic information triggering public disclosure of that information).

12 Section 202(a)(11)(A)-(G), 15 U.S.C. § 80b-2(a)(11)(A)-(G). In addition to these exclusions under § 202(a)(11), § 202(b), 15 U.S.C. § 80b-2(b), excludes the application of the Advisers Act to certain federal and state government agencies, instrumentalities and officers. *See* Sec. & Exch. Comm'n v. DiBella, 587 F.3d 553, 567-568 (2d Cir. 2009) (interpreting § 202(b)).

13 Section 202(a)(11), 15 U.S.C. § 80b-2(a)(11); *see also* Exchange Act § 3(a)(2), 15 U.S.C. § 78c(2) (definition of investment adviser identical to definition of investment adviser under § 202(a)(11)). *But see* § 2(a)(20) Investment Company Act of 1940 ("Investment Company Act"), 15 U.S.C. § 80a-2(a)(20) (definition of investment adviser different than § 202(a)(11) definition). *See* U.S. Sec. & Exch. Comm'n Investment Management Staff Issue of Interest, "Persons Who Provide Advice Solely Regarding Matters Not Concerning Securities," 4 (comparing Advisers Act § 202(a)(11) (definition of investment adviser) with Investment Company Act § 2(a)(20) (definition of investment adviser)).

14 *See*, *e.g.*, § 202(a)(5), 15 U.S.C. § 80b-2(a)(5) (defining "company"); § 202(a)(16), 15 U.S.C. § 80b-2(a)(16) (defining "person").

15 For a discussion of what is referred to in this article as a "Publication Adviser," *see* Lowe v. Sec. & Exch. Comm'n, 472 U.S. 181 (1985) (application of § 202 (a)(11) to an investment adviser who publishes a newsletter offering impersonal investment advice).

Advisers."[16] Although this article focuses on discerning investment adviser status under the first category of investment adviser, Publication Advisers and Report Advisers marginally come into play when discussing investment adviser status.

This definition of an investment adviser is limited by eight exceptions under § 202(a)(11)(A)-(G).[17] Only those exceptions that add significantly to our discussion of investment adviser status are noted. Two categories of exceptions stand out. First, there are two "solely incidental" exceptions, which play a recurring role. Section 202(a)(11)(B) excepts from the definition of an investment adviser lawyers, accountants, engineers and teachers who perform investment adviser services that are "solely incidental" to their professional practice.[18] Similarly, § 202(a)(11)(C) excepts a broker or dealer if it performs investment adviser services that are "solely incidental" to their broker or dealer business and does not receive any "special compensation" for these investment adviser services.[19] The second exception category authorizes the Commission to create exceptions. Under § 202(a)(11)(H), the Commission is authorized to promulgate rules and regulations or issue orders excluding from the definition of an investment adviser "other persons not within the intent"[20] of the § 202(a)(11).

16 *For examples* of what is referred to in this article as a "Report Adviser," *see*, *e.g.*, Abrahamson v. Fleschner, 568 F.2d 860, 862, *cert. denied*, 436 U.S. 905 (1978) (interpreting the application of § 202(a)(11) to investment adviser that, *inter alia*, issued reports); Sec. & Exch. Comm'n v. Saltzman, 127 F. Supp. 2d 660 (E.D. Pa. 2000) (same); Sec. & Exch. Comm'n v. Smith, 1995 U.S. Dist. LEXIS 22352 (E.D. Mich. Jan. 6, 1995) (same). *But see* Pozez v. Ethanol Capital Management, LLC, 2009 WL 2176574 (D. Arz. 2009) (reports did not adequately concern securities).

17 *See* § 202(a)(11)(A-G). In summary and without noting limitations, these exceptions generally cover certain (A) banks and bank holding companies unless it provides as defined under the Bank Holding Company Act of 1956; (B) professional offering investment advice that is "solely incidental" to their professional services; (C) broker and dealers offering investment adviser this is "solely incidental" to brokerage services and without receiving special compensation for the investment advice; (D) certain "bona fide" newspapers and other types of publications; (E) persons advising exclusively on securities designated by the Secretary of the Treasury pursuant to § 3(a)(12) of the Securities Exchange Act; (F) nationally recognized statistical rating organization, as defined under § 3(a)(62) of the Securities Exchange Act; (G) advisers offering family office services, as defined by the Commission; and (H) advisers excluded by Commission rule, regulation or order. Except as noted in the article text, discussions of these exceptions are beyond the scope of this article.

18 *See* § 202(a)(11)(B), 15 U.S.C. § 80b-2(a)(11)(B); Crabtree Invs., Inc. v. Aztec Enters., Inc., 479 F. Supp. 448, 450 (M.D. La. 1979) (investment advice provided by certified public accountant "incidental"); S & D Trading Academy, LLC v. AAFIS, Inc., 2008 WL 2325167 (S.D. Tex. 2008) (discussing teacher exception to definition of investment adviser under Texas Securities Act, the language of which is identical to § 202(a)(11)(B)). *See generally* Brian Carroll, *SEC Jurisdiction over Investment Advice*, 192 J. ACCOUNTANCY, Aug. 2001, at 32.

19 *See* § 202(a)(11)(C), 15 U.S.C. § 80b-2(a)(11)(C); Thomas v. Metro. Life Ins. Co., 631 F.3d 1153 (10th Cir. 2011) (analysis of "solely incidental" and "special compensation" language of § 202(a)(11)(C)); Fin. Planning Ass'n v. Sec. & Exch. Comm'n, 482 F.3d 481 (D.C. Cir. 2007) (vacating Commission rule, Certain Broker-Dealers Deemed Not to be Investment Advisers, 70 Fed. Reg. 20,424 (Apr. 19, 2005), permitting broker-dealer to receive special compensation for investment advice but still maintain exemption from definition of investment adviser); *see also* Sec & Exch. Comm'n v. Kenton Capital, Ltd., 69 F. Supp. 2d 1 (D.D.C. 1998) (broker-dealer received special compensation for providing non-incidental investment advice); Sec. & Exch. Comm'n v. Rauscher Pierce, Refsnes, Inc., 17 F. Supp. 2d 985 (D. Ariz. 1998) (broker-dealer investment advice not "solely incidental"); Polera v. Altorfer, Podesta, Woolard and Co., 503 F. Supp. 116 (N.D. Ill. 1980) (broker-dealer investment advice "solely incidental").

20 Section 202(a)(11)(H), 15 U.S.C. § 80b-2(a)(11)(H). *See* Atwater v. Nat'l Football League Players Ass'n, 2007 WL 1020848 (N.D. Ga. 2007). (Commission exemption under § 202(a)(11)(H), formerly § 202(a)(11)(G), noted).

III. Investment Adviser Status and Investment Adviser Registration with the Commission

Once the definition of an investment adviser is met, the adviser may or may not be required to register with the Commission. Sections 203 and 203A, and rules promulgated by the Commission thereunder, outline the circumstances triggering investment adviser registration.[21] Commission registration carries with it a host of obligations as reflected in the Advisers Act and its rules promulgated by the Commission. These obligations include, for example, filing with the Commission a registration form, Uniform Application for Investment Adviser Registration ("Form ADV"),[22] and maintaining certain books and records,[23] which are subject to Commission examination.[24] As noted, while § 206, antifraud provisions generally apply to both registered and unregistered investment advisers,[25] not all antifraud rules promulgated by the Commission pursuant to § 206(4)[26] apply to all investment advisers.[27]

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21 *See* § 203, Registration of Investment Advisers, 15 U.S.C. § 80b-3; § 203A, State and Federal Responsibilities, 15 U.S.C. § 80b-3A (establishing requirements for Commission registration and exclusion from Commission registration). The Commission has promulgated a series of rules interpreting the reach of these provisions. *See*, *e.g.*, Rule 203A-1, Eligibility for SEC Registration: Switching to or from SEC Registration, 17 C.F.R. § 275.3A-1; Rule 203A-2, Exemption from Prohibition on SEC Registration, 17 C.F.R. § 275.3A-2.

22 *See* § 203(c)(1)(A)-(H), Procedure for Registration; Filing of Application, Effective Date of Registration; Amendments of Registration, 15 U.S.C. § 80b-3(c)(1) (requiring certain investment advisers to complete and file with the Commission Form ADV); Rule 203-1, Application for Investment Adviser Registration, 17 C.F.R. § 275.3-1; *see also* Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010), 75 FR 49234 (Aug. 12, 2010) (adopting rule release).

23 *See* § 204, Annual and Other Reports, 15 U.S.C. § 80b-4; Rule 204-2, Books and Records to Be Maintained by Investment Advisers, 17 C.F.R. § 275.4-2.

24 *See* § 204(a), Annual and Other Reports, 15 U.S.C. § 80b-4(a) ("All records (as so defined) of such investment advisers are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the Commission as the Commission deems necessary or appropriate in the public interest or for the protection of investors."). *See generally* Brian Carroll, *When the SEC Knocks …*, 194 J. ACCOUNTANCY, Aug. 2002, at 35.

25 *See* § 206(1)-(2), 15 U.S.C. § 80b-6(1-2) ("It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly – (1) to employ any device, scheme, or artifice to defraud any client or prospective client; (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client […]."); Sec. & Exch. Comm'n v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (seminal case interpreting the reach of § 206(2) as imposing on investment advisers a fiduciary duty owed to clients). *See generally* Brian Carroll, *How To Prevent Investment Adviser Fraud*, 201 J. ACCOUNTANCY, Jan. 2006, at 40; Brian Carroll, *The Mutual Fund Trading Scandals*, 198 J. ACCOUNTANCY, Dec. 2004, at 32.

26 *See* § 206(4), 15 U.S.C. § 80b-6(4), ("It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly – […] (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purpose of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.").

27 Pursuant to § 206(4), 15 U.S.C. § 80b-6(4), the Commission to date has promulgated eight anti-fraud rules. Five anti-fraud rules state that the rule applies to "any registered investment adviser or required to be registered." *See* Rule 206(4)-1, Advertisements by Investment Advisers, 17 C.F.R. § 275.6(4)-1. *See* Brian Carroll, *Investment Adviser Advertising*, 196 J. ACCOUNTANCY, Nov. 2003, at 39; Rule 206(4)-2, Custody of Funds or Securities of Clients by Investment Advisers, 17 C.F.R. § 274.6(4)-2. *See* Brian Carroll, *Custody of Client Assets under Rule 206(4)-2*, 1 J. INV. COMPLIANCE, Spring 2001, at 47 (discussing predecessor rule to current Rule 206(4)-2); Rule 206(4)-3, Cash Payments for Client Solicitations, 17 C.F.R. § 275.6(4)-3. *See* Brian Carroll, *Third-Party Cash Solicitation Arrangements under Rule 206(4)-3 of the Investment Advisers Act*, Inv. Counsel Ass'n of America, Dec. 8, 2000, 1, 7; Rule 206(4)-6, Proxy Voting, 17 C.F.R. § 275.6(4)-6;, and Rule 206(4)-7, Compliance Procedures and Practices, 17 C.F.R. § 275.6(4)-7. In contrast, Rule 206(4)-5, Political Contributions by Certain Investment Advisers, 17 C.F.R. § 275.6(4)-5, states that it applies to "any investment adviser registered (or required to be registered) with the Commission, or unregistered in reliance on the exemption available under § 203(b)(3) of the Advisers Act […]." Finally, Rule 206(4)-8, Pooled Investment Vehicles, 17 C.F.R. § 275.6(4)-8, states that it applies to "any investment adviser to a pooled investment vehicle."

Investment adviser registration requirements have changed over time.[28] For example, historically, many investment advisers advising private funds,[29] such as hedge funds,[30] relied on a so-called private adviser exemption under former § 203(b)(3) as a basis for avoiding investment adviser registration with the Commission. This exemption applied to an investment adviser that maintained fewer than fifteen clients within a discrete twelve-month period, did not hold itself out to the public as an investment adviser,[31] and did not provide advice to an investment company.[32] In 2004, however, the Commission promulgated a rule reinterpreting the term "client,"[33] which caused the exemption to be applied more narrowly.[34] As a result, many investment advisers to private funds were required to register with the Commission. In 2006 the court in *Goldstein v. SEC* found the Commission's reinterpretation of "client" was arbitrary and vacated this Commission rule.[35] More recent amendments to the Advisers Act eliminated this private adviser exemption,[36] again triggering Commission registration for many investment advisers advising private funds. Currently, investment advisers to a wide range of private funds[37] are now required to register with the Commission.[38]

28 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, § 410, PL 111-203, 124 Stat. 1376 (July 1, 2010) ("Dodd-Frank Act"), *inter alia*, amending § 203A, State and Federal Responsibilities, 15 U.S.C. § 80b-3A (effectively increasing minimum amount of client assets under management from $ 25 to $ 100 million for Commission registration of certain investment advisers).

29 *See* § 202(a)(29), § 80b-2(a)(29) ("The term 'private fund' means an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act."); *see also* Rule 206(4)-8, Pooled Investment Vehicles, 17 C.F.R. § 275.6(4)-8.

30 Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004) 4, 69 FR 72054, 72055 (Dec. 10, 2004) (adopting rule release), *vacated*, Goldstein v. Sec. & Exch. Comm'n, 451 F.3d 873 (D.C. Cir. 2006) (footnotes omitted) ("There is no statutory or regulatory definition of hedge fund, although many have several characteristics in common. Hedge funds are organized by professional investment managers who frequently have a significant stake in the funds they manage and receive a management fee that includes a substantial share of the performance of the fund. Advisers organize and operate hedge funds in a manner that avoids regulation as investment companies under the Investment Company Act of 1940, and hedge funds do not make public offerings of their securities.")

31 *See* "Engaged in the Business" section of this article for a discussion of the concept of an investment adviser "holding out" to the public.

32 *See* former Section 203(b)(3), 15 U.S.C. § 80b-3(b)(3), and Rule 203(3)(b)-1, 17 C.F.R. § 275.3(3)(b)-1.

33 *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004), 69 FR 72054 (Dec. 10, 2004) (adopting rule release), (*inter alia*, reinterpreting the term "client" as it appears in § 203(b)(3), 15 U.S.C. § 80b-3(b)(3), and defined under Rule 203(b)(3)-1(a)(2), 17 C.F.R. § 275.3(b)(3)-1(a)(2)).

34 *See* Goldstein v. Sec. & Exch. Comm'n, 451 F.3d 873 (D.C. Cir. 2006) (vacating Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004), 69 FR 72054 (Dec. 10, 2004) (adopting rule release)).

35 *See id.*

36 § 403 Dodd-Frank Act amended § 203 by eliminating the § 203(b)(3) private adviser exemption. *See also* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3221 (June 22, 2011) n.4, 76 FR 42950 (July 19, 2011) (adopting rule release).

37 *See*, *e.g.*, § 203(m), Exemption of and Reporting by Certain Private Fund Advisers, 15 U.S.C. § 80b-3(m); Rule 203(m)-1, Private Fund Adviser Exemption, 17 C.F.R. § 275.3(m)-l; Section 203(l), Exemption of Venture Capital Fund Advisers, 15 U.S.C. § 80b-3(l); Rule 203(l)-1, Venture Capital Fund Defined, 17 CFR § 275.3(l)-1. *See generally* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $ 150 million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3222 (June 22, 2011), 76 FR 39646 (July 6, 2011).

38 SEC. AND EXCH. COMM'N, DODD-FRANK ACT CHANGES TO INVESTMENT ADVISER REGISTRATION REQUIREMENTS 5 (Jan. 2, 2013) (reporting on number of registered investment advisers advising private funds such as hedge funds, private equity funds, venture capital funds, securitized asset funds, liquidity funds and the like).

IV. Cases that Implicate the Investment Adviser Definition

Three types of cases inform this discussion on the definition of an investment adviser. The first is Commission enforcement actions filed in federal court alleging a violation of the Advisers Act.[39] These enforcement actions require that the Commission establish investment adviser status as a basis for subject matter jurisdiction.[40] Second, the U.S. Department of Justice is authorized to initiate criminal prosecutions against investment advisers for violating the Advisers Act,[41] which also requires establishing investment adviser status. Similarly, in criminal prosecutions, investment adviser status may play a role in calculating an appropriate criminal sentence under U.S. Sentencing Guidelines.[42] When sentencing a defendant convicted of committing a federal crime, the court may consider whether the defendant was acting as an investment adviser, as defined under § 202(a)(11), which could serve as a basis for lengthening the sentence.[43] Third, the Advisers Act permits certain investment adviser clients[44] to seek a limited private-civil remedy[45] against an investment adviser based primarily on contract law. If successful in establishing a violation of the Advisers Act,[46] an advisory client may seek to rescind the investment adviser contract, recover

39 *See* § 203, Registration of Investment Advisers, 15 U.S.C. § 80b-3; § 209, Enforcement of Title, 15 U.S.C. § 80b-9. Sections 203 and 209, *inter alia*, authorize the Commission to initiate enforcement actions against investment advisers and persons associated with an investment adviser for violating the Advisers Act in United States district court or as an administrative proceeding, or both. *See also* Commission Rules of Practice, 17 C.F.R. § 201.300-360 (rules governing administrative proceedings). *See generally* Sec. & Exch. Comm'n v. Mgmt. Dynamics, Inc., 515 F.2d 801, 808 (2d Cir. 1975) (the Commission appears "not as an ordinary litigant, but as a statutory guardian angel charged with safeguarding the public interest in enforcing the securities laws").

40 *See* 28 U.S.C. § 1331. *See*, *e.g.*, Sec. & Exch. Comm'n v. Berger, 322 F.3d 187 (2d Cir. 2003) (an enforcement action alleging, *inter alia*, a violation of § 206, court applied "conduct test" as basis for subject matter jurisdiction); Sec. & Exch. Comm'n v. Smith, 1995 U.S. Dist. LEXIS 22352 (E.D. Mich. 1995); Conrardy v. Ribadeneira, 1990 WL 66603 (D. Kan. 1990) (applying 28 U.S.C. § 1331 to private action against an investment adviser).

41 *See* § 217, Penalties, 15 U.S.C. § 80b-17. ("Any person who willfully violates any provision of this subchapter, or any rule, regulation, or order promulgated by the Commission under authority thereof, shall, upon conviction, be fined not more than $ 10,000, imprisoned for not more than five years, or both."); *see*, *e.g.*, U.S. v. Eberhard, 525 F.3d 175 (2d Cir. 2008) (defendant convicted of, *inter alia*, investment adviser fraud in violation of § 206); U.S. v. Gilman, 478 F.3d 440 (1st Cir. 2007) (defendant pleaded guilty to, *inter alia*, investment adviser fraud in violation of § 206); U.S. v. Mintz, 2010 WL 3075477 (W.D.N.C. 2010) (defendant pleaded guilty to one count of fraud by an investment adviser in violation of § 206).

42 *See* U.S. v. Onsa, 2013 WL 789182 (E.D.N.Y. 2013), *aff'd* 523 Fed. App'x 63 (2d Cir. 2013).

43 *See*, *e.g.*, U.S. v. Stein, 2010 WL 678122 (E.D.N.Y. 2010) (defendant's investment adviser status resulted in four-point enhancement in sentencing calculation under U.S.S.G. § 2B1.1(b)(17)(A)(iii)); *see also* U.S. v. Booker, 543 U.S. 220, 245-46 (2005) (rendering sentencing guidelines "advisory".).

44 *See* § 215, Validity of Contracts, 15 U.S.C. § 80b-15; *see*, *e.g.*, Rifkin v. Bear Stearns & Co., 248 F.3d 628 (7th Cir. 2001) (taxpayers lack standing to vindicate county's right under its agreement with an investment adviser); Oliver v. Black Knight Asset Management, LLC, 812 F. Supp. 2d 2, 13 (D.D.C. 2011) ("As the Supreme Court has stated, sections 206 and 215 were intended to benefit the *clients* of investment advisers.") (italics in original); Kassover v. UBS AG, 619 F. Supp. 2d 28, 32 (S.D.N.Y. 2008) ("Courts have required plaintiffs to allege that the parties entered into an investment advisory contract in order for the Advisers Act to apply."); Shaidi v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 2003 WL 21488228 (M.D. Fla. 2003) (shareholders of fund were beneficiaries but lacked standing to assert a claim under § 215 based on fund-adviser contract).

45 *See* Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979) (holding that no private right of action exists under § 206 but §§ 214 and 215 create, based on equity principles, a private injunctive and contract recession action against the continued operation of a contract between the adviser and its clients, with a restitution claim seeking recovery of contractual fees paid by the client to the adviser); *see* Brian Carroll, *Investment Advisers: The Bounds of Regulatory Authority and Private Causes of Action*, 10 INV. LAWYER 1, 17 (Oct. 2003); *see also* Reg'l Props., Inc. v. Fin. and Real Estate Consulting Co., 678 F.2d 552 (5th Cir. 1982) (comparing Advisers Act § 215 with Exchange Act § 29).

46 A private action under § 215 must be based on a violation of the Advisers Act. *See*, *e.g.*, Laird v. Intergrated Res., Inc. 897 F.2d 826, 841 (5th Cir. 1990) (plaintiff may allege "any provision of this chapter" to sustain a violation of § 215); In re Mutual Fund Investment Litigation, 384 F. Supp. 2d 873 (D. Md. 2005); *see* Brian Carroll, *Investment Advisers: The Bounds of Regulatory Authority and Private Causes of Action*, 10 INV. LAWYER 1, 17 (Oct. 2003).

limited restitution and enjoin the further operation of the contract.[47] Although there are other types of actions that may call into play investment adviser status,[48] the vast majority of federal court actions interpreting § 202(a)(11) are initiated by one of these three parties.

V. Observations on Judicial Approaches to Discerning Investment Adviser Status

This article focuses on judicial approaches to interpreting investment adviser status. For purposes of this discussion, the elements of the definition of an investment adviser are that a person: 1) engages in the business of providing 2) investment advice 3) to others 4) concerning securities 5) for compensation. The discussion of each element varies according to the issues raised in relevant judicial decisions and the nature of the author's observations offered along the way. Some elements provoke more commentary than others.

Because this article focuses on judicial approaches, Commission or Commission staff guidance on investment adviser status is generally discussed to the extent that it is relied upon in a judicial opinion. Two key examples come to mind. *In the Matter of Augustus P. Loring, Jr.*, ("In re Loring"),[49] a Commission order exempting a court-supervised trustee from the definition of investment adviser pursuant to § 202(a)(11)(H), has played a recurrent role in determining whether certain trust services meet the definition of an investment adviser and the role of "solely incidental" advice. Also significant is a Commission staff interpretive guidance discussing application of the definition of an investment adviser to certain financial services. In "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"[50] ("SEC Release 1092") Commission staff, not the Commission, express views on how each element of the definition may be interpreted.

47 Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 19 (1979) (Section 215 "permitting federal suit for recission of a contract or injunction against continued operation of the contract, and for restitution".); *see also* Douglass v. Beakley, 900 F. Supp. 2d 736, 746 (N.D. Tex. 2012) ("[…] the only apparent remedy available to an aggrieved investor under the IAA, aside from rescission, would be commissions, fees, or other compensation paid to the investment adviser pursuant to the investment contract."); Filson v. Langman, 2002 WL 31528616 (D. Mass. 2002) (no claim for damages permitted under Section 215); Fraioli v. Lemcke, 328 F. Supp. 2d 250 (D.R.I. 2004) (dismissed action because lost investment not recoverable and no standing to sue adviser).

48 In addition to these types of cases, other potential parties may initiate civil or criminal actions implicating investment adviser status. *See*, *e.g.*, Employment Retirement Income Security Act of 1974, 29 U.S.C. § 1002(38)(B) (incorporating by reference definition of an investment adviser under Advisers Act); West's Ann. Cal. Corp. Code § 25009 (defining an investment adviser under California law); McKinney's General Business Law § 359-eee(a) (defining an investment adviser under New York law); *see generally* Uniform Securities Act of 1956 § 401(f) (defining an investment adviser).

49 Investment Advisers Act Release No. 33, 1942 WL 34539 (July 22, 1942); *see also* In the Matter of Augustus P. Loring, Jr., 11 S.E.C. 885, Investment Company Act Release No. 33, 1942 WL 34853 (July 20, 1942).

50 Investment Advisers Act Release No. 1092 (Oct. 8, 1987), 52 FR 38400 (Oct. 16, 1987) (interpretive release).

A. Advice Must Concern Securities

An investment adviser must provide advice concerning securities.[51] The definition of a security under § 202(a)(18)[52] is consistent with other United States federal securities statutes' definition of a security.[53] Consequently, these definitions are generally interpreted as a single body of law.[54]

This body of law reflects several interpretative themes. Consistent with the broad legislative goal of United States federal securities laws to eliminate serious abuses in the securities markets, courts view as securities not only financial instruments that fall within the ordinary concept of a security, but also "virtually any instrument that might be sold as an investment".[55] When deciding whether an instrument meets the definition of a security, courts are not bound by any legal formalism,[56] rather they engage in a case-by-case[57] examination of the economic reality underlying the transaction.[58] Two Supreme Court opinions anchor the framework for determining whether a security is created: *SEC v. W.J. Howey Co.*[59] and *Reves v. Ernst & Young*.[60] In addition, Congress continues to play a legislative role in defining a security.[61] At bottom, the breath of the definition of an investment adviser is tied directly to the definition of a security. As more financial instruments are created and meet the definition of a security, the scope of investment adviser status correspondingly expands.

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51 *See*, *e.g.*, Rasmussen v. Thomson & McKinnon Auchincloss Kohlmeyer, Inc., 608 F.2d 175 (5th Cir. 1979) (commodities advice does not meet securities advice requirement under § 202(a)(11), 15 U.S.C. § 80b-2(a)(11); Mechigian v. Art Capital Corp., 639 F. Supp. 702 (S.D.N.Y. 1986) (art purchase does not meet securities advice requirement under § 202(a)(11), 15 U.S.C. § 80b-2(a)(11)).

52 Section 202(a)(18), 15 U.S.C. § 80b-2(a)(18), defines a security as "any note, stock, treasury stock, security future bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security', or any certificate on interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase any of the foregoing."

53 *See* Securities Act, § 2(a)(1), 15 U.S.C. § 77b(a)(1); Exchange Act, § 3(a)(10); 15 U.S.C. § 78c(a)(1), Investment Company Act, § 2(a)(36), 15 U.S.C. § 80a-2(a)(36).

54 *See*, *e.g.*, Sec. & Exch. Comm'n v. Edwards, 540 U.S. 389 (2004); Reves v. Ernst & Young, 494 U.S. 56, 61 n.1 (1990); Marine Bank v. Weaver, 455 U.S. 551, 555 n.3 (1982); United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975).

55 Reves v. Ernst & Young, 494 U.S. 56, 61 (1990).

56 Sec. & Exch. Comm'n v. Edwards, 540 U.S. 389, 393 (2004) ("Congress' purpose in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called. [...] To that end, it enacted a broad definition of 'security,' sufficient to 'encompass virtually any instrument that might be sold as an investment.'") (emphasis in original).

57 *See* U.S. v Leonard, 529 F.3d 83, 89 (2d Cir. 2008) (citing Reves v. Ernst & Young, 494 U.S. 56, 61 (1990)).

58 *See* Reves v. Ernst & Young, 494 U.S. 56, 61 (1990); Sec. & Exch. Comm'n v. W.J. Howey Co., 328 U.S. 293 (1946).

59 328 U.S. 293 (1946). Under SEC v. W. J. Howey Co., 328 U.S. 293 (1946) and its progeny, the Supreme Court established a multiple factor test for determining when an investment contract constitutes a security, including horizontal and vertical commonality tests.

60 494 U.S. 56 (1990). Under Reves v. Ernst & Young, 494 U.S. 56 (1990), the Court adopted the "Family Resemblance" approach for determining when a note may meet the definition of a security. It applied a rebuttable presumption that a note is a security unless it bears a "family resemblance" to a judicially recognized list of notes that do not meet the definition of a security.

61 For example, §§ 761(a)(2) and 768(a)(1) of the Dodd-Frank Act amend the definition of a security under the Exchange Act § 3(a)(10), 15 U.S.C. § 78c(a), and Securities Act § 2(a)(1), 15 U.S.C. § 77b(a)-(1), respectively, to define a security-based swap as a security. *See also* SEC. & EXCH. COMM'N, LIFE SETTLEMENTS TASK FORCE, STAFF REPORT TO THE U.S. SECURITIES & EXCHANGE COMMISSION (July 22, 2010) (recommending that the Commission considers requesting Congress to amending the definition of a security under federal securities law to include life settlements).

B. Compensation for Investment Advice

Section 202(a)(11) requires that an investment adviser be compensated for providing investment advice.[62] Unlike the definition of a security, the term compensation is neither defined by the Advisers Act nor is there a single body of United States federal securities law interpreting it. In the investment advisory business, it is common practice for investment advisers to be compensated by receiving a fee from clients based on a percentage of the amount of client's funds managed by the adviser or based on the rate of return on investments made by the adviser on behalf of the client, or some combination of both.[63] Beyond these widely recognized forms of compensation, the Eleventh Circuit Court of Appeals[64] has adopted an approach to interpreting the compensation element that is referred to in this article as the economic benefit approach. After presenting this approach, the discussion turns to two observations. The first discusses other provisions of United States federal securities law that may support further developing the economic benefit approach. The second takes an entirely different tact by offering a contract analysis approach.

1. The Eleventh Circuit's Economic Benefit Approach

The seeds of the economic benefit approach were sowed into the Eleventh Circuit by *U.S. v. Elliott*.[65] In appealing their criminal convictions under the Advisers Act, two defendants argued that they had not received a discrete fee for investment advice, were not compensated for investment advice and therefore were not investment advisers. Each defendant, however, had advised clients to invest in "investment vehicles"[66] created and marketed by defendants. One defendant received sales commissions[67] charged on client purchases of these investment vehicles and the other comingled client investment funds in his personal account to pay living expenses. The court

62 *See*, *e.g.*, Korman v. Sec. & Exch. Comm'n, 592 F.3d 173 (D.C. Cir. 2010) (upholding Commission finding that adviser had provided investment advice for compensation); Sec. & Exch. Comm'n v. SBM Inv. Certificates, Inc., 2007 WL 609888 (D. Md. 2007) (evidence of compensation insufficient to grant Commission motion for preliminary injunction against future violations of Advisers Act); Washington v. Baenziger, 656 F. Supp. 1176 (N.D. Cal. 1987) (failure to allege compensation element); Brown v. Producers Livestock Loan Co., 469 F. Supp. 27 (D. Utah 1977) (failure to allege compensation element). *But see* Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. 3043 (July 1, 2010), 38 & n.121, 75 FR 41018 (July 15, 2010) (adopting rule release) ("Rule 206(4)-5(a)(1) makes it unlawful for investment advisers covered by this rule to provide investment advisory services for *compensation* to a government entity within two years after a trigger [political] contribution. [...]. The adviser, therefore, should return all such compensation promptly upon discovering the triggering contribution.") (italics in original).

63 *See*, *e.g.*, Sec. & Exch. Comm'n v. Berger, 322 F.3d 187 (2d Cir. 2003) (noting investment adviser management fee of one percent of investment fund assets under management and incentive fee of twenty percent of fund's net gains); Abrahamson v. Fleschner, 568 F.2d 862 (2d Cir. 1978) (investment adviser earned a fee equal to twenty percent of the firm's net profit and net capital gains for each year and, for some years, an annual salary); Sec. & Exch. Comm'n v. Juno, 2012 WL 685302 (S.D.N.Y. 2012) (investment performance-based fee viewed as compensation); U.S. v. Young, 2011 WL 1376045 (E.D. Pa. 2011) (noting payment for investment advisory services); Sec. & Exch. Comm'n v. Rabinovich & Associates, 2008 WL 4937360 (S.D.N.Y. 2008) (fifty percent share of trading profits from client investments viewed as compensation); Sec. & Exch. Comm'n v. Saltzman, 127 F. Supp. 2d 660 (E.D. Pa. 2001) (receipt of twenty percent of investment fund's net profit and net capital gains as compensation).

64 *See* 28 U.S.C. § 43 (a) ("There shall be in each circuit a court of appeals, which shall be a court of record, known as the United States Court of Appeals for the circuit."). *See generally* Litman v. Mass. Mutual Life Ins. Co., 825 F.2d 1506, 1508 (11th Cir. 1987) ("As early as 1789, Congress created district courts and circuit courts. Judiciary Act of 1789, ch. 20, 1 Stat. 73. In 1891, Congress passed the Evarts Act, Act of Mar. 3, 1891, 26 Stat. 826, which established the circuit court of appeals as a separate intermediate level court.") The Eleventh Circuit is one of thirteen geographically based judicial circuits within the United States Court of Appeals. 28 U.S.C. § 41.

65 62 F.3d 1304 (11th Cir. 1996), *order amending opinion*, 82 F.3d 989 (11th Cir. 1996).

66 *Id.* at 1310-11. (court does not specify legal form of the "investment vehicles").

67 *Id.* at 1310. In *Elliott*, the court does not address whether this conduct meets the definition of a broker or dealer under federal securities law.

summarily rejected a discrete fee requirement by holding that even though defendants had not received a separate fee, they did receive compensation (sales commissions and comingling client funds) for investment advice. It found support for its holding in SEC Release 1092, particularly the court's italicized sentence:

> "This reading of § 80b-2(a)(11) is consistent with the SEC's definition of compensation for investment advice. The SEC Release [1092] states: This compensation element is satisfied by the receipt of any economic benefit, whether in the form of an advisory fee or some other fee relating to the total services rendered, commissions, or some combination of the foregoing. *It is not necessary that a person who provides investment advisory and other services to a client charge a separate fee for the investment advisory portion of the total services*."[68]

While *Elliot* makes clear that receipt of a discrete fee is not required to meet the compensation element, the importance of this decision lies not with this narrow holding but with its inclusion of the "economic benefit" language in its quotation of SEC Release 1092. Although *Elliot* does not explicitly identify or rely upon this language,[69] this reference has led to a series of cases within the Eleventh Circuit adopting the economic benefit approach. For example, in *U.S. v. Ogale*,[70] an unpublished opinion,[71] the defendant, convicted of wire fraud, appealed the application of a sentencing guidelines enhancement based on his status as an investment adviser. The defendant argued that he was not acting as an investment adviser, in part, because he was not compensated for investment advice. He argued that the investor funds that he misappropriated for personal use were "ill-gotten gains,"[72] not compensation. The court in *Ogale* relied on *Elliott's* inclusion of the economic benefit language in SEC Release 1092 as its authority for holding that "the receipt of any economic benefit qualifies as compensation under the Investment Advisers Act [...]."[73]

Application of the economic benefit approach was extended within the Eleventh Circuit in *Thomas v. Metropolitan Life Insurance Company*.[74] In *Thomas*, the court was called upon to decide what type of compensation met the "special compensation" requirement under § 202(a)(11)(C), the

68 *Elliott* at 3011 n.8 (emphasis in original).

69 This reference to economic benefit tends to support implicitly *Elliott's* holding that a defendant's comingling of client funds to pay personal expenses satisfied the compensation element.

70 378 Fed. App'x 959 (11th Cir. 2010).

71 Joyner v. Astrue, 2011 WL 4530678 7 n.11 (M.D. Fla. 2011) ("Unpublished opinions of the Eleventh Circuit Court of Appeals are not considered binding authority; however, they may be cited as persuasive authority pursuant to the Eleventh Circuit Rules, 11th Cir. R. 36-2.").

72 *See Ogale* at 960-61. Generally, the term "ill-gotten gains" is used to describe funds obtained through a violation of federal securities laws and subject to disgorgement, an equitable remedy available in certain Commission enforcement actions. *See*, *e.g.*, Sec. & Exch. Comm'n v. Platforms Wireless Inter. Corp., 617 F.3d 1072, 1096 (9th Cir. 2010) (citations omitted) ("A district court has broad equity powers to order disgorgement of ill-gotten gains obtained through the violation of securities laws. Disgorgement is designed to deprive a wrongdoer of unjust enrichment, and to deter others from violating securities laws by making violations unprofitable."); Sec. & Exch. Comm'n v. Cavanagh, 445 F.3d 105, 120 (2d Cir. 2006) (tracing development of disgorgement as an equitable remedy).

73 *See Ogale* at 960-61. ("The receipt of any economic benefit qualifies as compensation under the Investment Adviser's [sic] Act and thus the investment adviser enhancement. *See id. [Elliott]* at 1131 ('Th[e] compensation element is satisfied by the receipt of any economic benefit, whether in the form of an advisory fee or some other fee relating to the total services rendered, commissions, or some combination of the foregoing.') (quoting SEC Release notes for 15 U.S.C. § 80b-2(a)(11) [...]"). *Ogale* appears to be relying on *Elliott's* finding that one of the defendant's had comingled investor funds and used investor funds for personal expenses. As noted, *Elliott*, however, did not explicitly apply the economic benefit approach to these funds, or any other compensation issue in the case. *See also* U.S. v. Ellia, 2014 WL 4289389 (Cir. 11) (quoting *Ogale* quoting *Elliott* in holding that personal use of investor funds meets the compensation element); Sec. & Exch. Comm'n v. Young, 2011 WL 1376045 7 (E.D. Pa. 2011) (noting *Ogale* held that "ill-gotten gains qualify as compensation under the Advisers Act").

74 631 F.3d 1153 (10th Cir. 2011).

broker-dealer exception to the definition of an investment adviser.[75] Initially the court reviewed *Elliot's* any economic benefit language of SEC Release 1092 to note that the compensation element has been "defined broadly."[76] *Thomas* went on to view the compensation component of the "special compensation" branch under the broker-dealer exception as a "subset of the economic benefit received from a transaction involving investment advice."[77] With *Thomas*, the economic benefit approach gained further acceptance as the Eleventh Circuit's primary approach for interpreting not only the compensation element in the definition of an investment adviser but the special compensation component of the broker-dealer exception to this definition. In contrast, no other circuits have explicitly considered the economic benefit approach when interpreting any provision under § 202(a)(11).

2. Advisers Act Support for Developing the Economic Benefit Approach

Under the Advisers Act, Form ADV requires an investment adviser to disclose its receipt of an "economic benefit" from a source other than the client in connection with giving investment advice. This disclosure requirement seeks to reveal whether an adviser has a conflict of interest created by the adviser receiving an economic benefit from another party for recommending an investment to a client.[78] An adviser's failure to meet this requirement may violate § 207, Material Misstatements,[79] which prohibits an adviser from making an untrue statement of material fact or omitting a required material fact in certain Commission filings, including Form ADV.

Judicial analysis of this economic benefit language in deciding whether a violation of § 207 is established may prove helpful in developing the economic benefit approach for interpreting compensation under § 202(a)(11). In *Vernazza v. SEC*,[80] an enforcement action, the court held that an investment adviser violated § 207 by failing to disclose on its Form ADV,[81] among other places, the existence of two intertwined financial incentives offered by another investment adviser sponsoring investment funds. Under the first incentive, the adviser's clients had to invest at least a total of $ 1 million in certain investment funds in order for the adviser to be eligible to receive a success fee.[82] The second incentive was the actual success fee based on a percentage of client funds invested in the investment funds.[83]

In *Vernazza*, both forms of incentive were viewed by the court as requiring disclosure under the economic benefit language of Form ADV. This is important because the first incentive-meeting the

75 The broker-dealer exception to the definition of an investment adviser reads as follows: "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation thereof." Section 202(a)(11)(C), 15 U.S.C. § 2(a)(11)(C).

76 *See Thomas* 631 F.3d at 1160 (quoting *Elliott*, 62 F.3d at 1311 n.8 (citation omitted)).

77 *Id.* at 1165.

78 Rule 203-1, Application for Investment Adviser Registration, 17 C.F.R. § 275.3-1. *See*, *e.g.*, Amendments to Form ADV, Investment Advisers Release No. 3060 (July 28, 2010), 75 FR 49234 (Aug. 12, 2010).

79 See § 207, Material Misrepresentations, 15 U.S.C. § 80b-7, which reads as follows: "It shall be unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission under Section 203 or 204, or willfully to omit to state in any such application or report any material fact which is required to be stated therein."

80 Vernazza v. Sec. & Exch. Comm'n, 327 F.3d 851, 861 (9th Cir. 2003).

81 *Id.* at 856 (Form ADV, Part II, Question 13(A) requests information concerning "whether the investment adviser, or a related person, 'receives some economic benefit [...] from a non-client in connection with giving advice to the client.'").

82 *Id.* at 859.

83 *Id.* at 859.

$ 1 million investment threshold to be eligible for the success fee-is a contingent financial incentive, an investment threshold incentive not designed to deliver a payment but only to qualify the adviser for a potential payment (the success fee). *Vernazza's* holding that a contingent financial incentive is an economic benefit provides support for viewing an investment adviser's unrealized investment performance fee[84] as an economic benefit that would satisfy the compensation element.

Similarly, the case of *SEC v. Tandem Management, Inc*. supports this economic benefit approach.[85] In this enforcement action, the court held that an investment adviser violated, among other provisions, § 207 by failing to disclose on its Form ADV certain "soft dollar" arrangements. Under § 28(e)[86] of the Exchange Act, soft dollar arrangements between investment advisers and broker-dealers permit the adviser to place securities trades on behalf of investment adviser clients with the broker-dealer at a commission rate higher than the lowest rate available, if the broker-dealer is providing the adviser with certain investment research or other permissible "soft dollar" benefits.[87] As is typical with most brokerage arrangements, the investment adviser client, not the investment adviser, pays for the brokerage commission on trades placed on the client's own behalf. Here, the court found that the adviser engaged in several undisclosed fraudulent schemes to profit from abusing its soft dollar arrangements. These included permitting a broker-dealer to charge investment adviser clients excessively high brokerage commissions in return for investment research and then requiring the broker-dealer to kick back half of the excessive brokerage commission to the adviser.

Tandem Management's holding that undisclosed kickbacks of client commission brokerage payments constitute an economic benefit supports *Ogale's* holding that misappropriated client funds are an economic benefit that meets the compensation element. The client of *Tandem Management* paid an excessively higher brokerage commission, more than the amount permitted under a disclosed soft dollar arrangement. The amount of the commission paid in excess of the disclosed soft dollar ar-

84 Under certain terms and conditions, *see*, *e.g.*, § 205, Investment Advisory Contracts, 15 U.S.C. § 80b-5, and Rule 205-3, Exemption from the Compensation Prohibition of Section 205(a)(1) for Investment Advisers, 17 C.F.R. § 275.5-3, an investment adviser may charge a client an investment performance fee, which, essentially, is based on amount of gains, if any, resulting from the adviser's investment advice. If the investment advice achieves adequate investment gains to trigger payment by the client of the investment performance fee, the investment performance fee is "realized." If the investment adviser fails to achieve adequate gains to trigger the payment by the client of the investment performance fee, it is "unrealized." When an investment performance fee is "unrealized" the client does not pay the adviser an investment performance fee. It remains "unrealized" until the investment advice creates an adequate gain. Courts have not resolved whether an unrealized investment performance fee satisfies the compensation element. See Fife v. SEC, 311 F.3d. 1, 11 (1st Cir. 2002) (a Commission enforcement action where the court held, without explanation, that the compensation element was met, in part by finding that the adviser "understood" he would be compensated by receiving a percentage of investment profits "*if successful*, pursuant to a formula to be agreed upon at a later time.") (italics in original); but see U.S. v. Regensberg, 635 F. Supp. 2d 306 (S.D.N.Y. 2009), *aff'd* 381 F. App'x 60 (2d Cir. 2010) (a criminal appeal, the district court held, without explanation, that a contractual right to receive a contingent performance fee without actually meeting the conditions to receive the fee, did not constitute compensation under § 202(a)(11)).

85 2001 WL 1488218 (S.D.N.Y. 2001).

86 Effect on Existing Law, 15 U.S.C. § 78bb(e).

87 *See*, *e.g.*, Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010) n.126, 75 FR 49234 (Aug. 12, 2010) (adopting rule release) ("Under Section 28(e) [of the Exchange Act], a person who exercises investment discretion over a client account has not acted unlawfully or breached a fiduciary duty *solely* by causing the account to pay more than the lowest commission rate available, so long as that person determines in good faith that the commission amount is reasonable in relation to the value of the brokerage and research services provided. [...] Section 28(e) [...] provides a limited 'safe harbor' for [investment] advisers with discretionary authority in connection with their receipt of soft dollar benefits. [...] Advisers must disclose their receipt of soft dollar benefits to clients, regardless of whether the benefits fall inside or outside of the safe harbor."); *see also* Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Exchange Act Release No. 23170 (Apr. 23, 1986), 51 FR 16004 (Apr. 30, 1986).

rangement was arguably "misappropriated" from the client by the broker, who kicked back a portion of these "misappropriated" client funds to the investment adviser. These client funds paid to the investment adviser constituted an economic benefit that should have been disclosed. This analysis lends support to *Ogale's* broader view that "misappropriated" client funds are an economic benefit that satisfies the compensation element.[88]

In addition to § 207, other provisions of United States federal securities laws implicate an economic benefit approach to determine whether a compensation requirement is met. For example, an economic benefit approach was used to determine whether an employee of a securities issuer was compensated for participating in an unregistered, public securities offering in violation of § 5 of the Securities Act.[89] Also, in interpreting § 15(a) of the Investment Company Act of 1940,[90] the companion legislation to the Advisers Act, at least one court has applied an economic benefit approach to determine whether inappropriate compensation was paid to an investment adviser under contract with an investment company.[91] The economic benefit concept is also used to determine whether a security has been created.[92] In further developing the compensation element of § 202(a)(11), courts may find useful these examples of the application of an economic benefit approach in United States federal securities laws.

3. Another Way to Approach Compensation: Contract Analysis

Taking a step back from the economic benefit approach, the language and structure of the Advisers Act also supports viewing compensation within a contractual framework. Like other professional services providers, an adviser typically enters into a contract that establishes what services are to be provided and the compensation to be paid for those services. Consistent with this practice, the Advisers Act contemplates that a contract between the investment adviser and client will be formed.[93] Indeed, the Advisers Act specifically regulates the content of an advisory contract,[94]

88 Both *Vernazza* and *Tandem Management* are enforcement actions alleging violations of § 207, 15 U.S.C. § 80b-7, based on the economic benefit disclosure requirements of Form ADV. One of the purposes of Form ADV's economic benefit language, however, is to compel disclosure of investment adviser conflicts of interest, a goal arguably requiring a broader view of economic benefit than traditional notions of compensation in professional service relationships. *See generally* Sec. & Exch. Comm'n v. Capital Gains Research Bureau, 375 U.S. 180, 190 (1963) (discussing actual and potential conflicts of interest arising from investment adviser's undisclosed "economic self-interest").

89 Prohibitions Relating to Interstate Commerce and the Mails, 15 U.S.C. § 77e (2012). *See*, *e.g.*, Sec. & Exch. Comm'n v. Phan, 500 F.3d 895 (9th Cir. 2007) (receipt of an economic benefit by issuer employees for sale or distribution of securities relevant in determining whether a violation of Securities Act § 5 occurred); *see also* Sec. & Exch. Comm'n v. Solomon Inc., 1995 WL 412429 (S.D.N.Y 1995) (economic benefit of ownership of securities in prearranged, sham transactions), *vacated on other grounds by* 78 F.3d 802 (2d Cir. 1996); Securities Act § 17(b), Fraudulent Interstate Transactions, 15 U.S.C. § 77q, (undisclosed compensation paid to stock touter of securities is element of violation of Securities Act § 17(b)).

90 Investment Company Act § 15(a), Contracts of Advisers and Underwriters, 15 U.S.C. § 80a-15(a).

91 Steadman v. Sec. & Exch. Comm'n, 603 F.2d 1126 (5th Cir. 1979) (applying economic benefit approach in holding that interest fee loan to adviser qualified as compensation under Investment Company Act § 15(a)(1)).

92 *See*, *e.g.*, Sec. & Exch. Comm'n v. Kirkland, 521 F. Supp. 2d 1281 (M.D. Fla. 2007) (economic benefit relevant in determining if an investment contract meets the definition of a security).

93 *See*, *e.g.*, § 201(1), Findings, 15 U.S.C.§ 80b-1(1) ("[I]nvestment advisers are of national concern, [...] their [...] contacts [...] with clients are negotiated and performed, by the use of the mails and means and instrumentalities of interstate commerce [...].”); § 205(d), 15 U.S.C. § 80b-5(d) (defines for certain purpose an investment advisory contract as "any contract or agreement whereby a person agrees to act as investment adviser to or to manage any investment or trading account of another person other than an investment company registered under title I of this Act [Advisers Act]").

94 *See*, *e.g.*, § 205(a)(3), 15 U.S.C. § 80b-5(a)(3) (requires that an investment advisory contract includes a provision requiring an investment adviser organized as a partnership to notify the client of any change in membership of the partnership).

conditions for assigning the advisory contract,[95] and limitations on contractual waiver of certain rights under the Advisers Act.[96] Section 205 authorizes and regulates the circumstances under which an investment advisory contract may permit an adviser to receive a performance-based fee.[97] In addition, certain Commission rules promulgated under § 203 rely on the date the advisory contract is executed[98] as the trigger for requiring delivery of Form ADV (or its equivalent) to a client. Written advisory contracts must be maintained as a record available for Commission examination.[99] Under § 215, a private client action against an investment adviser requires that a contract be formed between the client and the investment adviser[100] and limits standing to initiate an action to the parties to the contract.[101] Based in part on these provisions, the contract analysis approach is consistent with cannons of statutory construction requiring that every provision of a statute be given effect[102] and, at least initially, both language itself along with the specific context used and broader context of the statute as a whole[103] be considered.

A contract analysis approach would build on this statutorily created contract framework. The essential inquiry would focus on whether an advisory contract was formed between the adviser and the client. Consistent with the Supreme Court's decision in *Transamerica Mortgage Advisors, Inc. v. Lewis*,[104] this inquiry will be guided by the application of state law concepts of contract

95 *See* § 205(a)(2), 15 U.S.C. § 80b-5(a)(2) (prohibits assignment of an investment advisory contract without the consent of the other party to the contract); *see also* § 202(a)(1), Assignment, 15 U.S.C. § 80b-2(a)(1); Rule 202(a)(1)-1, Certain Transactions Not Deemed Assignments, 17 C.F.R. § 275.2(a)(1)-1.

96 *See* § 215, Validity of Contracts, 15 U.S.C. § 80b-15 (limits waiver of provisions of the Advisers Act in investment advisory contracts).

97 15 U.S.C. § 80b-5.

98 Rule 204-3(b), Delivery of Brochures and Brochure Supplements, 17 C.F.R. § 275.3(b) (requires an investment adviser provide Form ADV to a client at least forty eight hours before entering into an investment advisory contract or, if not provided forty eight hours before entering into a contract, the client is permitted, without charge, to terminate the contract within five days of entering into the contract).

99 Rule 204-2(a)(10), Books and Records to Be Maintained by Investment Advisers, 17 C.F.R. § 275.4-2(a)(10) (requiring written agreements between an investment adviser and a client be maintained).

100 *See*, *e.g.*, Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979).

101 *See id.* § 214, Jurisdiction of Offenses and Suits, 15 U.S.C. § 80b-14; § 215, Validity of Contracts, 15 U.S.C. § 80b-15; *see also* Clark v. Nevis Capital Mgmt., LLC, 2005 WL 488641 1, 2-3 (S.D.N.Y. 2005) ("Only parties to an investment advisory contract may sue for rescission under section 215. See Zurich Capital Markets, Inc. v. Coglianese, 332 F. Supp. 2d 1087, 1114 (N.D. Ill. 2004) ('In order to sue under the Act and seek rescission of the contract, [a plaintiff investor] must be a party to the contract.') (citing Shahidi v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 2:02CV483FTM29SC, 2003 WL 21488228, at 3 (M.D. Fla. Apr. 28, 2003) (concluding that the plaintiff 'shareholders have no standing to individually sue either defendant in this case to void the contracts'); Soderberg v. Gens, 652 F. Supp. 560, 564 (N.D. Ill. 1987) (observing that the courts limit claims to 'persons actually in an advise/client relationship')); Neely v. Bar Harbor Bankshares, 240 F. Supp. 2d 44, 49 (D. Me. 2003) (observing that 'there is no right of action under the Act unless there is first an investment adviser contract between the parties') (citing Paul S. Mullin & Assoc., Inc. v. Bassett, 632 F. Supp. 532, 537 (D. Del. 1986) (stating that 'only the parties to [an investment adviser] contract can avail themselves of the remedy of rescission')); Washington, 656 F. Supp. at 1178 (holding that only parties to an investment adviser contract are proper parties in a claim brought under section 215).").

102 Corley v. U.S., 556 U.S. 303, 314 (2009) (quotations omitted) (Under this "most basic [of] interpretative cannons [...] [a] statute should be construed so that effect is given to all of its provisions, so that no part will be inoperative or superfluous, void or insignificant [...]."). *But see* Marx v. Gen. Revenue Corp., 133 S.Ct. 1166 (2013) (discussing limitations on application of cannon against surplusage).

103 Robinson v. Shell Oil Co., 519 U.S. 337, 341 (1997) (citation omitted) (In determining whether statutory language has a plain and unambiguous meaning, courts should refer "to the language itself, the specific context in which the language is used, and the broader context of the statute as a whole.").

104 444 U.S. 11 (1979).

law[105] to the extent consistent with the Advisers Act.[106] Depending on the applicable state's contract law, a wide array of contract theories may be available, including: third-party beneficiary status,[107] quasi-contract, unilateral contract, estoppel, equitable contract and the like.[108] These forms of contract provide an ample legal basis for developing this approach. Assuming that a contract is formed, the inquiry would then shift to determining whether a legally recognized form of compensation was exchanged consistent with the applicable contract theory.

C. What Constitutes Investment Advice?

Under § 202(a)(11) investment advice is described as "advising others [...] directly [...] as to the value of securities or as to the advisability of investing in, purchasing, or selling securities [...]."[109] Courts have discussed three types of investment advice without explicitly labeling them. For purposes of this article, these three types of advice are identified as traditional personal advice; allocation, selection and monitoring personal advice; and impersonal advice. As appropriate, some observations are offered with this analysis.

1. Traditional Personal Advice

Some courts have viewed investment advice as reflecting the personal nature of the relationship between an investment adviser and its client. Under this traditional notion of an investment adviser's role, the adviser questions the client about, among other things, its investment goals, risk tolerance, financial needs, and time horizon. Next, consistent with this personal information, the adviser tailors an investment strategy and executes it. This personal advice may be offered as either advisory, where an investment adviser recommends the purchase or sale of securities to a

105 *See*, *e.g.*, *id.* at 19 (the court concluded that "[w]hen Congress declared in § 215 that certain contracts are void, it intended that the customary legal incidents of voidness would follow, including the availability of a suit or rescission or for an injunction against continued operation of the contract, and for restitution."); *id.* at 25 n.14 ("Where rescission is awarded, the rescinding party may of course have restitution of the consideration given under the contract, less any value conferred by the other party. See 5 A. Corbin, Contracts § 1114 (1964)."); Wisnieski v. Rodale, 510 F.3d 294, 305 n.32 (3d Cir. 2007) (applying *Restatement (Second) of Contracts* § 7 when interpreting meaning of "void" under § 215, 15 U.S.C. § 80b-15); Omega Overseas Partners, Ltd. v. Griffith, 2014 WL 3907082 1, 3 (S.D.N.Y. 20014) ("[...] § 215(b)'s text strongly echoes the description of illegal contracts found in the *Restatement of Contracts*, which was published only a few years before the IAA's enactment."); Conrardy v. Ribadeneira, 1990 WL 66603 1, 4 (D. Kan. 1990). *See generally* Sekhar v. U.S., 133 S.Ct. 2720, 2724 (2013) (citation omitted) ("[W]here Congress borrows terms of art in which are accumulated the legal tradition and meaning of centuries of practice, it presumably knows and adopts the cluster of ideas that were attached to each borrowed word in the body of learning from which it was taken and the meaning its use will convey to the judicial mind unless otherwise instructed."); Carter v. U.S., 530 U.S. 255, 266 (2000) ("[W]e have not hesitated to turn to the common law for guidance when the relevant statutory text does contain a term with an established meaning at common law."); U.S. v. Shabani, 513 U.S. 10, 13 (1994) ("[A]bsent contrary indications, Congress intends to adopt the common law definition of statutory terms."); Miller v. Bridgeport Board of Education, 2013 WL 3936925 1, 8 (D. Conn. 2013) (citations omitted) ("The term 'contract' pursuant to [42 U.S.C.] § 1981 adopts its ordinary common law meaning.").

106 *See* § 203A, State and Federal Responsibilities, 15 U.S.C. § 80b-3A (addressing division of state and federal responsibilities for overseeing investment advisers); § 222, State Regulation of Investment Advisers, 15 U.S.C. § 80b-22 (addressing, *inter alia*, state responsibilities for regulating investment advisers).

107 *See generally* Bayerische Landesbank v. Aladdin Capital Mgmt., LLC, 692 F.3d 42 (2d Cir. 2012).

108 To the extent consistent with the Advisers Act, application of state law concepts of contract may be supported by other provisions of federal securities laws addressing certain types of compensation contracts and other compensation arrangements. *See*, *e.g.*, Investment Company Act § 36, Breach of Fiduciary Duty, 15 U.S.C. 80a-36, Exchange Act § 10C, Compensation Committees, 15 U.S.C. § 78j-3; Exchange Act § 14A, Shareholder Approval of Executive Compensation, 15 U.S.C. § 78n-1; Regulation S-K, Item 402, Executive Compensation, 17 C.F.R. § 229.402; Sarbanes-Oxley Act of 2002, § 304, Forfeiture of Certain Bonuses and Profits, Pub.L.107-204, 116 Stat. 745, codified at 15 U.S.C. § 7243.

109 § 202(a)(11), 15 U.S.C. § 80b-2(a)(11).

client and the client makes the ultimate decision; or discretionary, where the client authorizes an investment adviser to make investment decisions to purchase and sell securities on behalf of the client without the client first approving of each investment decision.[110]

Aspects of this personal one-on-one relationship were relied on by the Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.*,[111] which held that § 206(2) imposed on an investment adviser a fiduciary duty to its client.[112] Moreover, the Advisers Act recognizes that some investment advisers offer personal advice, while others do not.[113] Investment advisory business models based on offering personal advice, either on an advisory or discretionary basis, include individual client account management, financial planning services, certain sports and entertainment agent services, and certain internet advisory services.[114]

2. Allocation, Selection and Monitoring Personal Advice

Although § 202(a)(11) speaks primarily in terms of advising others on purchasing and selling securities, in *SEC v. Washington Investment Network*,[115] ("WIN"), an enforcement action, the court recognized as investment advice three different forms of personal advice, which, in varying degrees, are removed from the traditional process of selecting securities on behalf of clients. The first form of advice focuses on how to allocate client funds among different types of securities investments, essentially recommending what asset classes to invest in (equities, debt, and the like).[116] The second form of advice is to assist the client in selecting another investment adviser to invest client funds consistent with the asset allocation advice. Lastly, the third type of advice provided by the adviser is the monitoring of the execution of the asset allocation plan by the selected investment adviser. In *WIN*, this monitoring advice included periodically reviewing the investment

110 Lowe v. Sec. & Exch. Comm'n, 472 U.S. 181, 191–92 n. 31 (1985) (*inter alia*, describing advisory and discretionary forms of personal investment advice).

111 375 U.S. 180, 184 (1963).

112 *See id.* at 187 n.5, 191 (Court relied in part on the legislative history of the Advisers Act that described the "personalized counseling," and "personalized character" of providing investment advice on a "personal basis," as well as describing the relationship between an adviser and client as one of "trust and confidence."); *see also* Lowe, 472 U.S. 181, 192, n.31 (1985) (*inter alia*, discussing legislative history of the Advisers Act that addresses personal investment advice, as opposed to impersonal investment advice, in holding that the "bona fide" publication exemption under § 202(a)(11)(D) for Publishing advisers was appropriate when applied to purely impersonal investment advice).

113 *See* § 202(a)(13), 15 U.S.C. § 2(a)(13), ("'Investment supervisory services' means the giving of continuous advice as to the investment of funds on the basis of the individual needs of each client."); § 208(c), General Prohibitions, 15 U.S.C. § 8(c) (prohibiting use of "investment counsel" as description of investment adviser business unless: "a substantial part of his or its business consists of rendering investment supervisory services."); *see, e.g.*, § 203(c)(1)(H), Procedures for Registration; Filing of Applications; Effective Date of Registration; Amendment of Registration, 15 U.S.C. § 80b-3(c)(1)(H) ("[A] statement as to whether a substantial part of the business of such investment adviser, consists or is to consist of rendering investment supervisory services.").

114 Rule 203A-2(e), Exemption from Prohibition on SEC Registration, 17 C.F.R. § 275.3A-2(e) (defines internet investment adviser as "an investment adviser that provides investment advice to its clients exclusively through an interactive website. [...] interactive website means a website in which computer software-based models or applications provide investment advice to clients based on personal information each client supplies through the website."); *see also* Sec. & Exch. Comm'n v. Terry's Tips, Inc., 409 F. Supp. 2d 526 (D. Ver. 2006) (investment adviser advising client *via* telephone and e-mail meets definition of investment adviser); Sec. & Exch. Comm'n v. Park, 99 F. Supp. 2d 889 (N.D. Ill. 2000) (internet adviser meets definition of investment adviser under § 202(a)(11), 15 U.S.C. § 80b-2(a)(11)); Exemption for Certain Investment Advisers Operating Through the Internet, Investment Advisers Act Release No. 2091 (Dec. 12, 2002), 67 FR 77620-01 (Dec. 18, 2002).

115 475 F.3d. 392 (D.C. Cir. 2007).

116 *Id.* at 400 ("[B]ecause [WIN] also advised clients in regard to 'asset allocation,' we think WIN's activities easily fall within the Act's definition of investment adviser.").

returns or losses under each investment class and rebalancing the client's portfolio consistent with the client's personal investment strategy.[117]

The *WIN* court relied primarily on a factual analysis of each form of advice, including a discussion of the investment adviser's own description of the advice offered, in finding that those forms of advice satisfied the investment advice requirement. The court did not resort to an analysis of the Advisers Act or judicial interpretations of it. The first form of advice (asset allocation advice) is supported, however, by the language and structure of the Advisers Act. Section 202(a)(11) can be viewed as including two types of advice: 1) "[T]he advisability of [...] purchasing, or selling securities [...]" and 2) "advisability of investing in [...] securities [...]." Here, Congress chose to include the word "investing" in addition to the purchasing or selling securities. Invest is defined as "to commit (money) in order to earn a financial return."[118] In comparison to the specific acts of purchasing and selling, invest is a more general term that focuses on the initial decision to commit money, which could lead to purchasing and selling securities or some other means of earning a financial return. Arguably, asset allocation advice is a form of investing advice that is, in the context of the Advisers Act,[119] a precursor to purchasing and selling securities. Similarly, to the extent that the third form of advice (monitoring advice) represents an ongoing obligation to reallocate client investment funds among assets classes, it is arguably a continuous form of "investing," as interpreted under allocation advice.

The most developed analysis offered by the *WIN* court focused on the third form of advice, referred to here as manager selection advice: "WIN's business of selecting particular investment managers in lieu of others had the effect of channeling client funds to particular security investments."[120] Here, the *WIN* court's reliance on the "effect of channeling" client funds to securities investments is supported by the statutory interpretation of the word "investing" as discussed above. In *WIN*, the court took a significant step in recognizing asset allocation, monitoring and manager selection advice as investment advice, a view long held by the Commission.[121]

3. Impersonal Advice

Abrahamson v. Fleschner,[122] is the seminal case in establishing impersonal advice as satisfying § 202(a)(11), 15 U.S.C. § 80b-2(a)(11).[123] In *Abrahamson*, an investment partnership was formed to

117 *Id.* at 399–400. *But see* Pozez v. Ethanol Capital Mgmt., LLC, 2009 WL 2176574 (D. Ariz. 2009) (rejecting insufficient monitoring activities as providing investment advice under Report Adviser definition of an investment adviser).

118 WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 636 (9th ed. 1985).

119 Under § 205(d), Investment Advisory Contracts, 15 U.S.C. § 80b-5(d), the definition of an investment advisory contract includes "to manage any investment [...] of another person [...]." In turn, BLACK'S LAW DICTIONARY 865 (5th ed. 1979) defines "manage," as among other things: "To control and direct, to administer, to take charge of." The use of the word "manage" under § 205(d), 15 U.S.C. § 80b-5(d), supports interpreting "the advisability of investing" language of § 202(a)(11), 15 U.S.C. § 80b-2(a)(11), as including asset allocation advice.

120 475 F.3d. at 400.

121 Rule 203A-2(a), Pension Consultants, 17 C.F.R. § 275.3A-2(a) (defining investment advice provided by an investment adviser acting as a pension consultant as "including any advice with respect to the selection of an investment adviser to manage such [employee benefit plan] assets."); *see* SEC. & EXCH. COMM'N, STAFF REPORT CONCERNING EXAMINATION OF SELECTED PENSION CONSULTANTS, THE OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS (May 16, 2005); *see also* Rule 204-3(h)(5), Delivery of Brochures and Brochure Supplements, 17 C.F.R. § 275.4-3(h)(5) ("Wrap Fee program means an advisory program under which a specified fee or fees not based directly upon transactions in a client's account is charged for investment advisory services (which may include portfolio management or advice concerning the selection of other investment advisers) and the execution of client transactions."); SEC Release 1092.

122 568 F.2d 862 (2d Cir. 1977), *cert. denied*, 436 U.S. 905, *cert. denied*, 436 U.S. 913 (1978).

123 *Abrahamson*, 568 F.2d at 870–71 (analysis of investment advice is couched in terms of the "engaged in the business" element of § 202(a)(11), 15 U.S.C. § 80b-2(a)(11)).

raise capital by selling limited partnership interests in the partnership to investors. The capital held by the partnership was invested by the general partners in securities, consistent with a conservative investment policy. The general partners were authorized to decide what securities to purchase, hold and sell, while the limited partners did not participate in investing in securities. The general partners were compensated primarily[124] by receiving a percentage of the profits and net capital gains earned by the investment partnership.

In *Abrahamson*, the court held that the general partners provided investment advice because they were charged with "exercising control over what purchases and sales are made with their clients' funds."[125] In support of its interpretation, the court relied on the plain language of § 202(a)(11), 15 U.S.C. § 80b-2(a)(11),[126] the statutory structure of the Advisers Act,[127] and the legislative intent[128] and "broad remedial purposes of the Act."[129]

Supported by this analysis, *Abrahamson* has proven to be noteworthy because it held that an adviser providing impersonal advice to an investment partnership under discretionary authority satisfies the investment advice element.[130] Under this form of impersonal investment advice, the advice need not be tailored to an individual investor's needs (like personal advice), but is provided directly to the investment partnership, which typically explains its investment strategy to potential investors and leaves it to them to decide whether investing in the partnership is appropriate.[131] It stands in contrast to the traditional personal advice approach with an adviser providing

124 *See id.* at 870 ("In addition, the partnership agreement of October 1, 1968, provided for an annual salary of $ 25,000 for each general partner who managed the partnership's investments.").

125 *See id.* at 871 (in addition to finding managing investment partnership securities to be investment advice, court noted that adviser provided limited partner investors with a monthly report stating the percentage increase or decrease in value of the investment partnership holding and compared this performance with Standard and Poor 500 stock average, consistent with Report Adviser language of § 202(a)(11), 15 U.S.C. § 80b-2(a)(11); *see also*, Sec. & Exch. Comm. v. Saltzman, 127 F. Supp. 2d 660, 669–70 (E.D. Pa. 2000) (applying *Abrahamson* in holding that adviser sending limited partnership investors a copy of investment fund financial statements constituted a report under § 202(a)(11), 15 U.S.C. § 80b-2(a)(11)).

126 *Abrahamson*, 568 F.2d at 871.

127 *Id.* (The court looked to § 203, 15 U.S.C. § 80b-3, requiring disclosure of an adviser's authority over client funds, and § 205, 15 U.S.C. § 80b-5, setting standards for advisory contracts governing an adviser managing "investments or trading accounts.").

128 *Id.* at 870-71 (The court in *Abrahamson* reviewed numerous congressional committee reports, for example, Report of the Senate Committee on Banking and Currency, reflecting that the Advisers Act was intended to cover persons investing client funds, including "pools of liquid funds of the public.").

129 *Id.* at 870. Since the *Abrahamson* decision was issued in 1968, the traditional cannon of statutory interpretation that remedial statutes should be construed liberally has been criticized. *See* Estate of Heiser v. Islamic Republic of Iran, 885 F. Supp. 2d 429, 440 (D.D.C. 2012) (citing Antonin Scalia, *Assorted Cannards of Contemporary Legal Analysis*, 40 CASE W. RES. L. REV. 581, 581-82 (1990)) (In discussing remedial statute cannon: "Justice Scalia describes this cannon as 'surely among the prime examples of lego-babble.'").

130 *See*, *e.g.*, U.S. v. Elliott, 62 F.3d 1304, 1310 (11th Cir. 1996) (applying *Abrahamson* to definition of investment adviser); Wang v. Gordon, 715 F.2d 1187 (7th Cir. 1983) (applying *Abrahamson* to definition of investment adviser); Sec. & Exch. Comm'n v. Montana, 2005 WL 645143 1, 2 (S.D. Ind. 2005) (applying *Abrahamson* to definition of investment adviser); *Saltzman*, 127 F. Supp. 2d at 669-70 (E.D. Pa. 2000) (applying *Abrahamson* to definition of investment adviser); Sec. & Exch. Comm'n v. Smith, 1995 U.S. Dist. LEXIS 22352 (Jan. 6, 1995) (applying *Abrahamson* to definition of investment adviser).

131 *See* Sec. & Exch. Comm'n v. Goldstein, 451 F.3d 873, 881 (D.C. Cir. 2006) ("As recently as 1997, it [SEC] explained that a 'client of an investment adviser typically is provided with individualized advice that is based on the client's financial situation and investment objectives. In contrast, the investment adviser of an investment company need not consider the individual needs of the company's shareholders when making investment decisions, and thus has no obligation to ensure that each security purchased for the company's portfolio is an appropriate investment for each shareholder.' Status of Investment Advisory Programs Under the Investment Company Act of 1940, 62 Fed.Reg. 15,098, 15,102 (Mar. 31, 1997)."); Sec. & Exch. Comm'n v. Mannion, 2013 WL 5999657 1, 3 (N.D. Ga. 2013) ("In *Goldstein*, the court explained that, generally, a hedge fund manager's client is the hedge fund itself, and not the investors in the fund."). Commission rules promulgated under the Advisers Act reflect this con-

one-on-one personal advice with its client. *Abrahamson* provides legal analysis to support application of § 202(a)(11) to a wide range of advisers offering impersonal advice as sub-advisers,[132] advisers participating in wrap fee programs,[133] and advisers to certain private investment funds[134] and collateralized debt obligations.[135]

D. The Relationship between Investment Advice and Compensation: The Intertwined Purposes Issue

The structure of § 202(a)(11) requires that an investment adviser be compensated for investment advice. In *Elliott* the court held that discrete fee for investment advice need not be paid in order to meet the compensation element. The ambiguity created by permitting payment for unspecified services, however, has forced courts to unravel the intertwined purposes issue: whether compensation is paid for investment advice, as opposed to some other type of advice or service that is intertwined with investment advice. In addressing this intertwined purposes issue under § 202(a)(11), two different approaches have emerged: the "Purpose of the Partnership" and the "Primary v. Incidental" approaches.

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cept of impersonal advice. *See*, *e.g.*, Rule 203A-3(a)(3)(ii), Definitions, 17 C.F.R. § 275.3A-3(a)(3)(ii) ("'Impersonal investment advice' means investment advisory services provided by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts."); Rule 204-3(h)(1), Delivery of Brochures and Brochure Supplement, 17 C.F.R. § 275.4-3(h)(1) ("Impersonal investment advice means investment advisory services that do not purport to meet the objectives or needs of specific individuals or accounts."); Rule 206(4)-3(d)(3), Cash Payments for Client Solicitations, 17 C.F.R. § 275.6(4)-3(d)(3) ("Impersonal advisory services means investment advisory services provided solely by means of (i) written materials or oral statements which do not purport to meet the objectives or needs of the specific client [...].").

132 *See* Sec. & Exch. Comm'n v. Treadway, 430 F. Supp. 2d 293 (S.D.N.Y. 2006) (investment adviser as sub-adviser); *see also* Sec. & Exch. Comm'n Press Release, SEC, PIMCO equity Mutual Funds' Adviser, Sub-Adviser, and Distributor Agree to Pay $ 50 Million to Settle Fraud Charges for Undisclosed Market Timing, No. 2004-127 (Sept. 13, 2004).

133 Rule 204-3(h)(5), Delivery of Brochures and Brochure Supplements, 17 C.F.R. § 275.4-3(h)(5), ("Wrap fee program means an advisory program under which a specified fee or fees not based directly upon transactions in a client's account is charged for investment advisory services (which may include portfolio management or advice concerning the selection of other investment advisers) and the execution of client transactions."); Sec. & Exch. Comm'n v. Washington Investment Network, 475 F.3d 392 (D.C. Cir. 2007) (discussing wrap fee program structure); Geman v. Sec. & Exch. Comm'n, 334 F.3d 1183, 1185-86 (10th Cir. 2003) ("Under the wrap fee program, the firm's customers paid an 'all-inclusive' fee calculated as a percentage of the customer's assets under management. In return, the firm provided brokerage, advisory, and custodial services."); *see also* Disclosure by Investment Advisers Regarding Wrap Fee Programs, Investment Advisers Act Release No. 1411 (Apr. 19, 1994), 59 FR 21657 (Apr. 26, 1994) (adopting rule release).

134 *See generally* Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Release No. 3308 (Oct. 31, 2011), 76 FR 71128 (Nov. 16, 2011); Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $ 150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3222 (June 22, 2011), 76 FR 39646 (July 6, 2011); STAFF OF THE DIVISION OF INVESTMENT MANAGEMENT, U.S. SECURITIES & EXCHANGE COMMISSION, ANNUAL STAFF REPORT RELATING TO THE USE OF DATA COLLECTED FROM PRIVATE FUND SYSTEMIC RISK REPORTS 6 (July 25, 2013) (listing private funds filing with the Commission under Form PF (private fund): hedge funds, private equity funds, other private funds, real estate funds, securities asset funds, venture capital funds and liquidity funds).

135 The Commission has initiated enforcement actions against investment advisers serving as collateral managers for collateralized debt obligations. *See*, *e.g.*, In the Matter of Harding Advisory LLC and Wing F. Chau, Investment Advisers Act Release No. 3696, 2913 WL 5670841 (Oct. 18, 2013) (order instituting enforcement action alleging investment adviser serving as collateral manager violated, *inter alia*, § 206); In the Matter of Delaware Asset Advisers and Wei, Investment Advisers Act Release No. 3434, 104 S.E.C. Docket 651 (July 18, 2012) (settled enforcement action) (investment adviser serving as collateral manager and then portfolio manager found to have violated, *inter alia*, § 206(2)); In the Matter of GSCP (NJ), LP, Investment Advisers Act Release No. 3261101, S.E.C. Docket 3325 (Aug. 25, 2011) (settled enforcement action) (investment adviser serving as collateral manager found to have violated, *inter alia*, § 206(2)).

1. The Purpose of the Partnership

In *Wang v. Gordon*,[136] a private action, the defendant was a general partner to a limited partnership formed to own and operate an apartment building. The terms of the partnership agreement entitled the defendant to a five percent brokerage commission upon the sale of the apartment building, which he eventually received. The plaintiff was unsatisfied with the sale and sought relief under the Advisers Act. Plaintiff argued, among other things, that the defendant acted as an investment adviser in arranging for the sale of the apartment building. As part of the transaction, the defendant sent a letter to limited partnership investors outlining the terms of the sale. Because the apartment building was held by a limited partnership, plaintiff reasoned, the sale of the building would require the sale of securities, the limited partnership interests held by the limited partners. Plaintiff argued that the defendant's letter constituted investment advice concerning the sale of the building and, concomitantly, the securities (the limited partnership interests) required to transact the sale. Plaintiff contended that the defendant was compensated to this advice by receiving the five percent commission payment.

In rejecting plaintiff's argument, the *Wang* court found that the defendant was compensated for his advice concerning the sale of the apartment building, not the sale of the limited partnership interests. In making this determination, the court looked to the "purpose of the partnership"[137] to decide whether the advice satisfied the investment advice element. It distinguished the purpose of the real estate partnership at issue from the investment partnership discussed in *Abrahamson*. The *Wang* court viewed the "purpose of the partnership" in *Abrahamson* as advising on purchasing or selling securities for a limited partnership, which constituted investment advice. In contrast, the "purpose of the partnership" in *Wang* was to own and operate a building, not securities. The defendant had arranged the sale of a partnership asset, an apartment building, not a security, and therefore was not compensated for providing investment advice. Under *Wang*, the "purpose of the partnership" dictated the purpose of the compensation paid to the defendant.

In creating this "purpose of the partnership" approach to resolve the intertwined purposes issue, the court in *Wang* provides no guidance on how to determine this purpose or how to resolve competing purposes. For example, though investment partnerships typically state their purpose in limited partnership offering documents,[138] the activities of the partnership may diverge substantially from its stated purpose. In its simplest form, an investment partnership may state that its purpose is to invest in commodities, which are not a security, but instead it may invest in securities, ultimately satisfying the definition of an investment adviser. Indeed, courts have emphasized that it is not the description of a business that determines whether it falls within the definition of an investment adviser, but the actual business conduct.[139] On balance, the "purpose of the partnership" has gained no judicial support.

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136 715 F.2d 1187 (7th Cir. 1983).

137 *Id.* at 1192.

138 Generally, in a non-public securities offering under Securities Act § 4(a)(2), 15 U.S.C. 77a(d)(a)(2), the issuer of the securities may circulate privately among qualified, prospective investors offering documents explaining, *inter alia*, the securities offering, including the nature of the investment opportunity. These documents are known as a Private Placement Memorandum, Private Offering Memorandum, or some other non-public offering document. These documents, however, are generally the responsibility of the general partner, who may be a legal entity separate from the investment adviser.

139 *See*, *e.g.*, U.S. v. Onsa, 523 Fed. App'x 63, 65 (2d Cir. 2013) (in upholding enhanced sentence based on investment adviser status, court held that defendant having "explicitly told investors that he was not an 'investment adviser' under the [Advisers] Act" did not affect defendant's investment adviser status); *see also* Fresenius Medical Care Holdings v. U.S., 763 F.3d 64, 70 (1st Cir. 2014) (In tax cases, courts "look to the substance – that is, the economic reality of the particular transaction, objectively viewed – rather than to the form chosen by the parties.").

2. Primary v. Incidental

In *U.S v. Elliott*,[140] the defendants argued that they, like the defendant in *Wang*, had not received compensation for investment advice. They claimed that clients came to them to purchase a security, an investment vehicle created by the defendants, not to receive investment advice. In rejecting defendants' argument, the court held that investment advice to clients constituted a "significant component of the 'product' sold."[141] The defendants in *Elliott* assisted clients in "choosing individually tailored investment vehicles."[142] Next, it noted that after providing advice about the investment selection, the defendants continued to advise the clients by managing the underlying investments. The court held that these two forms of advice – the assistance in choosing an investment vehicle and management of the underlying investments held by the investment vehicle – were the "primary," not "incidental" reasons for investing in the investment vehicles. This primary role of the advice in making a decision to invest met the investment advice element.

While *Elliott's* "primary v. incidental" approach was helpful in distinguishing *Wang*,[143] *Elliott* did not offer a standard to measure primary as opposed to incidental advice. In *Thomas v. Metropolitan Life Insurance Company*,[144] a private action, however, the court adopted a standard to measure "solely incident" conduct under the § 202(a)(11)(C) broker-dealer exception to the definition of an investment adviser. As discussed, under this exception, a broker-dealer may offer investment advice that is "solely incident to" its broker-dealer services and may not receive "special compensation" for this advice.[145] In *Thomas*, the court noted that

> the word "incidental" has two components. To be considered incidental, two actions or objects must be related in a particular way – the incidental action or object must occur only as a result of or in connection with the primary. Additionally, the incidental action or object must be secondary in size or importance to the primary.[146]

Thomas' approach to distinguishing between primary and incidental services may assist in developing *Elliott's* distinction between primary and incidental advice.

E. Advising Others

Section 202(a)(11) requires that an adviser be engaged in advising "others." Typically, the adviser's client is the recipient of the adviser's advice and this would satisfy that the advice had been provided to "others." In interpreting this advising "others" language, courts have addressed two issues: 1) whether the person receiving the investment advice must be in a position to act on the advice;[147] and 2) whether a trustee's investment advice to a trust is advice to itself or "others."

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140 62 F.3d 1304 (11th Cir. 1996), *order amending opinion*, 82 F.3d 989 (11th Cir. 1996).
141 *Id.* at 1311.
142 *Id.*
143 *See* Sec. & Exch. Comm'n v. Saltzman, 127 F. Supp. 2d 660 (E.D. Pa. 2000) (distinguishing application of Wang v. Gordon, 715 F.2d 1187 (7th Cir. 1983)).
144 631 F.3d 1153 (10th Cir. 2011).
145 In addition to § 202(a)(11)(C), 15 U.S.C.§ 80b-2(a)(11)(C), § 202(a)(11)(B), 15 U.S.C. § 80b-2(a)(11)(B), exempts lawyers, accountants, engineers and teachers who offer investment advice that is "solely incidental."
146 *Thomas*, 631 F.3d at 1162.
147 Some courts have held that the advice element is satisfied if an adviser provides advice regardless of whether the advice is acted upon. *See*, *e.g.*, U.S. v. Elia, 2014 WL 4289389 2 (11th Cir. 2014) (per curiam) ("It [§ 202(a)(11), 15 U.S.C. § 80b-2(a)(11)] does not require that the adviser actually make an investment or act on that advice."); *see also* U.S. v. Olga, 378 F. App'x 959, 960 (11th Cir. 2010) (per curiam) ("Although *Ogale* never actually used investors' money to trade foreign currencies, his scheme involved 'advising others.'").

1. An Opportunity to Act by the Recipient of Investment Advice

The *Wang* decision also raised an issue of whether the recipient of advice must be in a position to act on that advice. As noted, Wang argued that by the defendant sending a letter to limited partnership investors outlining the sales terms of the property, he provided investment advice. In rejecting this argument, the court relied, in part, on its conclusion that Wang, as a limited partner, "had no input or say as to the sale [of the apartment building]"[148] by the limited partnership and his "inability to participate"[149] in the decision to sell meant that the advice was not investment advice. This "inability to participate" limitation on the advising "others" element, strongly implies that Wang as the recipient of the advice must be in a position to participate in the decision to sell the property for the advice to meet the requirements of § 202(a)(11).

An ability to participate in certain business decisions may run afoul of United States federal securities laws. A requirement that a holder of a security (Wang as a limited partner) must participate in the business affairs of the issuer of securities (the limited partnership) may contradict the definition of a security. In 1945, the Supreme Court in *SEC v. W.J. Howey*,[150] held that an investment contract may meet the definition of a security if, among other requirements, an investor is "led to expect profits solely from the effort of the promoter or a third party."[151] More recently, in developing this requirement, courts have not only made a distinction between passive investor conduct and significant investor control,[152] but, in determining whether a limited partnership interest is a security, have required that the relevant partnership agreement give the general partner the "exclusive right and power to manage, conduct, and operate [...]" the partnership's business.[153] To the extent that *Wang* is required to participate in investment decisions of a partnership, *Wang* jeopardizes the limited partnership interest meeting the requirements of a security.

2. The Trustee Conundrum – Is Advising "Yourself" Advising Others?

Given the legal relationship between a trustee and the trust, courts have struggled over whether trustee investment advice to a trust constitutes advice to itself or to another entity. By way of background, in 1942, the Commission granted an application of Augustus P. Loring, Jr. requesting an order, pursuant to then § 202(a)(11)(F),[154] exempting him from the definition of an investment adviser. After a public hearing, the Commission concluded that Mr. Loring served as a professional trustee in the administration of trusts and estates and the management of property. The vast majority of Loring's business[155] consisted of acting as a court appointed fiduciary (a trustee, guardian, conservator or executor) under court supervision. Loring administered both personal and real property. When acting under court appointment, he held legal title to the property and acts as a principal.[156]

148 715 F.2d at 1192.
149 *Id.*
150 Sec. & Exch. Comm'n v. W. J. Howey Co., 328 U.S. 293 (1946) (multiple factor tests for determining whether an investment contract meets the definition of a security).
151 *Id.* at 298–99.
152 Sec. & Exch. Comm'n v. Aqua-Sonic Products Corp., 687 F.2d 577, 582 (2d Cir. 1982).
153 Sec. & Exch. Comm'n v. Rabinovich & Associates, LP, 2008 WL 4937360 1, 3 (S.D.N.Y. 2008) (citations omitted); *see, e.g.*, Sec. & Exch. Comm'n v. Northshore Asset Mgmt., 2008 WL 1968299 1, 7 (S.D.N.Y. 2008).
154 Since the Commission issued its order In the Matter of Augustus P. Loring, Jr. in 1942, § 202(a)(11)(F), 15 U.S.C. § 80b-2(a)(11)(F), has been renumbered as § 202(a)(11)(G), 15 U.S.C. § 80b-2(a)(11)(G).
155 Loring also provided trustee services under trust indenture appointment and power of attorney arrangements. Investment Advisers Act Release No. 33, 1942 WL 34539 1 (July 22, 1942).
156 *Id.* at 2.

As a court fiduciary, Loring was required to give a "bond of acceptance for each trust" in an amount sufficient to protect the property, which is discharged after filings accounts with the court.[157] Loring's activities outside of court supervision but under power of attorney, constituted "only a minor part of his business and are, in effect, incidental to his business of acting as a trustee."[158] At the close of its order, the Commission noted that Loring neither solicited business, nor held himself out to the public as being engaged in the business of providing investment advice. Any advice given to others "as to securities" was "solely incidental to his activity as a professional trustee."[159]

In *Selzer v. Bank of Bermuda*,[160] a private action, a beneficiary to an investment trust managed by defendant Bank of Bermuda alleged that while acting as a trustee the Bank of Bermuda met the definition of an investment adviser and violated the Advisers Act. The court summarily noted that the Commission in *In re Loring* held that a trustee is not an investment adviser. It went on to explain that historically a trustee is the legal owner of the trust corpus and the beneficiary is the equitable owner. A trustee acts as a principal in making investment decisions for the trust and, therefore, does not provide advice to others.[161] Although the court acknowledged that there may be public policy reasons in support of trustees operating under the definition of an investment adviser, the "common sense"[162] meaning of the word "adviser"[163] militated against applying the Advisers Act. Since *Selzer*, the Commission's staff has expressed in No-Action Letters[164] its disagreement with the *Selzer* court's characterization of *In re Loring* and its broad holding that a trustee is does not meet the definition of an investment adviser.[165]

The *Selzer* court's approach to the trustee issue was rejected in *SEC v. Smith*[166], In *Smith*, an enforcement action, a formerly registered investment adviser created a new trust entity and transferred investment adviser client accounts to it. Smith then restyled his adviser role as one of a trustee. Smith argued that under *Selzer* and *In re Loring* he was operating as a trustee and, therefore, did not meet the definition of an investment adviser. The court in *Smith* rejected *Selzer* and instead applied the holding in *Abrahamson*, namely that exercising control over investments constitutes investment advice. *Smith* noted that the *Abrahamson* decision was the more cogent decision and because *Abrahamson* was an opinion of the circuit court of appeals that *Selzer* was

157 *Id.* at 1.
158 *Id.* at 2.
159 *Id.*
160 385 F. Supp. 415 (S.D.N.Y. 1974).
161 *Id.* at 420; *see also* Sec. & Exch. Comm'n v. Ficeto, 839 F. Supp. 2d 1101 (C.D. Cal. 2011) (defendant unsuccessfully argued that it served as the investment adviser to investment funds that it sponsored and therefore could not defraud itself).
162 *Selzer*, 385 F. Supp. at 420.
163 *Id.*
164 Commission staff will provide informal written advice – in the form of a No-Action Letter – in response to a letter providing specific facts and representations about an unresolved securities regulation issue. In its No-Action Letter, the Commission staff will state whether, under the facts and representations presented, it would or would not recommend any Commission enforcement action. *See* Procedures Applicable to Requests for No-Action and Interpretative Letters, Investment Advisers Act Release No. 281 (Feb. 8, 1971).
165 These Commission staff positions are reflected in various No-Action Letters. *See*, *e.g.*, Clair H. Spring (pub. avail. Sept. 13, 1990) ("In Selzer, et al. v. The Bank of Bermuda, 385 F. Supp. 415 (S.D.N.Y. 1974) (enclosed), the district court held that a trustee, acting as legal owner of a trust and principal, is not an adviser with the meaning of Section 202(a)(11) of the Investment Advisers Act of 1940. However, in [No-Action Letter] Joseph J. Nameth, Jr. (pub. avail. Jan. 31, 1983) (enclosed), the [Sec. & Exch. Comm'n] Division of Investment Management specifically disagreed with the district court's holding in Selzer because it rested on a misreading of an earlier SEC decision (In re Loring, 11 S.E.C. 885 (1942)). The Division's position, as reflected in our no-action letters, has not changed on this issue.").
166 1995 U.S. Dist. LEXIS 22352 (E.D. Mich.).

charged with following,[167] it undercut *Selzer's* precedential value, a view shared by at least one other court.[168]

Importantly, *Smith* viewed *In re Loring's* exclusion of a trustee from the definition of an investment adviser as limited to situations where a trustee's business activities are subject to an alternative oversight scheme. It noted that the Commission's order emphasized that Loring's trustee activities were under court supervision and the amount of activities outside this court supervision was "incidental."[169] Moreover, *Smith* noted that the trustee in *Selzer* was a highly regulated foreign bank (Bank of Bermuda), while no similar alternative regulatory structure oversaw the defendant's activities in *Smith*.[170]

While relying on *Abrahamson*, *Smith* did not address the legal-equitable ownership distinction relied on by *Selzer*. *Selzer* viewed a trustee as advising only itself as the legal owner of the trust corpus (securities) and therefore not as an investment adviser, while acknowledging the role of beneficiaries as equitable owners of corpus of the trust. As an equitable owner, however, a beneficiary generally has standing to initiate a legal proceeding against a trustee alleging violations of the trustee's fiduciary duty, including challenging the appropriateness of the trustee's investment advice.[171] This legal standing, at the very least, recognizes that in the investment advice context beneficiaries have a separate legal status from that of the trustee, which supports viewing them as recipients of the investment advice for purpose of § 202(a)(11). Moreover, this view is supported in part by the court's holding in *SEC v. Montana*.[172] There, UTA-BVI, Ltd, the trustee, invested the trust's funds of two other trusts, First National Equity Trust and P.K. Trust. In finding that UTA-BVI met the definition of an investment adviser, the court relied on relevant trust agreements that "[…] identified First National Equity Trust and P.K. Trust as beneficiaries of the trust and provide that UTA-BVI would manage the trust funds for the benefit of the beneficiaries."[173] The *Montana*

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167 *Id.* at 19. *See also* Condon v. Haley, 21 F. Supp. 3d 572, 583 (D.S.C. 2014) ("It is axiomatic that a decision of a circuit court, not overruled by the United States Supreme Court, is controlling precedent for the district courts within the circuit."); Cartica Management, LLC v. Corpbanca, S.A., 2014 WL 4804491 (S.D.N.Y. 2014) 6 ("District courts and other inferior courts are bound by decisions of the Circuit Court of Appeals in the appropriate circuit unless overturned by an intervening Supreme Court decision or other change in the law.").

168 *See* Sec. & Exch. Commn'n v. Montana, 2005 WL 645143 1-2 (S.D. Ind. 2005) (court, without noting either *In re Loring* or Sec. & Exch. Comm'n v. Smith, held that under *Abrahamson*, a "trust management agreement" with a trustee investing trust funds met the definition of an investment adviser, without making a distinction between beneficial and legal ownership of the trust corpus).

169 1995 U.S. Dist. LEXIS 22352 (E.D. Mich.) 18.

170 The presence of an alternative oversight authority scheme plays a role determining whether an instrument meets the definition of a security. *See* Reves v. Ernst & Young, 494 U.S. 56 (1990); Sec. & Exch. Comm'n v. J.T. Wallenbrock, 313 F.3d 532, 537 (9th Cir. 2002) ("[F]our Reves factors […]: (4) whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument […]."); Stober v. Sec. & Exch. Comm'n, 161 F. 3d 745 (D.C. Cir. 1998) (noting other Supreme Court cases holding that the regulatory schemes imposed by the Federal Deposit Insurance Corporation and Comptroller of the Currency met alternative regulatory scheme requirements under Reves' fourth factor); Sec. & Exch. Comm'n v. Smart, 2011 WL 2297659 (D. Utah 2011) (noting Reves' fourth factor as including alternative regulatory scheme); Sec. & Exch. Comm'n v. Novu Techs., LLC, 2010 WL 4180550 (D. Utah 2010) (same); Sec. & Exch. Comm'n v. Global Telecom Servs., LLC, 325 F. Supp. 2d 94 (D. Conn. 2004) (same); *see also* Inv. Co. Inst. v. Commodity Futures Trading Comm'n, 720 F.3d 370 (D.C. Cir. 2013) (discussing Commodity Futures Trading Commission's authority to exclude "otherwise regulated" entities from its regulations).

171 RESTATEMENT (THIRD) OF THE LAW OF TRUSTS: REMEDYING BREACH OF TRUST: GENERAL PRINCIPLES § 94 (2012), ("(1) A suit against a trustee of a private trust to enjoin or redress a breach of trust or otherwise to enforce the trust may be maintained by only a beneficiary or by a co-trustee, successor trustee, or other person acting on behalf of one or more beneficiaries.").

172 2005 WL 645143 (S.D. Ind. 2005).

173 *Id.*

court's acceptance of the trust beneficiaries as clients of the trustee's investment advice is an important step in light of *Selzer*. The court in *Montana*, however, relied primarily not on the separate legal status and roles of the trustee and beneficiary but on the strength of the holding in *Abrahamson*. In addition to the court's analysis in *Smith* and *Montana*, provisions of the Advisers Act support holding that a trustee is an investment adviser.[174]

E. Engaged in the Business

Section 202(a)(11) requires an investment adviser to "engage in the business" of providing investment advice. In interpreting this element, the Commission staff in SEC Release 1092[175] and courts[176] have relied primarily on the decision in *Zinn v. Parrish*[177]. After reviewing *Zinn*, some observations are offered.

1. Zinn v. Parrish

In *Zinn v. Parrish*, a private action, the court held that Zinn, a sports manager, provided services to Parish, a professional football player, that did not, among other things, satisfy the engaged in the business element. While providing sports management services, Zinn obtained a list of securities recommendations prepared by other persons, screened it and forwarded it to Parrish. The court acknowledged that had Zinn "made a business"[178] of screening securities recommendations, he would be required to register as an investment adviser. However, this "isolated transaction"[179] with Parrish was "incident"[180] to the main purpose of the manager-client relationship.

While *Zinn's* holding has factual support, its legal analysis raises questions. The court in *Zinn* analogized the sport manager's role to that of the professional trustee described in *In re Loring*. *Zinn* characterized the trustee *In re Loring* as a "professional trustee whose advice to his clients is 'solely incidental' to his duty as a professional trustee."[181] Also, as part of its discussion of *In re Loring*, the court in *Zinn* noted that the "SEC further concluded that the trustee was not an investment adviser because he did not 'hold himself out as being engaged in the business of giving advice to others as to securities.'"[182] *Zinn* went on to apply factors noted in Commission staff No-Action

174 Section 203, Registration of Investment Advisers, 15 U.S.C. § 80b-3, requires and exempts certain investment advisers (as defined under § 202(a)(11), 15 U.S.C. § 80b-2(a)(11)) to register with the Commission. Section 203(b)(4), 15 U.S.C. § 80b-3(b)(4), exempts from registration an investment adviser that is a trustee to a charitable organization. § 203(b)(5), 15 U.S.C. § 80b-3(b)(5), exempts from registration an investment adviser that is a trustee to a plan described under § 414(e) of the Internal Revenue Code of 1986 that provides investment advice exclusively to the plan.

175 SEC Release 1092, 4 & n.7 ("The 'Business' Standard [...] The staff considers a person to be 'in the business' of providing advice if the person: [...] (iii) on anything other than rare, isolated and non-periodic instances, provides specific investment advice. FN7 (Zinn v. Parris, 644 F.2d 360 (7th Cir. 1981)").

176 *See*, *e.g.*, Wang v. Gordon, 715 F.2d 1187, 1192-93 (7th Cir. 1983) (relying on the Zinn v. Parrish "engage in the business" approach); Pozez v. Ethanol Capital Mgmt., LLC, 2009 WL 2176574 6 (D. Ariz. 2009) (relying on the Zinn v. Parrish "isolated transactions" language).

177 644 F.2d 360 (7th Cir. 1981).

178 *Id.* at 364.

179 *Zinn*, 644 F.2d at 364.

180 *Id.*

181 *Id.*

182 *Id.*

Letters[183] for determining whether one "holds himself out"[184] to the public as an investment adviser. More fundamentally, *Zinn's* characterization of *In re Loring* fails to recognize that the vast majority of services provided by Loring were under court supervision, subject to a bonding requirement. This fact would support the Commission granting the exemptive request in *In re Loring*. Similarly, *Zinn* appears not to appreciate that the standard applied by the Commission in the *In Re Loring* exemptive application under § 202(a)(11)(H) is whether the applicant is a person "not within the intent" of § 202(a)(11). This is a far more general and inclusive standard than determining the reach of the engage in the business language of § 202(a)(11).

Finally, the *Zinn* decision does not acknowledge that Congress in enacting the Advisers Act choose to include "solely incidental" and "holding out" language in other provisions of the Adviser Act but not § 202(a)(11). Indeed, *Zinn's* imposition of the "holding out" to the public test and "solely incidental" limitation is not supported by the language of § 202(a)(11) and is undercut by the structure of the Advisers Act. Under § 202(a)(11), the definition of an investment adviser does not include "solely incidental" language. In contrast, the professionals exception under § 202(a)(11)(B) and broker-dealer exception under § 202(a)(11)(C) both limit offering investment adviser that is "solely incidental to the conduct" of the practice of a profession and business as a broker or dealer, respectively. Under § 202(a)(11) the definition of an investment adviser does not include any reference to "holding out" to the public. Under former § 203(b)(3) an investment adviser is not required to register with the Commission if certain requirements are met, such as that it does not "hold[s] itself out to generally to the public as an investment adviser." *Zinn's* approach is difficult to accept in light of the Supreme Court's holding in *Barnhart v. Sigmon Coal Company, Inc.*,[185] where the court held that "when 'Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.'"

2. Alternative Approaches to Engage in the Business

Courts may benefit from taking a fresh approach to the engage in the business element. Although neither the word "engage" nor "business" is defined by the Advisers Act, these words appear in other federal statutes and courts have routinely looked to their "ordinary and natural"[186] meanings in interpreting the words "engage"[187] and "business"[188] Some courts have been called upon

183 *See supra* footnote 165 above; *see also* Wilson v. Merrill Lynch & Co., 671 F.3d 120, 137 n.11 (2d Cir. 2011) (discussing degree of judicial deference due Commission staff No-Action Letters); Gryl ex rel. Shire Pharm. Grp. PLC. v. Shire Pharm. Grp. PLC, 298 F.3d 136, 145 n.8 (2d Cir. 2002) (citations omitted) ("It must be remembered, however, that SEC no action letter responses are staff interpretations rather than formal Commission action and thus are of more limited utility than formal rulemaking or policies announced in SEC releases.").

184 *Zinn*, 644 F.2d at 363 (citations omitted) ("Among the factors the SEC looks to in determining whether someone 'holds himself out' as an investment adviser are: '(t)he maintenance of a listing as an investment adviser in a telephone or business directory'; 'the expression of willingness to existing clients or others to accept new clients'; or 'the use of a letterhead indicating any activity as an investment adviser.'").

185 534 U.S. 438, 453, (2002) (citations omitted).

186 Scherr v. Marriott Int'l, Inc., 703 F.3d 1069, 1077 (7th Cir. 2013) ("When we do not have statutory definitions available, we accord words and phrases their ordinary and natural meaning and avoid rendering them meaningless, redundant, or superfluous; we view words not in isolation but in the context of the terms that surround them; we likewise construe statutes in the context of the entire statutory scheme and avoid rendering statutory provisions ambiguous, extraneous, or redundant; we favor the more reasonable result; and we avoid construing statutes contrary to the clear intent of the statutory scheme.").

187 *See*, *e.g.*, U.S. v. Graham, 305 F.3d 1094, 1102 (10th Cir. 2002) ("The term 'engage' is commonly defined as 'to occupy or involve oneself; take part; be active.' Webster's New World College Dictionary at 450 (3rd ed.

to interpret the phrase "engage in the business" as it appears in other federal statutes,[189] including definitional provisions of the Commodity Exchange Act.[190]

In addition to interpreting this language, the Advisers Act itself offers guidance. § 222, State Regulation of Investment Advisers, among other things, addresses the allocation investment adviser oversight authority among states. In part, this allocation is dependent on the location of the advisers "place of business."[191] To explain the meaning of this term, the Commission promulgated Rule 222-1, Definitions, which states in part: "(a) Place of business. 'Place of business' of an investment adviser means: (1) An office at which the investment adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients […]."[192] Putting aside the office location context, these factors arguably describe in general terms conduct that tend to reflect engaging in the business of an investment adviser. They focus on regularly providing investment advice, soliciting clients and servicing clients. At its essence, these activities speak to the potential components of an engaged in the business approach that are consistent with the language and structure of the Advisers Act.

VI. Conclusion

This analysis of judicial approaches to interpreting the elements of § 202(a)(11) and the accompanying observations illustrate the variety of definitional issues that for the most part remain undeveloped. In some instances, courts have tended toward an "I know it when I see it"[193] tact in relying on certain facts to support investment adviser status, with little resort to the language or structure of the Advisers Act. In others, there is some effort to identify a nascent legal concept to support a particular approach, but again without developing it within the structure of the Advisers Act or other relevant legal authority. It is hoped that some of the observations offered may provide a starting point for building a more grounded and reflective approach to interpreting these elements, which may eventually be recognized by courts as an appropriate approach.

1997)"); *see also* Gibbs v. I-Flow, Inc. 2009 WL 482285 3 (S.D. Ind. 2009) (applying similar dictionary definition to define the term "engage"); BLACK'S LAW DICTIONARY 474 (5th ed. 1979) (defining "engaged" as "to employ or involve oneself; to take part in; to embark on.").

188 *See*, *e.g.*, U.S. v. Graham, 305 F.3d 1094, 1103 n.5 (10th Cir. 2002) ("See also Black's Law Dictionary at 198 (6th ed. 1990) (defining business as '[e]mployment, occupation, profession, or commercial activity engage in for gain or livelihood.'"); *see also* U.S. v. Mazza-Alaluf, 607 F. Supp. 2d 484, 489 (S.D.N.Y. 2009) ("The statute [USA Patriot Act] does not define the 'business,' which should be afforded its ordinary meaning as an enterprise that operates for profit. *See Travelers Insurance Co. v. Carpenter*, 411 F.3d 323, 334 (2d Cir. 2005) (utilizing Black's Law Dictionary to define a term undefined by statute); Black's Law Dictionary (8th ed. 2004) (defining business as '[a] commercial enterprise carried on for profit.'").

189 *See*, *e.g.*, Bryan v. U.S., 524 U.S. 184 (1998) (discussing, *inter alia*, the "engaged in the business" language of 18 U.S.C. 922(a)(1)); U.S. v. Day, 476 F.2d 562, 567 (6th Cir. 1973) (citations omitted) (interpreting "engaged in the business" phrase).

190 U.S. Commodity Futures Trading Commission v. Hall, 2014 WL 4942312 (M.D.N.C. 2014) (discussing, *inter alia*, the engaged in the business language of § 1a(12)(A) of the Commodity Exchange Act defining a commodity trading advisor).

191 *See* § 222, State Regulation of Investment Advisers, 15 U.S.C. § 80b-22 (reference to investment adviser "place of business" throughout § 222).

192 Rule 222-1, Definitions, 17 C.F.R. § 275.22-1. *See also* Rule 202(a)(30)-1(c)(4), 17 C.F.R. § 275.2(a)(30)-1(c)(4), (defining investment adviser "place of business" as identical to definition of investment adviser "place of business" appearing in Rule 222-1(a), 17 C.F.R. § 275.22-1(a)). *See generally* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1633 (May 15, 1997), 62 FR 28112 (May 22, 1997) (adopting rule release).

193 Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart concurring) (when discussing difficulty in defining hard-core pornography, Justice Stewart stated, "I know it when I see it.")