Chapter 9

The Investment Advisers Act of 1940*

I. INTRODUCTION

II. WHO IS AN INVESTMENT ADVISER

III. REGISTRATION UNDER THE ADVISERS ACT

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as it would have been unlawful for such person to do directly under the Advisers Act. Section 208(d) prohibits any conduct that would have been illegal for the person to do directly under the Advisers Act, even if the person had done so indirectly, or through another person.

Like Section 206(2), scienter is not required to show a violation of Section 207[6] or 208. Section 203(d) also extends the prohibitions under Sections 207 and 208.

§ 9:54 Validity of contracts

Parties may not waive compliance with any provision of the Advisers Act or any rules, regulation or order thereunder. Any such conditions, stipulations or provisions to waive compliance shall be void.[1] Additionally, contracts which violate any Advisers Act provision or require the performance of activities which violate the Advisers Act provision are "void" as against the wrongdoer or any non-contracting party who, with actual knowledge of the defect, acquires any right under such a contract. The courts have refined this position to read "void" in Section 215 as "voidable" at the option of the innocent party.[2]

§ 9:55 Defenses in general

Any liability imposed by the following provisions will not apply to any act done or omitted in good faith, in conformity with any rule, regulation or order of the SEC. This applies even if the aforesaid rule, regulation or order is subsequently amended, rescinded or invalidated after such act or omission.[1]

V. ENFORCEMENT MECHANISMS UNDER THE ADVISERS ACT

§ 9:56 Introduction

The Advisers Act empowers the SEC with several mechanisms to sanction unlawful investment adviser behavior. In turn, the SEC must submit an annual report to Congress, covering its work for the

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[6]In re Parnassus Investments, et al. 1998 SEC Lexis 1877.

[Section 9:54]

[1]Section 215(a).

[2]The wrongdoer may not enforce such a contract against an unwilling innocent party. However, the innocent party may enforce the contract. This interpretation of Section 215 protects the innocent party's interest, where rescission might impose hardship. See Mills v. Electric Auto-Lite Co., 396 U.S. 375, 386–388, 90 S. Ct. 616, 24 L. Ed. 2d 593, Fed. Sec. L. Rep. (CCH) P 92556 (1970); Greater Iowa Corp. v. McLendon, 378 F.2d 783, 792 (8th Cir. 1967).

[Section 9:55]

[1]Section 211(d).

preceding year and furnishing any information, data and recommendations for further legislation under the Advisers Act.[1]

§ 9:57 Investigative powers

The SEC may require any investment adviser to disclose the identity, investments or affairs of any client if "necessary or appropriate in a particular proceeding or investigation" for enforcement of an Advisers Act provision or "for purposes of assessment of potential systemic risk."[1]

Section 209 of the Advisers Act allows the SEC to implement this authority. Under subsection (a), the SEC is authorized to investigate any persons whenever it appears that any provisions of the Advisers Act or rules promulgated under it have been violated.[2] Subsection (b) empowers the SEC to "administer oaths and affirmations, [subpoena] witnesses, compel their attendance, take evidence" and require production of documents which are relevant or material to the inquiry.[3] Subsection (c) even permits the SEC to invoke the aid of the courts should any person not cooperate with the investigative process.[4]

§ 9:58 Proceedings to enforce compliance

The SEC may institute administrative proceedings, civil proceedings and/or criminal proceedings to enforce compliance with the provisions of the Advisers Act.

The U.S. district courts have jurisdiction over violations of the Advisers Act or any rules, regulations or orders promulgated thereunder.[1] These courts also have extraterritorial jurisdiction over proceedings brought by the United States or the SEC alleging a violation of Section 206 if: (1) the alleged violation was by a foreign adviser's conduct within the United States and involving only foreign investors; or (2) the alleged violation was by "conduct occurring outside the United States with foreseeable substantial effect within the United States."[2]

[Section 9:56]

[1]Section 216.

[Section 9:57]

[1]Section 210(c).

[2]Section 209(a).

[3]Section 209(b).

[4]Section 209(c).

[Section 9:58]

[1]Section 214(a).

[2]Section 214(b).

§ 9:59 Administrative proceedings; sanctions under Section 203(e) and (f)

If an investment adviser or any person associated therewith commits any transgression under Section 203(e), the SEC shall give notice to such investment adviser and provide an opportunity for hearing.[1] The SEC shall censure, limit the activities/functions/operations of, suspend or revoke the registration of said investment adviser if (1) it finds that the investment adviser had indeed committed said transgressions and (2) provided it is in the public interest[2] to do so.[3]

The transgressions covered under Section 203(e) are as follows:

"Willful" misstatements or omissions in documents related to registration

Should an investment adviser willfully make any false or misleading statements or any omissions of material fact in documents related to registration, the SEC may sanction the investment adviser.[4] This also includes such findings made by a foreign financial regulatory authority.[5]

Conviction of a felony or misdemeanor involving a securities transaction

The SEC may sanction an investment adviser convicted of certain felonies or misdemeanors within 10 years before the filing of the registration application or anytime thereafter. A conviction by a foreign court of competent jurisdiction would also qualify under this section.[6] This would also include convictions for any crime that is punishable with imprisonment of more than 1 year or a substantially equivalent crime by a foreign court of competent jurisdiction.[7]

Acting in certain capacities

The SEC may sanction an investment adviser if it is enjoined by a (foreign) court of competent jurisdiction from acting in certain capacities as listed in the section.[8]

Willful violations of securities regulations (and aiding and abetting thereof)

The SEC may sanction an investment adviser if it willfully violates any

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[1]See Section 211(c), which details the requirements for notice and opportunity for hearing.

[2]Section 203(i)(3) outlines the factors that the SEC may consider in the determination of public interest. See Paragraph 156 below.

[3]Section 203(e).

[4]Section 203(e)(1).

[5]Section 203(e)(8)(A).

[6]Section 203(e)(2).

[7]Section 203(e)(3).

[8]Section 203(e)(4).

provision of or rules promulgated under the Securities Act, Exchange Act, Investment Company Act, Advisers Act, or the Commodity Exchange Act.[9]

Willfully aiding, abetting, counseling, commanding, inducing or procuring the violation by another person of aforesaid securities regulation may also trigger sanctions. This includes the reasonable failure to supervise a subordinate who commits such a violation, with a view to preventing violations. An adviser will not have failed reasonably in its supervision if: (1) there had been established procedures and a system for application, which would reasonably be expected to prevent and detect such violations; and (2) the adviser had reasonably discharged its duties and obligations by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.[10]

This includes findings by a foreign financial regulatory authority of violations of foreign statutes.[11]

Barred or Suspended from being Associated with an Investment Adviser

The SEC may raise sanctions against an investment adviser if said adviser has been barred or suspended by the SEC from being associated with an investment adviser.[12]

Subject to Final Order of Federal or State Authorities

The SEC may sanction an investment adviser if said adviser is subject to a final order issued by certain federal or state authorities, barring it from associating with a regulated entity or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities. This would also apply if the final order is based on violations of any laws or regulations that prohibit fraudulent, manipulative or deceptive conduct.[13]

For the same transgressions above (except barring or suspending association with an investment adviser under Section 207(e)(7)), the SEC shall also censure, limit the activities of any person associated or seeking to be associated with an investment adviser, or bar such person from being associated with various persons.[14] Like Section 203(e), the SEC must give notice and provide an opportunity for hearing.[15] An investment adviser, or person under an order barring association therewith, may not be or become mutually associated without SEC's consent. However, the investment adviser is only guilty

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[9]Section 203(e)(5).

[10]Section 203(e)(6).

[11]Sections 203(e)(8)(B) and (C).

[12]Section 203(e)(7).

[13]Section 203(e)(8).

[14]Section 203(f).

[15]Section 203(f). See also Section 211(c), which details the requirements for notice and opportunity for hearing.

if said adviser knew, or should have known upon exercising reasonable care, of such order on such person.[16]

Section 203(i)(3) states the factors the SEC uses to determine public interest under Section 203:

a. Whether the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;[17]
b. The resulting harm to others[18] and the extent to which any person was unjustly enriched, taking into account any restitution made;[19]
c. Whether such person previously violated certain securities laws, felonies or misdemeanors;[20]
d. The need to deter persons from committing such acts or omissions;[21]
e. The ability of a respondent to pay the civil penalty (if any);[22] and
f. Other matters as justice may require.[23]

§ 9:60 Cease and desist proceedings

Section 203(k) further implements the preventive aims of the Advisers Act. Under Section 203(k)(1), the SEC may issue cease-and-desist orders if it finds that any person is violating, has violated or is about to violate any Advisers Act provision, provided that notice and opportunity for hearing has been given.[1]

The order may require any person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to the violation, to cease and desist from the violation. Additionally, the order may require compliance with provisions, rules, regulations and upon such terms and conditions the SEC may specify.[2]

If the violation, or risk or continuation thereof, would likely result in significant dissipation or conversion of assets, significant harm to investors, or substantial harm to public interest, Section 203(k)(3) allows SEC to issue a temporary cease-and-desist order. While notice

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[16]Section 203(f).

[17]Section 203(i)(3)(A).

[18]Section 203(i)(3)(B).

[19]Section 203(i)(3)(C).

[20]Section 203(i)(3)(D).

[21]Section 203(i)(3)(E).

[22]Section 203(i)(4).

[23]Section 203(i)(3)(F).

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[1]Section 203(k)(1). See also Section 211(c), which details the requirements for notice and opportunity for hearing.

[2]Section 203(k)(5).

and opportunity for hearing is generally required, the SEC may dispense with this requirement if it determines that notice and hearing would be impracticable or contrary to public interest.[3] The order becomes effective upon service and remains so unless set aside, limited, or suspended pending completion of the proceedings.

However, the temporary orders may only apply to persons acting as, associated with, or seeking to be associated with certain classes of people.[4]

The temporary order may be reviewed in two ways. First, the aggrieved party may apply to the SEC to set aside, limit or suspend the order. If the order was served without a hearing, the respondent may request, within 10 days after the date on which the order was served, the SEC to hold a hearing and render a decision at the earliest possible time.[5] Second, the respondent may apply for judicial review of the order, provided that the SEC has heard the case and issued an order or decision. The application must be made within 10 days after the date the respondent was served with the order (entered with a prior SEC hearing) or after a decision was rendered (for orders entered without a prior SEC hearing).[6] The application for judicial review generally does not operate as a stay of the order.[7] It should be noted that Section 213, which provides for court review of orders, does not apply to temporary orders.[8]

§ 9:61 Penalties under administrative proceedings

For any proceeding instituted under Section 203, Section 203(j) allows the SEC to require accounting and disgorgement, including reasonable interest.

Specifically for proceedings instituted pursuant to Sections 203(e) or (f), Section 203(i)(1)(A) allows the SEC to impose a civil penalty provided notice and opportunity for hearing is given.[1] Two further requirements exist. Firstly, the penalty is in the public interest.

Secondly, the person must have:

a. Willfully violated any provision of or rules promulgated under

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[3]Section 203(k)(3)(A).

[4]Section 203(k)(3)(B).

[5]Section 203(k)(4)(A).

[6]Section 203(k)(4)(B).

[7]Section 203(k)(4)(C).

[8]Section 203(k)(4)(D).

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[1]See also Section 211(c), which details the requirements for notice and opportunity for hearing.

the Securities Act, Exchange Act, Investment Company Act or Advisers Act;[2]

b. Willfully aided, abetted, counseled, commanded, induced or procured such a violation;[3]
c. Failed reasonably to supervise, with a view to preventing such violations, a supervisee who committed such a violation;[4] or
d. Provided false and misleading statements or omissions as to material facts.[5]

Specifically for cease-and-desist proceedings instituted pursuant to Section 203(k), Section 203(i)(1)(B) further allows the SEC to impose civil penalties and accounting or disgorgement orders. Likewise, notice and opportunity for hearing must be given.[6] The person must have violated, or have caused a violation of, any provision, rule or regulation under the Advisers Act.

The maximum monetary penalties in administrative proceedings are prescribed in Section 203(i)(2), based on three different tiers.[7]

Section 203(i)(4) entitles a respondent to present evidence of its ability to pay any penalty. The evidence may relate to the amount of its assets, the collectability of the penalty, other claims upon the same assets and its ability to continue in business. This inquiry may also go towards the public interest consideration (discussed above).

§ 9:62 Civil proceedings

The SEC also has the discretion under Section 209(d) to "bring suit in a federal district court to enjoin violations of the Act or the rules promulgated under it,"[1] whenever it appears that a person has violated or is about to violate the Act.[2] This would also include aiding and abetting the violation of any provision of the Advisers Act and any rules promulgated under it.[3] If the SEC proves a violation, the court shall impose a civil penalty on the transgressor, the amount of which shall be determined by the court in light of all the facts and circumstances, but not exceeding the limits set for the respective viola-

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[2]Section 203(i)(1)(A)(i).

[3]Section 203(i)(1)(A)(ii).

[4]Section 203(i)(1)(A)(iv).

[5]Section 203(i)(1)(A)(iii).

[6]See also Section 211(c), which details the requirements for notice and opportunity for hearing.

[7]Section 203(i)(2).

[Section 9:62]

[1]Transamerica Mortg. Advisors, Inc. (TAMA) v. Lewis, 444 U.S. 11, 14, 100 S. Ct. 242, 62 L. Ed. 2d 146, Fed. Sec. L. Rep. (CCH) P 97163 (1979).

[2]Section 209(d).

[3]Section 209(f).

tions in subsection 209(e)(2).[4] Such penalties imposed shall be payable by the person who committed such violation and paid into the Treasury of the United States, unless otherwise provided.[5]

§ 9:63 Criminal proceedings

Under Section 217, the SEC may seek a criminal conviction against any investment adviser who willfully violates the act or any rule, regulation or order promulgated thereunder.[1]

§ 9:64 Powers of exemption

Alongside the wide array of disciplinary tools wielded by the SEC, the SEC also has discretion under Section 206A to conditionally or unconditionally exempt any classes of persons or transactions from any provisions under the Advisers Act, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the Advisers Act. Under this section, the SEC deemed an investment adviser's proposal for a performance-based fee arrangement not to be in the public interest as it failed to provide sufficient alternative investor protections to compensate for the subjective and objective tests of client sophistication.[1]

§ 9:65 Hearings, standard of proof, limitation periods, orders and review

Hearings may be public and held before the SEC, and any members or officers thereof. Appropriate records of the hearing shall be kept as well.[1]

In *Steadman* v. *Securities and Exchange Commission,*[2] the Supreme Court (a 7-2 majority) held that the SEC correctly applied the preponderance-of-the-evidence standard of proof (instead of the clear-and-convincing standard). Its decision was premised on the traditional deference Courts grant to Congress' prescriptions, absent countervail-

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[4]Section 209(e).

[5]Sections 209(e)(1) and 209(e)(3)(A).

[Section 9:63]

[1]Section 217. See also Nickson, The Regulation of Investment Advice: Subscription Advisers and Fiduciary Duties, 63 No. 7 Mich. L. Rev. 1220, 1224 (May 1965).

[Section 9:64]

[1]In re John Harvey Early, 1994 SEC Lexis 1835.

[Section 9:65]

[1]Section 212.

[2]Steadman v. S. E. C., 450 U.S. 91, 101 S. Ct. 999, 67 L. Ed. 2d 69, Fed. Sec. L. Rep. (CCH) P 97878 (1981).

ing constitutional constraints. In SEC proceedings, Section 7(c) of the Administrative Procedure Act ("APA") applied. It provided that a sanction may only be imposed "in accordance with . . . substantial evidence," which denoted a quantitative measure. This conclusion was buttressed by the SEC's longstanding practice of sanctioning based on the preponderance-of-the-evidence standard.

Powell J. dissented,[3] on the ground that the relevant Advisers Act sanctions were the functional equivalent of penalties for fraud, which in common law required clear and convincing evidence. Further, the APA only became law seven years after the Advisers Act was enacted, and no proof was adduced showing Congress' intent to supplant the applicable standard of proof.

The SEC may only issue orders after appropriate notice and opportunity for hearing. Notice shall be given by personal service upon each party or by registered mail or certified mail or confirmed telegraphic notice to the party's last known business address. Notice to any interested parties may be given in the same manner or by publication in the Federal Register.[4]

Securities and Exchange Commission v. *Jones* held that the SEC is subject to a five-year limitation period to bring its claims, based on 28 U.S.C.A. § 2462.[5] Any person aggrieved by an order issued by the SEC may seek judicial review in the Court of Appeals by filing a written petition within 60 days after the entry of such order.[6]

VI. INTERACTION WITH STATE REGULATION

§ 9:66 Generally; Blue Sky aspects

While the Advisers Act regulates and enforces investment adviser conduct on a federal level, the Advisers Act does not affect the jurisdiction of a State securities commissioner (or equivalent) over any security or person as long as it does not conflict with the Advisers Act, or the rules and regulations thereunder.[1]

However, as long as an investment adviser is registered or licensed in the State in which it maintains its principal office and place of business, and it complies with the State's book-keeping and net capital/bonding requirements, the Advisers Act prevents other states

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[3]Stewart, J., joining.

[4]Section 211(c).

[5]S.E.C. v. Jones, 476 F. Supp. 2d 374, Fed. Sec. L. Rep. (CCH) P 94,161 (S.D. N.Y. 2007).

[6]Section 213.

[Section 9:66]

[1]Section 222(a).