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Articles

Institutionalization, Investment Adviser Regulation, and the Hedge Fund Problem

ANITA K. KRUG*

This Article contends that more effective regulation of investment advisers could be achieved by recognizing that the growth of hedge funds, private equity funds, and other private funds in recent decades is a manifestation of institutionalization in the investment advisory context. That is, investment advisers today commonly advise these "institutions," which have supplanted other, smaller investors as advisory clients. However, the federal securities statute governing investment advisers, the Investment Advisers Act of 1940, does not address the role of private funds as institutions that now intermediate those smaller investors' relationships to investment advisers. Consistent with that failure, investment adviser regulation regards a private fund, rather than the fund's investors, as both the "client" of the fund's adviser and the "thing" to which the adviser owes its obligations. The regulatory stance that the fund is the client, which recent financial regulatory reform did not change, renders the Advisers Act incoherent in its application to investment advisers managing private funds and, more importantly, thwarts the objective behind the Advisers Act: investor protection. This Article contends that policymakers' focus should be trained primarily on the intermediated investors—those who place their capital in private funds—rather than on the funds themselves and proposes a new approach to investment adviser regulation. In particular, investment advisers to private funds should owe their regulatory obligations not only to the funds they manage but also to the investors in those funds.

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Introduction

A prominent topic in securities law scholarship during the past few decades has been the fact and implications of the "institutionalization" of the U.S. securities markets and the related phenomenon of "intermediation." Individual and smaller investors have ceased to be the primary investors in these markets, having been replaced by institutions, some of which—mutual funds, for example—serve as intermediaries through which retail and other, smaller investors now primarily pursue their investing activities.[1] There are numerous reasons for the trend, though perhaps one of the more pronounced is that most investors simply cannot compete effectively with their institutional counterparts,

1. *See infra* notes 20–26 and accompanying text.

given the latter's resource advantages, such as in evaluating investments and engaging third party advisers.[2]

Causal claims aside, it can at least be said that the growth of institutional investors and the movement of capital into them evinces a robust symbiotic relationship. However, the effects have so far been only partially explored. In particular, the growing body of literature on institutionalization has sought to evaluate its implications for the capital markets—such as whether institutional investors in public companies may encourage greater shareholder activism and the extent to which institutional access to private securities markets may render public markets obsolete—and for investor protection.[3] Although the literature to date has produced some lively and important scholarly debate, as yet it has centered generally on institutionalization as it pertains to corporate issuers and the associated implications for the application and efficacy of federal securities laws, particularly the Securities Act of 1933[4] and the Securities Exchange Act of 1934,[5] vis-à-vis regulation of corporate issuers.[6] Scholarly work has not encompassed the existence or effects of institutionalization as manifested in the financial services industry—that is, in the services provided by investment advisers or other financial services professionals.

Investment advisory services have become institutionalized not so much in terms of the services themselves but in terms of the clients to whom those services are provided. It used to be the case, prior to the institutionalization phenomenon of the past several decades, that investment advisers provided personalized investment advice or counseling to individuals and their alter ego entities (IRAs, trusts, and so forth).[7] They also advised what this Article refers to as "monolithic entities"—entities embodying a unity of beneficial and legal ownership, in the sense that they were not themselves vessels created for the purpose of providing investment access to others.[8] Over time, investment advisers increasingly have come to provide their advisory services to institutions of a certain stripe.[9] These institutions are *intermediating*

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2. *See* Brian G. Cartwright, *Whither the SEC Now?*, 95 VA. L. REV. 1085, 1099 (2009) ("Sophisticated institutional investors have highly professional staffs and substantial resources. They can hire outside firms and advisers. They have access to extensive information technology resources . . . . It is no wonder retail investors choose to invest through institutional intermediaries rather than try to compete.").

3. *See infra* Parts I.A–I.B and accompanying text.

4. Ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2010)).

5. Ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78oo (2010)).

6. *See infra* Parts I.A–I.B and accompanying text.

7. *See infra* notes 81–83 and accompanying text.

8. *See* SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 76-477, at 1, 8–9 (1939) (setting forth a chart showing that investment advisory clients in the late 1930s included banks, insurance companies, and nonprofit organizations).

9. *See infra* notes 23–26 and accompanying text.

institutions.[10] They are pools of capital, including not only mutual funds and other funds regulated by the Securities and Exchange Commission (SEC) as investment companies under the Investment Company Act of 1940[11] but also—and more significant for this Article's purposes—funds that are "private," labeled as such because they are not so regulated.[12] Hedge funds and private equity funds are in the latter category.[13]

However, the federal securities statute that governs investment advisers, the Investment Advisers Act of 1940 (the "Advisers Act"),[14] does not, in many important respects, even contemplate that some investment advisers may advise intermediating institutions such as private funds. That disconnect is more than a little problematic. Under the Advisers Act, "clients" are deemed to have autonomy and an independent voice; they are seen as parties to an arms-length contract with the adviser they have engaged, meaning that they may meaningfully provide or withhold consent to any self-interested transactions the adviser might propose, without *themselves* being conflicted or under the adviser's influence and control.[15] An advisory client that is an individual

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10. In light of the primary role of intermediating institutions in the institutionalization phenomenon, the term "institutions" as used throughout this Article is intended to mean *intermediating* institutions, except to the extent otherwise required by the relevant context.

11. 15 U.S.C. §§ 80a-1–80a-64 (2010). In addition, the securities of SEC-registered investment companies, like those of any public company, must be registered under the Securities Act of 1933. *See id.* § 77e (2010). Accordingly, anyone can invest in them regardless of their level of financial sophistication or net worth, unlike private funds. *See infra* note 12.

12. Private funds are able to rely on one of the exclusions from the Investment Company Act's definition of "investment company" set out in section 3 of the Act. *See id.* § 80a-3(c). Private funds such as hedge funds and private equity funds, for their part, rely on the exclusions set forth in section 3(c)(1) or 3(c)(7) of the Investment Company Act. *See id.* § 80a-3(c)(1), (c)(7). Among other things, those sections, in combination with private-placement requirements under the Securities Act, require that these funds' investors meet certain net-worth thresholds or other financial-sophistication criteria. In particular, section 3(c)(1) effectively requires that investors be "accredited," as defined in Regulation D of the Securities Act, and section 3(c)(7) requires that investors be "qualified purchasers," which, for a natural person, is a requirement that the person own at least one million dollars in net assets. *See* 17 C.F.R. § 230.501(a)(5) (2011).

13. Different types of private funds came to acquire different labels—"hedge fund," "private equity fund," and "venture capital fund," for example—only through common parlance, as a result of the different types of activities the funds pursued and the resulting differences in the capital contribution and withdrawal rights provided to their investors. The "hedge fund" label was attached to a type of fund for which the investment strategy revolved around relatively short-term and relatively liquid investments and whose business terms, as a result, permitted investors to contribute capital over the fund's life and to withdraw capital at periodic intervals. Although the earliest hedge funds may have contemplated both long and short positions and therefore pursued true "hedge"-based strategies, that criterion is no longer important. For its part, "private equity fund" was the label given to a fund whose investment strategy was to acquire large positions in private companies—rendering the fund's investments both long-term and relatively illiquid—and whose business terms, as a result, required investors to invest, if at all, at the beginning of the fund's term and permitted the return of investors' capital only as the fund's investments were "realized" several years hence.

14. 15 U.S.C. §§ 80b-1–80b-21 (2010).

15. *See infra* note 86.

or a monolithic entity fits the Advisers Act's prototype, having his or her or its own voice and viewpoint, distinct from the adviser's.

Failing to recognize institutionalization in the investment advisory context, the SEC and most state securities regulators have come to regard private funds, being the direct recipients and beneficiaries of investment advice provided by their investment advisers, as merely another type of advisory client, alongside clients that are individuals, individuals' personal trusts or retirement accounts, or monolithic entities.[16] In so doing, they generally have extinguished the independent voice of the "client." That is because, very often, a fund's investment adviser is the person who created, controls, and speaks for the fund.[17] In other words, the obligations the adviser owes to its "client" are effectively obligations that the adviser *owes to itself*. Beyond its effects on the Advisers Act's coherence, that anomaly, which renders virtually meaningless many obligations of investment advisers under the Advisers Act,[18] has important (adverse) implications for investor protection, the long-standing goal of U.S. securities regulation.

Once investment advisory services are seen as yet another locus of institutionalization—in the specific form of hedge funds and other private funds—and once investment adviser regulation is evaluated through the lens of institutionalization, a better approach to investment adviser regulation reveals itself. In particular, this Article argues that more effective regulation of investment advisers could be achieved by recognizing that the growth of private funds in recent decades is a manifestation of institutionalization and intermediation in the investment advisory context. That recognition renders apparent that regulation should focus on the ultimate, if indirect, recipients of the investment advice provided by a private fund's investment adviser: fund *investors*. More specifically, investment advisers to hedge funds and other private funds should owe most of their obligations (such as disclosure and consent obligations) to fund investors, while continuing to owe certain obligations (such as those relating to participation in the securities markets) to the fund.

In making the case for reformed investment adviser regulation, this Article brings together two strands of the literature: (1) the trends toward institutionalization and intermediation as scholars have observed and dissected them in other securities law contexts, and (2) the regulatory issues created by the growth of hedge funds and other private funds in the last thirty years or so. In doing so, the Article elucidates not only the far reach of the institutionalization trend and dispels confusion

16. *See infra* notes 123–26 and accompanying text.
17. *See infra* notes 127–30 and accompanying text.
18. *See infra* notes 127–30 and accompanying text.

about "hedge fund regulation," but also illustrates how the renewed regulatory focus on fund investors that it proposes is consistent with and supported by the history and the objectives of the Advisers Act.

Part I of this Article discusses what is meant by "institutionalization" and "intermediation," surveying the literature to date that raises observations and concerns about the phenomena but fails to see the broader context in which they have arisen. Turning to the other side of the equation, Part II explores how Congress and the SEC regulate private funds not through the adoption and refinement of a coherent body of doctrine but rather through piecemeal add-ons to the Advisers Act, which, until its recent amendment through the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"),[19] had not recognized the existence of hedge funds or other private funds. Part III discusses how that result came to be, exploring the characteristics and evolution of U.S. regulation of investment advisers and, in light of the institutionalization of the investment advisory industry, the ultimate failure of that regulation. Part IV demonstrates how institutionalization analysis, when applied to the investment adviser context, reveals a new approach for thinking about investment adviser regulation in the private-fund context, one that is better equipped to achieve the goals of that regulation: protection of those who entrust their assets with investment advisers, whether directly or indirectly. In particular, it proposes that, for some regulatory purposes, investors in private funds should be deemed advisory clients of the investment advisers managing the funds. Finally, Part V addresses possible objections to the approach this Article proposes, including that existing regulation sufficiently protects private-fund investors and that the proposed approach is inconsistent with the long-standing notion that investment advisory services are necessarily tailored to each client's particular needs and circumstances.

I. Institutionalization and Intermediation

Securities law scholars have devoted significant attention to the phenomenon of institutionalization of U.S. and global securities markets.[20] The gist of institutionalization, as typically understood, is that, over the last quarter century or so, the securities markets have become increasingly dominated by a certain stripe of institutional investor: mutual funds, pension funds, bank collective trusts, and other sorts of

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19. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

20. *See, e.g.*, Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 Va. L. Rev. 1025 (2009); Steven M. Davidoff, *Paradigm Shift: Federal Securities Regulation in the New Millennium*, 2 Brook. J. Corp. Fin. & Com. L. 339, 347–53 (2008) (discussing intermediation and deretailization). *See generally* Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. Pa. L. Rev. 1961 (2010); Usha Rodrigues, *Corporate Governance in an Age of Separation of Ownership from Ownership*, 95 Minn. L. Rev. 1822 (2011).

investment entities that pool the assets of numerous other, smaller investors.[21] Through that process, institutions have effectively supplanted retail and other smaller investors.[22]

Given the trend toward institutionalization, one might readily discern another phenomenon arising from institutionalization that has likewise received scholarly attention: intermediation. Whereas individual and household investors and monolithic entities—"unitary investors," for the sake of expediency—previously pursued their securities investing activities by investing directly in issuer companies, they now increasingly invest indirectly, through institutional pools of capital.[23] Scholarship focusing on institutionalization and intermediation has largely centered on their implications for the SEC's regulatory regime, which (so the argument goes) was designed to protect investments in corporate issuers by individuals and households rather than by large institutions.[24] One strand of the scholarship has centered on the capital and securities markets, evaluating the implications of institutionalization for regulatory oversight of corporate issuers.[25] A second strand has honed in on what institutionalization means for the traditional regulatory objective of protecting retail investors in connection with their investments in corporate issuers.[26]

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21. *See* Langevoort, *supra* note 20, at 1026 ("The last thirty years or so have brought a rapid shift toward institutionalization in the financial markets in the United States—in other words, a shift toward investment by mutual funds, pension funds, insurance companies, bank trust departments, and the like.").

22. *See* Davidoff, *supra* note 20, at 350–51 ("Public securities are now increasingly held through intermediaries and other private funds . . . rather than by retail investors."); Fisch, *supra* note 20, at 1962–63 ("The ownership of public equity has shifted substantially from retail to institutional investors since Congress enacted the federal securities laws in the 1930s."); Rodrigues, *supra* note 20, at 1828 ("Individual long-term capital holders no longer hold shares of corporations directly; the direct holders of shares predominantly are institutional investors.").

23. *See* Fisch, *supra* note 20, at 1963–64 ("Many institutional investors are intermediaries in that they invest a pool of capital contributed by other investors, most frequently retail investors. . . . A growing percentage of ordinary citizens are invested in the capital markets through intermediaries . . . ."). The trend is evidenced in the significant growth of the mutual fund industry over the past several decades. *See* Investment Company Institute, *Trends in Ownership of Mutual Funds in the United States*, RESEARCH FUNDAMENTALS, Nov. 2007, at 1, 2 ("The mutual fund is the dominant form of intermediated investment. At the end of 2008, even after much of the market collapse, equity mutual funds held over $3.7 trillion in assets, ninety-two percent of which were contributed by the household sector." (footnote omitted)).

24. *See, e.g.*, Alison Grey Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 HASTINGS L.J. 311, 315–16 (1974) (observing that Congress's primary concern in enacting the Securities Act and the Exchange Act was "to provide protection for small investors").

25. *See, e.g.*, Davidoff, *supra* note 20, at 352 ("[I]f sophisticated intermediaries now undertake the bulk of investing, the protections of [the Securities Act and the Exchange Act] become procedural, and the opportunities for deregulation increase.").

26. *See, e.g.*, Langevoort, *supra* note 20, at 1025 ("[T]hroughout the SEC's history and culture, the rhetorical stress has been on the plight of average investors, ones who lack investing experience and sophistication so as to need the protection of the securities laws.").

A. The Capital Markets

Focusing on the investing prowess of institutional investors, some scholars have questioned whether the SEC can be—or, indeed, needs to be—an effective regulator in an increasingly institutional capital marketplace. As an initial matter, they note that, unlike retail investors, institutional investors, which generally are presumed to be "sophisticated," may have the means and regulatory freedom to supply capital to issuers that are inclined to eschew public registration and offering processes and ongoing reporting obligations.[27] This state of affairs, according to these observers, encourages the growth of private securities markets largely beyond the bounds of regulatory oversight.[28] Beyond that, institutional investors also have implications for the public securities markets, in that their growing dominance in those markets may render extensive regulation of them superfluous, not to mention needlessly burdensome.[29] That result, the argument proceeds, could be a catalyst for deregulation, which, as some have suggested, could take the form of simplified disclosure requirements or registration procedures, or, indeed, the growth of "antifraud-only" markets, characterized by the absence of disclosure and other regulatory requirements.[30]

Those and other relatively descriptive analyses of the institutionalization phenomenon have been met with more normative evaluations of it. Viewing the trend relatively optimistically, several scholars point to institutionalization as a force for greater shareholder participation in corporate governance, a product of institutional investors' having replaced shareholders that were too small and dispersed to seek or achieve any meaningful say in corporate policies and decisionmaking.[31] From that perspective, by requiring corporate

27. *See, e.g.*, Davidoff, *supra* note 20, at 352 ("Intermediaries . . . provide a strong alternative supply of private capital to issuers who wish to avoid the costs associated with registration, the scrutiny of the public offering process generally, and on-going public reporting obligations."); Langevoort, *supra* note 20, at 1057 (posing the question of whether, if institutional investment may be "equated" with sophistication, "it might make sense to encourage a stark distinction between public and private capital markets, letting the latter grow without substantial regulation based on the belief that, in contrast to the public markets, sophisticated participants can 'fend for themselves'").

28. *See* Davidoff, *supra* note 20, at 352.

29. *See id.* ("[I]f investors in public offerings and public securities are largely sophisticated intermediaries . . . . compliance with the federal securities laws becomes, to some extent, an unnecessary transaction cost.").

30. *See* Langevoort, *supra* note 20, at 1056; *see also* Davidoff, *supra* note 20, at 352 ("[I]f sophisticated intermediaries now undertake the bulk of investing, the protections of [the Securities Act and the Exchange Act] become procedural, and the opportunities for deregulation increase.").

31. *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. Rev. 811, 815 (1992) ("[C]orporate managers need to be watched by someone, and the institutions are the only watchers available."); s*ee also* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 Colum. L. Rev. 1277, 1336–37 (1991); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 Geo. L.J. 445, 449 (1991).

management to be more responsive to shareholders, institutional investors ultimately benefit those smaller investors who now hold interests in the institutions that replaced them.[32] Others sound rather more dire notes, asserting that institutional investors' power, particularly combined with their extensive activity in relatively less regulated securities markets, means that they are poised to "exploit weaknesses anywhere in the financial markets"—and have the motive to do so.[33]

Still others, however, question institutional investors' presumed sophistication. Among other things, these scholars note that institutional investors may, themselves, be prone to falling prey to certain types of fraudulent activity or making ill-conceived investment decisions, highlighting the inadequacy of the SEC's investor protection mandate in the institutional world. Jill Fisch, for example, argues that, given recent revelations of fraud, such as the Madoff Ponzi scheme, and losses arising from investments in collateralized debt obligations ("CDOs"), "even sophisticated institutional investors require greater regulatory protection."[34] If that is the case, Brian Cartwright notes, additional regulatory challenges present themselves.[35] For one thing, because the SEC's core competence is protection of retail investors, a regulatory regime aimed at protecting institutional investors would have to look very different from the one that presently exists.[36] Moreover, making the necessary changes to that regime would be difficult because, historically, protecting retail investors has been more politically palatable than protecting institutional investors.[37]

B. Retail Investors

Some scholars have also, or instead, evaluated institutionalization from the perspective of retail investors and how or whether they continue to be protected in the age of institutionalization, in which their relationships with issuer corporations are intermediated. The basis for that project is evident from the simple fact that retail investors are an integral component of the institutionalization phenomenon. In Cartwright's words, "[r]etail investors have not vanished," but rather

32. *See* Black, *supra* note 31, at 871 ("Small shareholders are already frozen out of corporate governance decisions. . . . The real question is whether small shareholders will gain or lose if large institutions are more active. As long as the institutions can't easily obtain private benefits from influence, their oversight should benefit all shareholders, large and small.").

33. Langevoort, *supra* note 20, at 1057.

34. Jill E. Fisch, *Top Cop or Regulatory Flop? The SEC at* 75, 95 Va. L. Rev. 785, 817 (2009). Specifically, Fisch notes that large investors failed to assess and to manage the risks arising from CDOs and were among the investors in Madoff's Ponzi scheme. *See id.*

35. *See* Cartwright, *supra* note 2, at 1099, 1103.

36. *Id.* at 1103.

37. *See id.* at 1092 ("[Institutionalization] threatens eventually to undermine the SEC's base of rhetorical and political support.").

"have simply shifted to investing primarily through financial intermediaries such as mutual funds."[38] Or, as Donald Langevoort puts it, institutionalization "does not mean that retail investors make fewer or less important investment decisions, simply different ones."[39] In this segment of the institutionalization literature as well, themes of regulatory insufficiency and inefficacy are pronounced.

As an initial matter, according to some observers, because institutional investors may be subject to fewer regulatory restrictions on their investment decisions, their beneficial owners—that is, the retail investors for whom they serve as intermediaries—are deprived of a clear understanding of the assets that the institutions hold and the basis for their investment decisions.[40] Other commentary has pointed out that beneficial owners have a difficult time on that front even where the intermediating institutions (such as mutual funds and other funds regulated under the Investment Company Act) are subject to fairly stringent regulatory requirements, including disclosure obligations.[41] Specifically, although mutual funds and other regulated investment companies' disclosure obligations are similar to those to which operating companies are subject, those obligations are inadequate given that "[p]urchasing a mutual fund . . . is not the same as investing in an operating company."[42]

On top of that, institutional investors, such as mutual funds and other intermediating institutions, actually are not necessarily all that good at making investment decisions.[43] For one thing, because institutions—at least those acting as intermediaries—by definition work

38. *Id.*

39. Langevoort, *supra* note 20, at 1030.

40. *See, e.g.*, Fisch, *supra* note 34, at 819–20.

41. *See* 15 U.S.C. § 80a-29 (2010) (setting forth requirements for periodic disclosures by mutual funds and other registered investment companies); Fisch, *supra* note 20, at 2017–18 (critiquing the Investment Company Act's regulatory structure in part on the basis that it allows funds to "obscure" information that investors need to evaluate mutual fund investments).

42. Fisch, *supra* note 20, at 2016. Fisch argues:

> In moving toward product regulation, regulators should reject the analogy to common stock. Investors are not attempting to determine the going concern value of productive assets when they evaluate mutual funds or [exchange-traded funds]. Returns from a mutual fund will not, for the average mutual fund shareholder, be based on managerial talent . . . .

Id. at 2029. Langevoort has also raised concerns about intermediaries that are mutual funds, observing:

> With the recent trend toward greater institutionalization, some important regulatory questions are self evident. Does the SEC (and/or other regulators who have responsibility in financial services) do a good enough job of protecting retail investors who invest through an institutional intermediary (that is, does mutual fund regulation need reform)?

Langevoort, *supra* note 20, at 1055.

43. *See* Langevoort, *supra* note 20, at 1046 ("[T]he evidence suggests that managed portfolios offered to retail investors, on average, under-perform indexed portfolios with the same risk characteristics when costs and fees are taken into account.").

with assets that ultimately belong to someone else (again, the intermediated retail investors), "they may lack adequate incentives to take appropriate levels of risk, to investigate thoroughly, or to disclose conflicts of interest."[44] In other words, they make poor decisions out of nonchalance and complacency. For some institutions, as others note, poor investment decisions are a product of pure bad judgment and analysis (apart from that produced by the absence of adequate incentives) or a result of a drive to achieve competitive investment results even in the face of "palpable" risk.[45] The upshot of the literature, then, is that the more relaxed regulatory environment and attenuation between investment and beneficial owner in the institutional context has eroded investor protection, insofar as the investor at issue is the smaller, retail investor.

It is in the discussions about investor protection that the literature on institutionalization and intermediation suggests an intersection with the regulation of investment advisers. The regulation of investment advisers is founded on investor protection objectives,[46] and perhaps the most fundamental trend in the investment advisory industry over the past eighty years falls squarely in the institutionalization phenomenon. That trend is the widespread displacement of individual or other smaller investment advisory clients by institutional clients—specifically, by hedge funds, private equity funds, and other (generally privately offered) pooled investment entities that investment advisers create and manage and market to people who, in an earlier era, would themselves have been direct advisory clients.[47] In addition, it should be no surprise that an associated phenomenon has emerged, in which those displaced advisory clients now obtain advice about investing indirectly, by placing assets with advisers through the very institutions that have become the new advisory clients.[48]

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44. Fisch, *supra* note 34, at 819; *see also* Robert C. Illig, *The Promise of Hedge Fund Governance: How Incentive Compensation Can Enhance Institutional Investor Monitoring*, 60 ALA. L. REV. 41, 57 (2008) ("[Institutional investors are not] properly incentivized to play the role of loyal servant to shareholder interests.").

45. Donald C. Langevoort, *Brokers as Fiduciaries*, 71 U. PITT. L. REV. 439, 450–51 (2010) (evaluating why, prior to the financial crisis, institutional investors were "such willing buyers" of securitized debt and postulating (among other things) that "market participants took no evasive action because of a felt need to compete and not leave any money lying on the table").

46. *See* James C. Sargent, Comm'r, SEC, The SEC and the Investment Counselor, Address Before the Investment Counsel Association of America, Inc. 2 (May 19, 1960), *available at* http://www.sec.gov/news/speech/1960/051960sargent.pdf ("The basic purpose of the Investment Advisers Act was to protect the public and investors against malpractices on the part of persons engaged for compensation in the business of advising others with respect to securities.").

47. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45,172, 45,174–75 & n.36 (proposed July 28, 2004) (to be codified at 17 C.F.R. pts. 275 & 279) [hereinafter 2004 Proposed Rule] ("[From 1993 to 2003] the rate of growth of hedge funds [was] substantially greater than that of other sectors . . . . [and] assets of insurance companies and commercial banks doubled; and deposits of commercial banks barely doubled.").

48. *See infra* notes 107–14 and accompanying text.

II. The Problem of Hedge Fund Regulation

As most anyone who has read the news in recent years is aware, private funds—particularly hedge funds—often have been regarded by regulators, not to mention the public, as problems that need to be solved.[49] This sentiment reached new heights in the aftermath of the financial crisis that took hold in 2008, when policymakers, commentators, and scholars set about to formulate and evaluate laws and regulations intended to prevent a similar turn of calamitous events in the future.[50] Through mid-2010, when the House of Representatives and the Senate agreed in conference committee on the content of new legislation,[51] financial regulatory reform was a central policy issue[52] and hedge fund regulation was prominent in reform discussions.[53] The final legislation,

49. *See* Editorial, *Closing in on Hedge Funds*, N.Y. Times, Oct. 20, 2006, at A22 ("[H]edge funds that are active in both equity and debt markets face huge temptations to trade on insider information. . . . [Administration officials should] respond to the obvious problems posed by hedge funds—before those problems become crises."); Editorial, *Regulating Hedge Funds*, N.Y. Times, Sept. 24, 2006, at C11 (noting, after the collapse of the Amaranth group of hedge funds, that regulators must act now to create enforceable rules and proposals for Congress regarding hedge fund oversight); *see also* Dane Hamilton & Svea Herbst-Bayliss, *Connecticut Official Blasts Hedge Fund Proposal*, Reuters, Apr. 15, 2008, *available at* http://uk.reuters.com/article/companyNewsMolt/idUKN1547928220080415; Editorial, *Hedging on Hedge Funds*, N.Y. Times, Nov. 30, 2006, at A28 ("[Hedge funds] remain largely beyond the reach of federal overseers . . . . It's time to move the discussion beyond whether hedge funds require more regulation to how they should be regulated."); Rachelle Younglai, *Critics Call for Better Policing of Hedge Funds; Need "Real Teeth*,*"* Nat'l Post, Apr. 16, 2008, at 5 ("We need regulations with real teeth that require registration, increased disclosure and strict standards for risk management." (quoting Rich Ferlauto, director of pension and benefit policy for the American Federation of State, County, and Municipal Employees)).

50. *See, e.g.*, Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 Geo. Wash. L. Rev. 39, 112–13 (2009) (urging caution in "[t]he increasing focus on bold reform to concentrate regulatory authority," given that there may be "some enduring merits of the traditional U.S. fragmented approach" and that "[a]dditional concentration . . . may . . . prove unsustainable"); Kenneth W. Dam, *The Subprime Crisis and Financial Regulation: International and Comparative Perspectives*, 10 Chi. J. Int'l L. 581, 582 (2010) ("[A]n analysis of the subprime crisis and proposed solutions is incomplete if international and comparative perspectives are not brought to bear."); Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U. L. Rev. 1, 2 (2010) ("Regulators must focus on the principal problems that financial regulation is intended to address—relating to financial stability and risk-taking—without regard to fixed categories, intermediaries, business models, or functions.").

51. *See, e.g.*, David S. Huntington, *Summary of Dodd-Frank Financial Regulation Legislation*, Harv. L. Sch. F. Corp. Governance & Fin. Regulation (July 7, 2010, 9:15 am), http://blogs.law.harvard.edu/corpgov/2010/07/07/summary-of-dodd-frank-financial-regulation-legislation ("On June 25, 2010, a House-Senate conference committee reached final agreement on the [Dodd-Frank Act] . . . .").

52. *See, e.g.*, *State Street Spends $380,000 to Lobby Government*, Bus. Insider (June 28, 2010), http://www.businessinsider.com/state-street-spends-380000-lobbying-in-1q-2010-6 ("Regulatory reform has been hotly debated for more than a year following the recession and credit crisis.").

53. *See, e.g.*, Joel Seligman, *The SEC in a Time of Discontinuity*, 95 Va. L. Rev. 667, 682 (2009) ("[Financial regulatory reform should address] obvious areas of omission like credit default swaps and hedge funds."); Rob Silverblatt, *Kanjorski Discusses Hedge Fund Regulation*, U.S. News & World Rep., Fund Observer Blog (Oct. 15, 2009), http://money.usnews.com/money/blogs/Fund-Observer/2009/10/15/kanjorski-discusses-hedge-fund-regulation (noting, in an interview with Rep. Paul Kanjorski, that

the Dodd-Frank Act, brought the widely predicted result that hedge funds and other private funds will henceforth be subject to additional regulation.[54]

This most recent round of hedge fund regulation had its origins in the worst days of the financial crisis, when mitigating systemic risk[55] became a primary objective of financial regulatory-reform efforts, including securities regulatory reform. Two concerns, in particular, underlay that objective. First, as the events of the financial crisis highlighted, financial institutions are connected with one another in ways that can magnify the effects of any single institution acting alone.[56] In the worst of outcomes, one firm's failure can trigger the failure of other firms that had entered into transactions with the failed firm, which in turn can trigger failures with still other counterparties down the line.[57] Second, these intertwined financial institutions' activities had become too *complex* in the years leading to 2008.[58] Investment banks, in particular, had taken to creating and marketing increasingly complicated securities and derivative instruments in which institutional investors had taken to investing.[59] The combination of these two factors meant not only that investors were at risk of losses arising from unknown risks and untoward sales pitches but also that the financial system as a whole was at risk of financial contagion. That contagion would assume the form of system-wide failures stemming from the activities of one or two institutions but spreading far beyond, in the process destroying value and growth throughout the economy.[60]

"hedge funds have emerged as a key puzzle piece" in financial regulatory reform efforts).

54. *See, e.g.*, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (2010).

55. "Systemic risk is the potential that a single event, such as a financial institution's loss or failure, may trigger broad dislocation or a series of defaults that affect the financial system so significantly that the real economy is adversely affected." Robert K. Steel, Under Sec'y Domestic Fin., Remarks on Private Pools of Capital (Feb. 27, 2007), *available at* http://www.treasury.gov/press-center/press-releases/Pages/hp280.aspx.

56. *See* MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE 259–63 (2010).

57. By most accounts, the concern about the possible failure of large financial firms stemmed from the fact that "some gargantuan, unknown dollar amount of credit default swaps had been bought and sold on every one of them." *Id.* at 263. Accordingly, a firm's failure would "trigger the payoff of a massive bet of unknown dimensions." *Id.*

58. *See, e.g.* Editorial, *The Crisis Agenda*, N.Y. TIMES, Oct. 7, 2008, at A30 (arguing that, in a debate between then-presidential candidates John McCain and Barack Obama, "the candidates need to say what rules they would support to rein in derivatives, like . . . the complex and unregulated financial bets that led to the bailouts of Bear Stearns and American International Group").

59. *See* CHARLES R. MORRIS, THE TRILLION DOLLAR MELTDOWN: EASY MONEY, HIGH ROLLERS, AND THE GREAT CREDIT CRASH 73–85 (2008) (detailing the development and spread of complex CDOs).

60. In the 2008 crisis, the dots were not difficult to connect: Structured credit instruments created and marketed by investment banks permitted mortgage lenders to transfer the risks of subprime mortgage loans, leading to a bubble in the housing market that, upon bursting, endangered the liquidity of Wall Street financial firms and sapped the wealth of Main Street businesses and consumers. *See id.* at 84.

Beyond the concerns that financial firms were bound together in a web of complexity, policymakers and commentators perceived still another threat on the systemic risk front. That threat arose from the concern that there exists a "shadow" banking system consisting of unregulated institutions engaging in the same sorts of financial activities pursued by regulated financial institutions.[61] Those activities, precisely because they are beyond regulators' purview, could, the argument went, fuel systemic disruptions in ways that regulators would be poorly equipped to address.[62] Included in an oft-cited litany of shadowy bankers were unregulated affiliates of regulated brokerage firms and insurance companies, at least to the extent they were engaging in proprietary trading and other speculative investment activities, and hedge funds.[63] If financial regulatory reform had to address systemic risk, doing so would entail addressing all institutions, including hedge funds, whose activities were perceived as having systemic implications.[64]

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61. *See* Mike Konczal, *Shadow Banking: What It Is, How It Broke, and How to Fix It*, ATLANTIC (July 13, 2009, 1:08 PM), http://www.theatlantic.com/business/archive/2009/07/shadow-banking-what-it-is-how-it-broke-and-how-to-fix-it/21038/ (describing the origins of, and problems associated with, the shadow banking system);

62. *See* Sewell Chan, *Paulson and Geithner Back Calls for Tighter Regulation*, N.Y. TIMES, May 7, 2010, at B5 (quoting Treasury Secretary Timothy F. Geithner's statements that the 2008–2009 financial crisis would have been "less severe" if the United States had had "better-designed constraints in risk taking" and that the United States "didn't have the tools to prevent the fire from jumping the firebreak and infecting the system").

63. *See id.* ("[The] shadow banking system [is] the network of investment banks, insurance companies, mortgage finance entities and hedge funds that largely went unchecked by a regulatory system that was structured around commercial banks."). Among other things, hedge funds are significant participants in the markets for credit default swaps and other types of derivative instruments, and they (and private equity funds) often use leverage in their investment activities. However, by many accounts, hedge funds' involvement in the sorts of investment and trading activities that gave rise to the financial crisis paled in comparison to the activities conducted by major brokerage firms. *See, e.g.*, Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 BERKELEY BUS. L.J. 240, 292 (2009) ("[Hedge fund investments in mortgage-related securities were very limited compared to those of other market participants."); Edmund L. Andrews & Louise Story, *U.S. to Detail Plan to Rein In Finance World*, N.Y. TIMES, Mar. 26. 2009, at A1 ("Hedge funds have generally not been implicated in the financial collapse, which stemmed primarily from reckless mortgage lending and exotic financial instruments tied to subprime mortgages."); Joe Nocera, *Hedge Fund Manager's Farewell*, N.Y. TIMES, May 16, 2009, at B1 ("As it turns out, it was the big regulated entities, the banks and investment banks, that were the problem, not the unregulated hedge funds.").

64. *See* Andrews, *supra* note 63, at A1 ("[A] growing number of lawmakers and policymakers are worried that hedge funds have become too big a part of the financial market to operate without government monitoring.") Somewhat secondarily, with the revelation of a number of high-profile financial fraud cases, including Madoff's Ponzi scheme, investor protection—and, particularly, more stringent "transparency" requirements—became another basis for additional "hedge fund regulation." *See The Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. 4 (2009) (statement of Sen. Christopher Dodd, Chairman, S. Comm. on Banking, Hous. & Urban Affairs). Transparency, in the investor-protection context, has generally referred to requirements that hedge funds make available to their investors information about their operations and investment activities,

Accordingly, by 2009 it was a given that whatever financial reform legislation Congress adopted, it would subject hedge funds and, most likely other private funds, to greater regulation.[65] However, the literature, the commentary, and testimony before Congress regarding financial regulatory reform, to the extent relating to hedge funds and other private funds, reflected misunderstandings about the nature of private funds and their place within the U.S. securities-regulation framework. Most prominently, the discussions revolved around changing the regulations to which *funds* were subject, as though there exists a regulatory regime where those amendments might be at home.[66] There does not. As testimony to that fact, all but one of the reform proposals put before Congress in 2009 addressed hedge funds and other private funds through proposed amendments to the Advisers Act, the federal securities statute that regulates *investment advisers*.[67] However, one would generally never have known that based on the surrounding media coverage and political commentary.

Commentary about the proposals generally did not speak in terms of how the new legislation would eliminate, or substantially curtail, an exemption in the Advisers Act that had permitted investment advisers to hedge funds and other private funds to avoid becoming registered as investment advisers, nor did it discuss how new hedge fund "transparency" requirements were to be implemented through subjecting *investment advisers* to additional obligations, namely, obligations to report to the SEC certain information about any hedge funds they

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including their prior performance, how they value their portfolio investments, the terms on which investors may place capital with or redeem interests in them, and the nature of their portfolio investments, including whether those investments are relatively illiquid or liquid. *See* ASSET MANAGERS' COMM. TO THE PRESIDENT'S WORKING GRP. ON FIN. MKTS., BEST PRACTICES FOR THE HEDGE FUND INDUSTRY 1, 12 (2009) (discussing what information hedge funds should disclose to increase transparency). With that information, transparency proponents contend, investors should be able to better evaluate whether the funds are suitable investments and, based on that evaluation, act accordingly. *See* Shadab, *supra* note 63, at 288 ("[A]s competition for investor capital increases and investors become more sophisticated and comfortable with the funds, investors are increasingly demanding that hedge funds disclose information about the types of investments they make, their risk management policies, and other practices.")

65. Most legislative proposals for financial regulatory reform included provisions covering hedge funds or investment advisers to hedge funds. *See infra* note 67 (listing several of the more prominent proposals).

66. *See infra* note 68.

67. *See, e.g.*, Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. §§ 401–16 (2010) (setting forth Senator Christopher Dodd's March 2010 comprehensive financial regulatory reform proposal, including the Private Fund Investment Advisers Registration Act of 2010); Private Fund Investment Advisers Registration Act of 2009, H.R. 3818, 111th Cong. (2009) (regulatory reform proposed by Representative Paul Kanjorski in October 2009, which in turn was based on the Obama administration's July 2009 proposal on financial regulatory reform); Private Fund Transparency Act of 2009, S. 1276, 111th Cong. (2009) (regulatory reform proposed by Sen. Jack Reed in June 2009); Hedge Fund Adviser Registration Act of 2009, H.R. 711, 111th Cong. (2009) (regulatory reform proposed by Representatives Michael Castle and Michael Capuano in January 2009).

happen to manage. Rather, policymakers, commentators, and observers alike placed discussions about the prospective changes to the Advisers Act within the rubric of hedge fund regulation.[68] Presumably, the discussion would have been framed differently had participants understood that the proposed changes were to be made to a statute that governs investment advisers and that, prior to the recent financial regulatory reform, did not so much as mention hedge funds.[69]

The Advisers Act was the target of regulatory reform insofar as it addressed hedge funds not because it was the most logical candidate, at least not as it was structured prior to the Dodd-Frank Act. Even with the recent amendments that the Dodd-Frank Act brought about, the Advisers Act remains woefully ill suited to encompass hedge fund regulation because it still fundamentally reflects how investment advisers operated their businesses in 1940, when investment advisers did not manage pools of capital that we now think of as hedge funds.[70] Rather, the new regulation of hedge funds found its way into the Advisers Act presumably because the rules adopted by the SEC over the years pursuant to its authority under the Advisers Act had come to acknowledge that at least some advisers manage private funds and on that basis subjected those advisers to sporadic additional regulation.[71] Indeed, amending the Advisers Act was arguably the only choice because, with the exception of the Investment Company Act (which had its own difficulties as a repository of the new regulations) no other securities statute addressed hedge funds at all.

68. *See, e.g.*, Raymond Hernandez, *Citing Financial Reform, Dodd Quits Fund-Raiser*, N.Y. Times, May 1, 2010, at A14 (noting that the financial regulatory reform bill proposed in the Senate by Senator Christopher Dodd would, among other things, "impose new rules on hedge funds"); Carl Hulse, *House Approves Tougher Rules on Wall Street*, N.Y. Times, Dec. 12, 2009, at A1 (noting that the financial regulatory reform bill approved by the House of Representatives in December 2009 "include[d] a number of other provisions to address . . . regulation of hedge funds"); Stephen Labaton, *An Overhaul of Financial Rules Is Taking Shape*, N.Y. Times, June 2, 2009, at B1 (noting that, under the Obama administration's proposal on financial regulatory reform, "hedge funds would be required to register with the S.E.C. and provide access to their books"); Stephen Labaton, *Senators Bid to Regulate Hedge Funds*, N.Y. Times, Jan. 30, 2009, at B1 ("It's time to subject financial heavyweights like hedge funds to federal regulation and oversight to protect our investors, markets and financial system." (quoting Sen. Carl Levin)); Editorial, *Starting the Regulatory Work*, N.Y. Times, Jan. 8, 2009, at A30 ("[I]n addition to regulating previously unregulated investment instruments, Washington must impose regulations on equally unregulated hedge funds."); Louise Story, *Hedge Funds Step Up Efforts to Avert Tougher Rules*, N.Y. Times, June 23, 2009, at B3 ("The registration of hedge funds . . . has figured prominently in discussions of reform for years.").

69. Over the years, however, the SEC had incorporated into its rules under the Act various sporadic references to "private fund" and "private investment company," categories that include hedge funds. *See* 17 C.F.R. § 275.203(b)(3)-1(d) (2011) (defining "private fund"); *id.* § 275.205-3(d)(3) (defining "private investment company").

70. *See infra* notes 73–83 and accompanying text.

71. *See, e.g.*, 2004 Proposed Rule, *supra* note 47 (setting forth proposed regulations that would require hedge fund advisers to register with the SEC).

In light of the historical (yet understandable) omission of hedge funds from the Advisers Act's coverage, Dodd-Frank's amendments to the Advisers Act have the unfortunate effect of perpetuating hedge fund regulation through hodge-podgism. They tack hedge fund regulation onto a statute that covers investment adviser regulation, with no attempt to integrate the two realms or make the case that, in fact, the two should be integrated for the sake of better regulation of both investment advisers and private funds. Because the Advisers Act has retained its 1940 objectives and structure, which revolve around the SEC's mission of investor protection, it no longer achieves the goals for which it was intended—precisely because so many investment advisers *do* manage hedge funds, which these days are subject to regulatory scrutiny in part, if not primarily, on the basis of their perceived contributions to systemic risk.[72] As discussed in Part III, that the Advisers Act has ceased to reflect the activities of investment advisers in the twenty-first century is largely a product of the institutionalization phenomenon, despite that being far from obvious based on the literature about institutionalization or, for that matter, hedge fund regulation.

III. INVESTMENT ADVISER REGULATION AND ITS EVOLUTION AND FAILURE

The regulation of investment advisers in the United States has become obsolete. This is not because investment advisers have diminished in importance or because regulation has otherwise become unnecessary. It is because the federal statute governing investment advisers—the Investment Advisers Act of 1940—and related SEC regulations have ceased to speak to what many investment advisers today do. That may seem to be a striking claim and may raise the question of why, if investment adviser regulation no longer works, more has not been made of it. Arguably, one of the more prominent reasons is that the extent of obsolescence of investment adviser regulation went from being merely apparent to being incontrovertible only recently, in the wake of the financial crisis. At the same time, however, that obsolescence generally was misdiagnosed, discussed in the context of hedge fund regulation or investor protection. Policymakers, scholars, and

72. *See, e.g.*, Steven M. Davidoff, *To Reduce Hedge Fund Risk, Let Everyone In*, N.Y. TIMES, Sept. 17, 2009, at F8 (arguing that systemic risk is the real issue with hedge funds and, accordingly, that the main focus of hedge fund supervision should be monitoring systemic risk); Stephen Labaton, *An Overhaul of Financial Rules Is Taking Shape*, N.Y. TIMES, June 2, 2009, at B1 ("A central goal of [the Obama administration's proposal on financial regulatory reform] is to more tightly control companies that are now largely unregulated but could pose risks to the financial system if they failed, such as hedge funds."); Louise Story, *Hedge Funds, Unhinged*, N.Y. TIMES, Jan. 18, 2009, at B1 ("[T]here's been a near-consensus that hedge funds can cause systemic risk." (quoting Rep. Carolyn B. Maloney, House Financial Services Committee)).

commentators have had great interest in those topics but, by all appearances, often have not been sufficiently versed in the doctrines and legal principles that underlay and shape the reforms they advocate.

A. Origin and Nature of Investment Adviser Regulation

1. *Investment Advisers as Personal Counselors*

For almost as long as the U.S. public has been investing in securities, there have been people whose business has been to provide advice on investment options. Beginning in the 1920s, the U.S. investment advisory industry came into its own alongside the nascent U.S. securities industry.[73] In early investment advising, the relationships between client and adviser were generally regarded as close and personal consulting relationships, although there were always exceptions.[74] Advisers were seen as trusted counselors advising wealthy clients regarding their portfolios and securities investments, and their advice and recommendations were tailored to their clients' specific concerns and investment needs.[75]

These images of investment advisers as personal consultants to neighbors needing trustworthy securities-investing guidance permeated investment advisers' Senate testimony as Congress considered legislation that would, for the first time, regulate the business of providing investment advice. One investment adviser testifying before Congress in 1940 stated that the investment advisory industry "depend[ed] for its success upon a close personal and confidential relationship between the investment-counsel firm and its client."[76] Another claimed that "when you are dealing with investment counsel, you are dealing with reputation . . . . [and with] [m]en who depend for their livelihood upon the opinion of others as to their integrity and their capabilities."[77]

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73. *See* SEC, Investment Trusts and Investment Companies, H.R. Doc. No. 76-477, at 3–4 (1939) ("[After World War I] a marked tendency developed in the growth of a class of investment counselors unaffiliated with any other form of financial organization. . . . The post-war boom in stocks . . . attracted . . . the attention of private individuals who up to that time had been more likely to put their funds in savings banks, mortgages, [and] local investments . . . .").

74. *See id.* at 5 (discussing the emergence of investment advisory firms and, observing in that regard that, in the years after 1920, "there developed . . . a distinct class of persons who held themselves out as giving only personalized investment advisory service").

75. *See id.* at 23 (noting that, in the view of various representatives of investment advisory firms, "the primary function of investment counselors" was "to render, on a personal basis, competent, unbiased, and continuous advice regarding the sound management of investments").

76. *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the S. Comm. on Banking and Currency*, 76th Cong. 713 (1940) [hereinafter *Senate Hearings*] (statement of Charles M. O'Hearn, Vice President & Director, Clarke, Sinsabaugh & Co., Investment Counsel).

77. *Id.* at 751 (statement of Rudolf P. Berle, General Counsel, Investment Counsel Association of America).

Of course, even in the early years of the investment advisory industry, advisory relationships did not conform to a single model. Many relationships were of the so-called "non-discretionary" variety, in which advisers would merely recommend securities transactions to their clients, leaving it to the clients to determine whether to act on those recommendations for their own accounts.[78] Other advisory relationships were of the "discretionary" variety, meaning that once a client had engaged an adviser, the adviser had full authority not only to determine which securities investments might be appropriate for the client but also to "pull the trigger"—to purchase or sell those securities on behalf of the client's account without further input from the client.[79] There were other differences as well: among them, advisers charged different fees, maintained different limitations on the number of clients and minimum size of client accounts, and claimed different strengths based on the professional experience of their personnel.[80]

The characteristic that investment advisers throughout the industry largely shared, however, was their small size and local focus—two factors that arguably served to reinforce one another. In a world in which communication lacked speed and ease, at least relative to today's standards, investment advisory firms were local businesses and therefore sought local clientele.[81] And, perhaps as a result of those circumstances, advisory clients, though comprising some institutions, were often unitary clients—individuals, their family members, and their alter ego accounts.[82] In other words, the investment advisory industry, at the time that Congress first saw fit to regulate it, was more "retail" and less institutionalized and intermediated than what it would become.[83]

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78. *See* SEC, Investment Trusts and Investment Companies, H.R. Doc. No. 76-477, at 13 (1939) ("[Some investment advisers surveyed had the power to] make recommendations to [their] client[s], with whom rest[ed] the ultimate power to accept or reject such recommendations . . . [while others had] firm control over the client's funds, with the power to make the ultimate determination with respect to the sale and purchase of securities for the client's portfolio.").

79. *See id.* ("No consistent practice has been adopted by investment counsel firms with respect to discretionary or advisory powers.").

80. *See id.* at 16–18.

81. *See id.* at 7 ("[In the mid-1930s, investment advisory firms] ha[d] been organized as sole proprietorships and have remained 'one-man investment counsel firms' [and] apparently ha[d] not, as yet, achieved the degree of popularity with the investing public sufficient to warrant their expansion through the medium of branch offices.").

82. *See id.* at 9 (discussing the composition of advisory clients in the mid-1930s and noting that "[t]he importance of private or individual clients is indicated by the fact that . . . these individual or personal accounts represented about 83% of all the accounts administered").

83. *See, e.g.*, Davidoff, *supra* note 20, at 351 ("[R]etail investors, who once owned more than 90% of publicly traded equity, now own less than 30%.").

2. *Investment Advisers as Fiduciaries*

At the inception of the U.S. investment-adviser regulatory regime, then, the industry looked substantially different than it does today. For many in the early generations of investment advisers, the profession was hardly one in which the federal government should intervene.[84] Nonetheless, since 1940 investment advisers in the U.S. have been subject to federal regulation: The Investment Advisers Act of 1940 was a final component of the post-Depression overhaul of the U.S. financial regulatory system.[85] True to the expectations of the advisory personnel testifying before Congress about the then-impending legislation, the Advisers Act had the effect of requiring investment advisers to become registered with the SEC and to comply with myriad substantive requirements.[86]

To be sure, in the aftermath of the Depression, investment advisers were not alone in becoming regulated. The Advisers Act was just a part of the new regime of financial industry regulation and, more specifically, *securities* industry regulation. Perhaps most significant for the investment adviser profession, the dawn of investment adviser regulation coincided with the passage of another federal statute governing the investment industry: the Investment Company Act of 1940.[87] While the Advisers Act was to govern investment advisers,[88] the Investment Company Act set about to regulate investment companies[89]—entities to which many (generally smaller or "retail") investors contributed capital and that invested that capital on an aggregate, or pooled, basis. Preceding the

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84. *See, e.g.*, *Senate Hearings*, *supra* note 76, at 716 (statement of Charles M. O'Hearn, Vice President & Director, Clarke, Sinsabaugh & Co., Investment Counsel) (arguing that the federal regulation of investment advisory firms proposed by Congress would, among other things, weaken investment advisory firms' incentives to maintain "self-disciplinary" efforts, such as establishing and adhering to "codes of professional practice").

85. *See* LARRY D. SODERQUIST & THERESA A. GABALDON, SECURITIES LAW 12–13 (4th ed. 2011).

86. *See* 15 U.S.C. §§ 80b-1–80b-21 (2010). Among the Advisers Act's requirements, both then and now, are that an adviser's agreements with its clients must contain certain provisions regarding assignment of the advisory contract, *id.* § 80b-5(a), and advisers are prohibited from entering into transactions with their clients unless they provide certain disclosures and obtain the clients' consent, *id.* § 80b-6(3). The Advisers Act also contains broad antifraud provisions that govern all investment advisers, whether or not they are registered as such with the SEC. *Id.* § 80b-6. In addition, the SEC staff "examines" each registered adviser periodically—meaning that the examiners visit the adviser's premises for several days, ask questions of the adviser's personnel about the adviser's business activities and procedures, and review the adviser's books and records. *See id.* § 80b-4. Registered advisers deemed to have "custody" of client assets must also take special measures to ensure the safekeeping of those assets. 17 C.F.R. § 275.206(4)-2 (2011).

87. Ch. 686, tit. I, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1–80a-64).

88. An investment adviser that is subject to federal regulation under the Advisers Act registers with the SEC by submitting a registration application with the SEC (and updating the information on that application on at least an annual basis) and must comply with the Advisers Act and the SEC's rules under that Act. *See* 15 U.S.C. §§ 80b-3(c) & 80b-4.

89. 15 U.S.C. § 80a-3(a)–(c).

passage of the Advisers Act and the Investment Company Act was Congress's enactment of the bread-and-butter legislation regulating public companies' issuance and resale of securities: the Securities Act of 1933[90] and the Securities Exchange Act of 1934.[91]

Securities industry regulation, perhaps more than regulation of nonsecurities financial services, is based on the circumstance that customers' and clients' participation in securities transactions is characteristically a product of aspirations of capital appreciation—increased wealth or income—through wise investment decisions.[92] Of course, with today's near-universal access to the securities markets, participation in them has become so prevalent that it may now be seen by prudent investors as a necessary activity rather than as merely an elective. Nonetheless, the prospect of the substantial rewards (with, of course, the attendant risks) that are often part of securities-investing activity historically has made the securities industry, as compared with other financial services industries, particularly susceptible to fraudulent and manipulative activities. This is especially true when combined with the characteristically intangible nature of securities—the uncertainty about what, exactly, a security holder owns.[93] In the United States, of course, these factors gave rise to a special regulator (the SEC) charged with policing misconduct in the securities markets and to a particular flavor of regulation.

Securities industry regulation, in simplest terms, has historically focused on disclosure—the sharing of all material facts and risks.[94] That

90. Ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2010)).

91. Ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78oo (2010)). Companies intending to raise capital in the public markets became subject to the registration and reporting requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934, which, for their part, also subjected broker-dealers to regulation by the SEC and, later, the National Association of Securities Dealers (which in 2007 became the Financial Industry Regulatory Authority). *See* Order Approving NASD and NYSE Proposed Rule Change Relating to Consolidation of Regulatory Functions, 72 Fed. Reg. 42,169, 42,169-70 (July 26, 2007). In addition to the Securities Act and the Exchange Act, the Public Utility Holding Act of 1935, ch. 687, 49 Stat. 803 (repealed 2005), and the Trust Indenture Act of 1939, ch. 411, 53 Stat. 1149 (codified as amended at 15 U.S.C. §§ 77aaa–77bbbb (2010)), also preceded the enactment of the Investment Company Act and the Advisers Act.

92. *See* Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982) ("[S]hareholders to a very real degree voluntarily undertake the risk of bad business judgment. Investors need not buy stock, for investment markets offer an array of opportunities less vulnerable to mistakes in judgment by corporate officers.").

93. *See* STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 89 (2d ed. 2008) (noting that securities markets are characterized by an "information asymmetry" between insiders and outsiders and that "[i]f . . . insiders and professionals are free to exploit that informational advantage, outsiders will be reluctant to participate in the market").

94. *See* Theresa A. Gabaldon, *Financial Federalism and the Short, Happy Life of Municipal Securities Regulation*, 34 J. CORP. L. 739, 744 (2009) ("It is a given, if not invariably true, that federal securities regulation is disclosure-based, and it is logical, if not inevitable, that the issuers of securities be the ones made responsible for disclosure."); Elisabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities*

is, issuers and other sellers possess information that, when disclosed, assists investors' evaluation of whether to buy the securities, furthering the larger goal of efficient allocation of capital.[95] Again, however, investors are not required to invest, and if they choose to forge ahead after the required disclosures, then they assume the risks that have been disclosed and generally are hard-pressed to complain later if those risks materialize.[96] Like other financial industry regulation, securities regulation has as a primary goal consumer or customer protection—or, more accurately, *investor* protection.[97] However, it achieves that goal less through substantive rules governing the firms' operations and provision of services and more through disclosure requirements intended to level the playing field.

With that in mind, a primary theme of U.S. regulation of investment advisers has historically (and persistently) been oversight of disclosure practices. Both the Advisers Act and the Investment Company Act were responses to perceived abuses in the investment industry in the 1920s and 1930s and, in particular, to advisers' using their relationships with their clients to further their own interests, whether through causing clients to enter into transactions with the advisers, causing clients to invest in the same securities as those held by the advisers, or myriad other self-interested transactions involving client relationships.[98] Given the objectives of the Advisers Act and securities law more generally (among other rationales), the Advisers Act obligates investment advisers to act in furtherance of their clients' best interests and to disclose to clients all conflicts of interest that may affect their ability to meet that obligation.[99]

Exchange Act of 1934, 49 OHIO ST. L.J. 329, 330 (1988) (observing that securities registration requirements were designed to effect "the full disclosure of truthful information regarding the character of the securities offered to the public").

95. *See, e.g.*, Henry N. Butler & Larry E. Ribstein, *Corporate Governance Speech and the First Amendment*, 43 U. KAN. L. REV. 163, 191–92 n.129 (1994) ("[A] principal rationale for securities regulation [turns on] efficient allocation of resources."); John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 66 n.245 (2001) (noting that improving allocative efficiency or pricing accuracy is widely assumed to be the primary rationale of securities regulation).

96. *See* C. George Nnona, *In the Wake of the Mortgage Bubble and Financial Crisis: What Should Securities Regulation Become?*, 79 UMKC L. REV. 31, 41 (2010) ("[Under disclosure philosophy, disclosure is] a regulatory mechanism that evinces the view that securities are inherently speculative and that the decision to get involved in that speculation is one to which each ought to come with fully open eyes and informed minds following appropriate disclosures.").

97. *See* Amir N. Licht, *Genie in a Bottle? Assessing Managerial Opportunism in International Securities Transactions*, 2000 COLUM. BUS. L. REV. 51, 104 ("[T]he very root of the mandate for securities regulation [is] investor protection."); Franklin Allen & Richard Herring, *Banking Regulation Versus Securities Market Regulation* 2 (Wharton Fin. Inst. Ctr., Working Paper No. 01-29, 2001), *available at* http://fic.wharton.upenn.edu/fic/papers/01/0129.pdf.

98. *See* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186–92 (1963) (discussing the history and purpose of the Advisers Act).

99. *See* Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 701, 718 (2010). The regulation of broker-dealers under the Securities Exchange Act

Put another way, unlike many financial services professionals outside the securities industry, U.S. law perceives investment advisers as *fiduciaries* to their clients.[100] If there were any doubt about that initially, the Supreme Court eliminated it in a 1963 case, *SEC v. Capital Gains Research Bureau*, in which the Court concluded that the Advisers Act reflects "a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,'"[101] along with a purpose of eliminating or disclosing "all conflicts of interest which might incline an investment adviser . . . to render advice which was not disinterested."[102] Among the purposes of the federal securities laws, the Court noted, was promoting "a high standard of business ethics in the securities industry" and replacing a "philosophy of *caveat emptor*" with "a philosophy of full disclosure."[103] Investment adviser regulation, which began as regulation of a specific type of professional relationship—between advisers and their generally smaller and local clients—involves a specific type of duty—one requiring investment advisers to place clients' interests above their own.[104]

B. The Evolution and Failure of Investment Adviser Regulation

1. The New Advisory Client

Today, as in 1940, the job of investment advisers is to advise their clients on their securities investments.[105] In addition, advisers' relationships with their clients continue to be either discretionary or nondiscretionary, depending on a particular adviser's strengths and

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was founded on a similar sentiment, that of ensuring that brokers and dealers act fairly toward their customers in effecting securities transactions, whether for their own accounts or the accounts of others. However, that regulation has been "ambiguous" on the question of whether broker-dealers owe fiduciary-like obligations to their customers. *See id.* at 723 ("Courts have looked to a number of factors to determine whether brokers are fiduciaries . . . . Most courts . . . conclude that only brokers for discretionary, as opposed to non-discretionary, accounts are considered fiduciaries.").

100. *See Capital Gains Research Bureau*, 375 U.S. at 191–92.

101. *Id.* at 191 (quoting 2 Louis Loss, Securities Regulation 1412 (2d ed. 1961)).

102. *Id.* at 191–92.

103. *Id.* at 186.

104. Importantly, to the extent investment advisers' status as fiduciaries has particular implications for the standards of conduct to which advisers must adhere, advisers and their clients generally may qualify those standards. For example, the investment advisory agreement could provide that the investment adviser may cause other accounts it manages (including its own accounts) to invest in the same securities as the client's account and may receive fees or other compensation from issuers of securities held in the client's account, without having any obligation to account to the client for any part of those fees or other compensation. Moreover, the agreement's liability provisions could provide that the adviser will not incur liability to the client in connection with its services under the agreement, except to the extent of losses arising from the adviser's gross negligence or willful violation of law.

105. *See* Advisers Act, 15 U.S.C. § 80b-2(a)(11) (2010) ("'Investment adviser' means any person 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 . . . .").

modes of operations and their clients' preferences. Advisers are still varied in their strategies, strengths, and experience. And investment advice remains investment advice, in the sense that it is still fundamentally a process in which advisers advise clients on securities investments (and, increasingly, other types of investments, such as in commodities futures, options, and derivatives). Notwithstanding the considerable continuity, however, much has changed in the past eighty-plus years.

As an initial matter, a primary point of departure from the post-Depression era is that client-adviser relationships have diverged from the counselor-client model, with advisory services turning away from the idiosyncratic needs and diversification requirements of individual clients. Rather, today the services investment advisers seek to provide (financial-planning services aside) are based on the special and proprietary investment processes they have developed, their "secret sauces" designed to achieve returns that surpass the returns of the broader market.[106] Accordingly, an investment adviser that has developed a proprietary strategy is unique among investment advisers to the extent of that strategy. The adviser will seek to sell prospective clients and investors not on the individualized services it provides but, rather, on the advantages of its strategy—of the particular way that it makes securities investments for *all* of its clients (often on an aggregated basis). With this evolution, advisory services have, in a sense, become approaches to investing that clients can take or leave, by either engaging the relevant adviser(s) or by using other advisers.

That investment advisers offer clients access to proprietary strategies along with, or (as is often the case) *instead of*, more personalized and encompassing investment advice is inseparable from another important change in the nature of advisory clients. As discussed above, the trend has been toward the institutionalization of advisory clients—that is, an increase in the portion of advisory clients that are institutions, as opposed to unitary investors, such as individuals and their alter ego accounts and monolithic entities. Moreover, the institutions that have received the most attention in recent years on that point are those that serve as intermediaries for retail and other unitary investors, namely investment funds—pools of capital contributed by a number of investors, whose objective is to invest that capital on an aggregate basis. Smaller investors, both of the retail and the more sophisticated varieties, that in an earlier era may have directly contracted for investment

106. That is, advisers' strategies aim to realize "alpha." *See Alpha—Definition and Other Information*, HEDGE FUNDS CONSISTENCY INDEX, http://www.hedgefund-index.com/d_alpha.asp (last visited Oct. 31, 2011) ("Alpha is a risk-adjusted measure of the so-called 'excess return' on an investment. It is a common measure of assessing an active manager's performance as it is the return in excess of a benchmark index or 'risk-free' investment.").

advisory services have increasingly moved away from such direct relationships in favor of placing their assets in pooled investment vehicles: mutual funds, hedge funds and other private funds,[107] pension funds, insurance products, and the like,[108] which, in turn, enter into investment advisory relationships.

Investment funds, whether of the private or the public variety, are ideal investment-management vehicles for those advisers who effectively offer strategies rather than more personal advisory services. Of practical necessity, a fund has an investment objective and pursues an investment strategy of its own, apart from any investment objectives or strategies of the fund's various investors. Therefore, the investment adviser managing the fund's investment activities can market the fund to investors based on the particular strategies that the adviser has developed rather than on the adviser's approach to (and expertise at) advising clients on which investments, out of the spectrum available, will be most desirable for a client's total investment portfolio in light of the client's particular needs, desires, and circumstances.

In this regard, private funds (as opposed to their public counterparts) are particularly interesting and, from a regulatory perspective, particularly nettlesome. Private funds exist by virtue of exclusions set forth in the Investment Company Act that permit small pools of capital that offer their securities privately to investors meeting specified financial sophistication criteria.[109] They can pursue most any investment strategy and most any type of investment, including "short" positions, leveraged transactions, and derivative instruments, and, unlike public funds, are permitted to enter into performance-based compensation arrangements with their advisers.[110] Although the original drafters of the Investment Company Act may have intended that funds meeting the requirements of the exclusions would comprise only a small portion of the investment-fund universe, the exclusions came to effectively swallow the rules as capital invested in private funds began to rival the amounts invested in funds that were subject to SEC regulation under the

107. Although private funds' investors are not "retail" in the usual sense of the word, they may comprise individuals and their personal accounts and in that sense are relatively more retail than the institutional investors that have come to dominate direct investments in securities.

108. *See* Davidoff, *supra* note 20, at 348 ("[Retail] investors increasingly eschew or are effectively closed off from direct purchase of securities and instead invest through intermediaries. This 'deretailization' trend is most prominently illustrated by the extraordinary growth of the mutual fund industry."); *id.* at 349 (noting "[a] separate investment intermediation trend among private, sophisticated investors" who have increasingly invested in hedge funds and other private funds).

109. *See supra* note 12 and accompanying text.

110. *See* Davidoff, *supra* note 20, at 363. Such arrangements generally provide that the adviser is entitled to a specific percentage—usually twenty percent—of the fund's net profit each year in excess of any net profit that merely recovers prior losses. *Id.*

Investment Company Act.[111] Given the amount of assets that private funds encompass, the incentives that perpetuate them, and their status as unregulated investment funds, private funds are at the heart of the question of how the institutionalization phenomenon may speak to investment adviser regulatory reform.[112]

Although it is imprecise to characterize the evolution of the investment advisory industry in hard-and-fast terms, it is inescapable that, today, *direct* (as opposed to intermediated) advisory clients are generally larger and more institutional—and are working with relatively more capital—than was the case in the 1920s and 1930s.[113] These institutional clients have displaced many smaller clients, who now pursue their investment activities as investors in private funds.[114] The Advisers Act, however, does not reflect the changes that have taken place in the investment advisory industry, whether in terms of products and services offered or in terms of the clients that engage advisers to provide those products and services. This is not to say the Advisers Act has not changed at all over the years or that those changes ignore developments in the advisory client "census." Since 1940, Congress has periodically amended the Advisers Act, and the SEC has adopted an array of Advisers Act rules pursuant to the authority provided by Congress—and at least some of those amendments and new rules acknowledge and purport to address concerns arising from the institutionalization of the investment advisory industry.

As discussed in Part II, the most recent changes occurred in 2010, when Congress amended the Advisers Act as part of the Dodd-Frank Act. Most significantly, those amendments eliminated the exemption from registration under the Advisers Act on which many large advisers

111. *See id.* at 353 ("[H]edge funds in part exist outside the regulatory purview of the SEC . . . and other private capital pools . . . are largely unregulated. The consequence is . . . a significant portion of the U.S. capital market increasingly outside the federal securities laws . . . .") While the financial crisis had the effect of reducing substantially the amount of assets placed in hedge funds and other private funds, these funds remain a desirable repository of investment capital both for high net worth individuals and institutions. *See* Shadab, *supra* note 63, at 243–44 (noting that hedge funds lost nineteen percent of their value following the 2008 financial crisis, compared with a loss of forty-two percent for global equities).

112. Mutual funds and other "public" funds, by contrast, are less important to that question because of the extent to which they, as institutions, are directly regulated for the specific purposes of protecting investors.

113. Advisers' clients have changed in other ways. Some advisers, as an alternative to (or in addition to) managing private funds, continue to manage client assets on a nonpooled basis. Those clients may be high-net-worth individuals, but they also increasingly are institutions—those of the variety that are prime candidates for hedge fund investments but that may see advantages in the "separately managed account" model of investing, to the extent that advisers are willing to offer that model given the arguably higher administrative and compliance costs involved. *See infra* note 129.

114. *See* 2004 Proposed Rule, *supra* note 47, at 45,173 ("Instead of managing client money directly, [a growing number of investment] advisers pool client assets by creating limited partnerships, business trusts or corporations in which clients invest.").

to hedge funds and other private funds had relied.[115] They also require a registered investment adviser to maintain certain records regarding each private fund it manages, including the amount of leverage the fund employs and the fund's counterparty credit-risk exposure; trading and investment positions; valuation policies and practices; and trading practices.[116] The amendments further allow the SEC to mandate periodic reports from private fund advisers for possible use by the Financial Stability Oversight Council in assessing systemic risk.[117] Despite these and earlier amendments to the statute and associated episodes of SEC rulemaking, however, the contours and structure of investment adviser regulation have remained relatively static and, more to the point, have not successfully confronted and addressed the regulatory gaps created by institutionalization.

2. *The Obsolescence of Investment Adviser Regulation*

The Advisers Act regulates the relationships between investment advisers and their clients.[118] Accordingly, the Act obligates advisers to do certain things vis-à-vis their clients, such as seek consent before engaging in certain self-interested transactions,[119] provide disclosure regarding conflicts of interest to which the adviser might be subject and other information about the adviser's business activities,[120] and, under certain circumstances, deliver periodic account statements to them.[121] That advisers should owe their obligations to their clients seems incontrovertible: to whom else should advisers owe duties, particularly given that those duties are fiduciary in nature? The evolution of the investment advisory industry has made things more complex than that, however, and in that complexity now lies the critical flaw in the Advisers Act.

115. *See* Dodd-Frank Act, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1570–71 (2010). The statute exempts from the Advisers Act's (new) registration requirements advisers that manage only "venture capital funds"—a term to be defined by the SEC—or that have less than $150,000,000 under management, though it expressly grants the SEC authority to require those exempted advisers to "maintain such records and provide to the Commission such . . . reports as the Commission determines necessary or appropriate in the public interest or for the protection of investors." *Id.* §§ 407–408.

116. *Id.* § 404(2) (to be codified at 15 U.S.C. § 80b-4(b)(3)).

117. *See id.* § 404 (to be codified at 15 U.S.C. § 80b-4(b)(4)–(5)).

118. *See* 15 U.S.C. § 80b-1–22 (2010).

119. *See id.* § 80b-6(3).

120. This disclosure is required under Part II of Form ADV, the investment adviser registration application. *See* Amendments to Form ADV, 75 Fed. Reg. 49,234, 49,287 (Aug. 12, 2010) ("As a fiduciary, you also must . . . make full disclosure of all material conflicts of interest between you and your clients that could affect the advisory relationship."). The SEC adopted Form ADV pursuant to its authority under section 203(c) of the Advisers Act. *See* 15 U.S.C. § 80b-3(c); 17 C.F.R. § 279.1 (2011).

121. *See* 17 C.F.R. § 275.206(4)-2(a) (2011) (setting forth requirements for advisers deemed to have "custody" of client funds or securities).

At the Advisers Act's inception, clients—again, the subjects to whom the adviser owed its regulatory obligations—were by and large understood to be those persons (individuals, in many cases) who placed certain of their assets under the adviser's management.[122] Those persons were both the legal owners and the beneficial owners of the assets, and, accordingly, the question of who should be deemed the client presumably did not arise. That is not the case today, at least not to the extent an adviser is managing a hedge fund or other pooled investment entity. That is, the emergence and growth of private funds, such as hedge funds, private equity funds, so-called family partnerships, and similar entities that pool capital largely for the purpose of investing in securities and related instruments has separated legal ownership from beneficial ownership: the fund is the legal owner of the assets being managed; its investors are the beneficial owners.

The Advisers Act not having taken a position on who, exactly, the client should be in the fund context, subsequent SEC rulemaking and congressional amendments have produced a doctrine under which the "client" is the person or entity that has *legal* ownership (as opposed to beneficial ownership) of the assets being invested.[123] In other words, when an investment adviser manages a hedge fund or other private fund, the persons who place their assets with the adviser and who decide when to terminate the adviser's services—that is, the investors—counterintuitively are largely *not* those to whom the adviser owes its obligations.[124] They do not have client status, and, as such, they are not entitled to many of the protections the Advisers Act provides to clients.[125] Rather, the adviser's client in this context is the fund, which, therefore, enjoys the consent, disclosure, and reporting rights set forth in the Advisers Act and, conversely, is the "thing" to which the adviser owes its obligations under the Advisers Act. Fund investors, by contrast, not being clients, are not entitled to the protections of the Advisers Act.[126]

This Author has elaborated elsewhere the difficulties with that circumstance. In brief, it effectively obviates the statute's investor

122. *See supra* notes 73–83 and accompanying text.

123. Despite the incoherent results produced by designating an investment fund the "client" of its investment adviser, how that result came about can be discerned from post-1940 case law and SEC interpretations. For an explanation of the evolution of the definition of "client" in the private fund context, see Anita K. Krug, *Moving Beyond the Clamor for "Hedge Fund Regulation": A Reconsideration of "Client" Under the Investment Advisers Act of 1940*, 55 VILL. L. REV. 661, 664–68, 686–91 (2010).

124. *See id.* at 673.

125. *See id.* at 673–79.

126. *See id.* at 672–73 (noting that, under current SEC doctrine, an investment adviser managing a hedge fund or other private fund may consider the fund—rather than any investor in the fund—to be the adviser's client).

protection function.[127] More specifically, in many cases, private funds are structured such that the investment advisers managing them effectively speak for and control them, whether as general partner, managing member, or sponsor (the actor responsible for the fund's creation and operation).[128] In those cases, the adviser's obligations under the Advisers Act to disclose information to clients or to obtain clients' consent effectively distill to obligations for the adviser to obtain its own consent and to disclose information to itself.[129] Or, using the terminology of rights rather than obligations, the rights held by the adviser's client are held by the fund, meaning that only the adviser itself may exercise and enforce them.[130]

These anomalies mean that the Advisers Act is to some degree incoherent, given the investor-protection rationale for securities industry regulation: In light of the institutionalization of the investment advisory industry, current investment adviser regulation does not address the theory of market failure that drives investment adviser regulation in the first place. If regulation of investment advisers remains necessary—that is, if market forces still create unacceptable market externalities that should be addressed through regulation[131]—then there currently is a

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127. *See id.* at 672–83 (arguing that current doctrine, whereby a fund is regarded as the advisory client for regulatory purposes, redounds to the detriment of fund investors).

128. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,055 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279).

129. This result is rendered more troublesome as a result of the fact that a fund investor would have generally the same investment experience with the adviser but *with* client status if the investor, rather than investing in the fund, instead pursues a so-called "separately managed account" arrangement with the adviser. In such an arrangement, the investor would place assets in a custodial account under her own name and grant the adviser power of attorney to manage the account, which would often be managed pursuant to the same strategy that the adviser employs for the funds it manages and often subject to the same or similar fee and liquidity terms as the ones that apply to the funds. The investor would enjoy the rights of a client simply because of the separateness of the investor's assets. Placing them in an account under the investor's own name removes the intermediation that arises from pooling assets in a separate entity with the assets of other investors and creates a direct relationship between investor and client.

130. There are exceptions to that result. Private funds are commonly structured using "subadvisory" arrangements, in which the advisers actually responsible for investing a fund's assets are not the same firms that formed and control the fund. Those advisers—or subadvisers, as they are usually called—are often third-party independent contractors to the funds whose assets they manage. In those cases, in connection with a subadviser's advisory obligations vis-à-vis the funds it subadvises, the Advisers Act's requirements may be more meaningful. There, someone independent from the subadviser (namely, whoever happens to be the fund's managing member, general partner, or other control person who engaged the subadviser in the first place) retains control over the fund.

131. Regulation might not be necessary, for example, if clients and investors were able adequately to protect themselves through negotiating the terms of the advisory relationship. In the private fund context, it may be that investors could bargain for the inclusion of investor-protective terms in the fund's governing documents, such as the operating agreement or limited partnership agreement. Such terms might include a right for investors to initiate the fund's dissolution, to remove or replace the fund's investment adviser, to approve certain types of transactions or substantive changes to the fund's investment strategies, or to receive periodic, comprehensive disclosures about the fund's and the

mismatch. Regulation remains targeted at a particular problem, namely, misconduct by investment advisers vis-à-vis those who entrust the advisers with management of their assets. That problem, however, has been largely overshadowed by externalities that regulation mostly ignores, namely, the severing of the entrustor-advisor relationship that has arisen with institutionalization.

Correcting that situation involves considerably more than tweaking a definition here or there. For example, the regulatory incoherence this Article highlights does not necessarily mean that fund investors should be deemed clients for all regulatory purposes or that there are not meaningful differences between investors that place assets with investment advisers through private funds and those that place assets with the advisers directly (such as through so-called separately managed account arrangements[132]). Accordingly, if the Advisers Act is going to have a cogent regulatory purpose going forward, the challenge is to address the anomalies that have arisen with institutionalization and resolve competing understandings of what is a "client." The regulatory reforms involving the Advisers Act made in the aftermath of the most recent financial crisis neither take on this challenge nor acknowledge it. Rather, beyond broadening the swath of advisers that must become registered under the Advisers Act, they merely address the concern, highlighted in the financial crisis, that private funds (read: hedge funds) were engaging in investment activities that were not only risky and complex but also unknown to regulators and investors.

In other words, the recent changes do not address the investor-protection concerns that gave rise to investment adviser regulation and that the growth of the private-fund model has brought, once again, to the fore. Rather, they take as a given the Advisers Act's continued efficacy as to investor protection and focus primarily on the recently heralded objective of systemic risk mitigation.[133] Granted, in the revised regulatory regime, investment advisers to most hedge funds now (or soon-to-be) SEC registered, must disclose to the SEC information regarding the

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adviser's activities and possible conflicts of interests. Any such assumption of investor negotiating power, however, would depend not only on investors' knowing what terms to request but also, and more critically, on their being able to identify and coordinate with one another, agree on a common approach or course of action, and share the costs of pursuing it. Although investors have to some extent overcome this collective action problem in various contexts, such as in the private equity fund context, particularly where a large investor takes the lead in negotiating investor-protective terms, the challenge is substantially greater where investors are generally smaller and more dispersed.

132. *See supra* note 129.

133. In particular, the Dodd-Frank Act requires investment advisers to hedge funds and other private funds to register as investment advisers with the SEC under the Advisers Act and to report information to the SEC about the funds they manage, with the intent that regulators will be able to determine whether the funds' activities threaten systemic stability. *See* Dodd-Frank Act, Pub. L. No. 111-203, §§ 403–404, 124 Stat. 1376, 1571–72 (2010).

funds' investment strategies and objectives, including leverage levels and data regarding portfolio positions.[134] Beyond that, however, little has really changed—certainly not the identity of an adviser's client or the obligations owed to those who have (indirectly) entrusted their assets with the adviser. As discussed below, the Advisers Act should be restructured to focus on how hedge funds and other private funds fit within the Advisers Act as a matter of institutionalization and intermediation—intermediation that separates sophisticated unitary investors (the original focus of the Act)—from their investment advisers.

IV. A New Approach to Investment Adviser Regulation

The preceding Parts have discussed the evolution of the investment advisory industry from one in which clients were generally individuals or other smaller investors to one in which hedge funds are some of the most common, and most desirable, advisory clients. That is a product of institutionalization, as it has manifested itself in the provision of investment advisory services. The concerns created by institutionalization, however, are not unlike some that have emerged in the context in which institutionalization has been traditionally discussed: institutions' supplanting retail and other unitary investors as shareholders of corporate issuers.[135] In the investment advisory context, the pertinent questions involve the relative obligations of investment advisers to the funds they manage versus their responsibilities to the investors in those funds. More to the point, to what extent should investment adviser regulation be concerned with investors who now pursue their activities through investing in hedge funds and other private funds, rather than through direct relationships with investment advisers?

A. Reconceptualizing "Client"

As suggested above, one response to the fact that intermediation deprives investors of rights they enjoyed as direct (un-intermediated) advisory clients may be to declare that intermediation does not matter. Policymakers could simply determine that there should be no substantive regulatory difference between, on one hand, someone's directly engaging an adviser to manage his or her portfolio and, on the other hand, his or her investing in a fund that the adviser manages. The result of such a determination would be that, for purposes of the Advisers Act and its rules, intermediated investors would be treated the same as un-intermediated investors and, therefore, would have the same rights and protections vis-à-vis the adviser they have (indirectly) engaged. So, for example, a fund's investors would be entitled to receive the disclosures to

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134. *See id.* § 404; *see also supra* notes 115–17 and accompanying text.
135. *See supra* notes 38–48 and accompanying text.

which clients are entitled under the Advisers Act and have the same rights to consent to any self-interested transactions proposed by the fund's investment adviser.

That seemingly easy solution—to redefine "client," in the private-fund context, to mean a fund's investors—becomes less plausible when one considers more closely the content of an investment adviser's regulatory obligations. As fiduciaries, advisers' obligations extend beyond satisfying disclosure and consent requirements and otherwise adhering to the Act's formal specifications.[136] Rather, in connection with investing their clients' assets, advisers must act in clients' best interests.[137] Among other things, advisers must seek the "best" brokerage and trade-execution services on behalf of clients,[138] ensure fair treatment to all clients who buy or sell securities at the same time and otherwise treat similarly situated clients fairly,[139] and make investments in accordance with the applicable investment objectives and strategies.[140] They must also seek to mitigate conflicts of interest that may arise from their (or their employees' or agents') trading in the same securities, or in the same types of securities, as they are buying and selling on behalf of their clients.[141] The nature of those obligations is such that, in the intermediated context, their subject *must* be the entity that is actually engaging in the buying or selling activities—that is, the *thing* that legally owns the assets being managed—rather than the entity's beneficial owners. Any displacement of the entity by the investor as the subject of an adviser's obligations raises the question of what remains, if anything, of the adviser's obligations to the entity.

One approach to addressing that concern could be to specify that an adviser owes its obligations not only to fund investors but, in keeping with current doctrine, also to the fund itself. That solution has its own

136. *See, e.g.*, Proxy Voting by Investment Advisers, 67 Fed. Reg. 60,841, 60,842 (proposed Sept. 26, 2002) (to be codified at 17 C.F.R. pt. 275).

137. *See, e.g.*, *id.* at 60,848 ("Under the Advisers Act, investment advisers are fiduciaries that must act in their clients' best interest with respect to functions undertaken on behalf of their clients . . . .").

138. *See, e.g.*, Scott E. Desano, Investment Advisers Act Release No. 2815, Investment Company Act Release No. 28534, 94 SEC Docket 2738, 2740 (Dec. 11, 2008) ("Under Section 206 of the Advisers Act, an investment adviser has a fiduciary duty to seek best execution for its clients' securities transactions.").

139. *See, e.g.*, Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV, 65 Fed. Reg. 20,524, 20,538 n.178 (Proposed Apr. 17, 2000) (to be codified at 17 C.F.R. pts. 200, 275, 279) ("Generally, our staff has not recommended enforcement action against advisers that aggregate trade orders on behalf of clients, so long as the adviser allocates the trades in a way that treats all clients fairly.").

140. *See, e.g.*, Concourse Capital Asset Mgmt., Inc., Investment Advisers Act Release No. 1451, Securities Act Release No. 33-7111, Investment Company Act Release No. 20698, 58 SEC Docket 26, 28 (Nov. 15, 1994) (observing, in an SEC enforcement action, that the respondent was "was required to engage only in transactions that complied with the Fund's investment policies and restrictions").

141. *See* Investment Adviser Codes of Ethics, 69 Fed. Reg. 41,696, 41,702-03 (July 9, 2004) (to be codified at 17 C.F.R. pts. 270, 275, 279).

complications, however, especially when evaluated against the backdrop of corporate-governance doctrine. In particular, to conclude that advisers should owe obligations both to the intermediating institution and to its investors would require careful consideration of the two constituencies' competing interests. As corporate-governance doctrine evidences, any particular investor's interests may be markedly different from other investors' interests, not to mention those of the entity.[142] The business judgment rule and the demand requirement in the derivative lawsuit context are merely two examples of that recognition.[143] Corporations' interests are furthered and defended by those who have been designated fiduciaries to the corporation as an entity (and the shareholders *as a group*[144])—the directors—rather than the shareholders or any particular group of shareholders.[145] To the extent that investment-adviser regulatory

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142. *See, e.g.*, ROBERT W. HAMILTON & RICHARD D. FREER, THE LAW OF CORPORATIONS IN A NUTSHELL 151 (6th ed. 2011) ("In most instances . . . a shareholder does not have to act with the best interests of the business or other shareholders in mind.").

143. *See* CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 399 (6th ed. 2010) (noting that the demand requirement, like the business judgment rule, supports the board of directors' authority to govern the corporation).

144. *See, e.g.*, Chenery Corp. v. SEC, 128 F.2d 303, 308 (D.C. Cir. 1942), *aff'd*, 318 U.S. 80 (1943) ("[W]hile officers and directors are trustees for stockholders as a body with respect to the business and property of the corporation and in the management of its affairs, they are not trustees . . . to the individual stockholder, since they have no control over his shares."); O'KELLEY & THOMPSON, *supra* note 143, at 267 ("[A] director . . . owes fiduciary duties to the corporation, and to the shareholders collectively.").

145. It may seem that state entity-governance law could be an answer to concerns arising from institutionalization in the investment advisory context by virtue of the fact that many private funds formed under U.S. law (as opposed to under the law of so-called tax haven jurisdictions such as the Cayman Islands or the British Virgin Islands) are formed as limited partnerships—and, more specifically, Delaware limited partnerships. One suggestion is that, much as corporate directors owe fiduciary obligations to shareholders as a group, general partners owe fiduciary obligations to limited partnerships as a group. Indeed, the SEC threw its support behind this prospect in its 1985 adoption of Rule 203(b)(3)-1 under the Advisers Act, which specified that an adviser to a limited partnership may count the partnership, rather than each of its partners, as a client for purposes of the private adviser exemption under then-section 203(b)(3) of the Advisers Act. *See* 17 C.F.R. § 275.203(b)(3)–1(a)(2)(i) (2011). The SEC based the rule on the notion that an investment adviser to a fund does not manage the fund based on the investors' different investment objectives but instead manages the fund based on the investors' collective investment objectives. *See* Definition of "Client" of Investment Adviser for Certain Purposes Relating to Limited Partnerships, 50 Fed. Reg. 8740, 8741 (proposed Mar. 5, 1985) (to be codified at 17 C.F.R. pt. 275). However, in its adopting release, the SEC suggested that regulatory protections would be available to the limited partners (who, in light of the rule, would not have the protections of advisory clients) through "general partnership law," which may provide that a general partner owes certain fiduciary duties to the partnership's limited partners. *Id.* at 8741 n.17. That suggestion is problematic because it is not the case that state partnership law necessarily imposes fiduciary obligations on general partners. Under the Delaware Revised Uniform Limited Partnership Act, for example, to the extent that a general partner may otherwise be deemed to owe fiduciary duties to the limited partnership or to any of its partners (for instance, under common law principles), those "duties may be expanded or restricted or eliminated" by the partnership agreement, provided that "the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing." DEL. CODE ANN. tit. 6, § 17-1101(d) (2011).

reform would require that advisers owe obligations to two different constituencies (the fund and its investors), then the challenge would be to strike a balance between what obligations advisers should owe to the now-intermediated investors and what obligations they should owe to the intermediating institution, determining in the process how those obligations should be coordinated so as to avoid or mitigate conflicts between them.

Put another way, it would appear problematic if the obligations advisers owed to the fund, on one hand, and to its investors, on the other hand, were the *same* obligations. For example, if both the fund and its investors were entitled under the Advisers Act to provide consent as to an interested transaction proposed by the fund's adviser, then there surely would be a meaningful conflict if the investors, as a group, declined to allow the transaction to proceed but the fund opted to allow it (not an inconceivable result in light of the close relationship that typically exists between a private fund and its adviser). Whose preferences should take precedence and under what rationale? Before diving into that thicket, and with the hopes of avoiding it altogether, it is worth considering whether the types of obligations advisers should owe to the funds they manage are in any way different in kind from the obligations they should owe to the intermediated investors. If there is a difference, then presumably the two sets of obligations would not conflict with one another, and both the fund and its investors would be protected in the ways most relevant to the particular relationship that exists between each of them and the adviser.

As previously noted, advisers owe their clients obligations in connection with the actual process of buying and selling issuer securities on behalf of the clients' accounts.[146] It makes sense that those and similar obligations are owed to the person or entity on whose behalf the adviser is directly acting—that is, the *fund*, rather than its investors. The Advisers Act's disclosure and consent requirements are another matter, however. Take, for example, the requirements that advisers seek the consent of their clients under certain circumstances and provide certain types of disclosures to their clients.[147] A hedge fund, private equity fund, or other private fund that an adviser may manage cannot speak for itself and is not in a position to make decisions about its adviser's capabilities or track record (or anything else). Instead, such a fund is generally controlled by the adviser that formed it, and it is that adviser who generally speaks for the fund and makes decisions on the fund's behalf. In light of that circumstance, it serves little purpose to require the adviser to seek the fund's consent or to disclose conflicts of interest to the fund.

146. *See supra* notes 136–41 and accompanying text.
147. *See supra* notes 118–21 and accompanying text.

Moreover, if institutional investors, including intermediating entities such as private funds, are more market-savvy and more sophisticated, by whatever metric is used to measure "savvyness" and "sophistication," even where there *is* an arms-length relationship between the fund and the adviser, the Advisers Act's intricate consent and disclosure requirements may verge on expendable.[148] Conversely, it does make sense for the adviser to direct disclosure, consent, and similar types of obligations to the fund's investors—the investors being those who evaluate the adviser and determine whether to place capital with the adviser (by investing in the fund) or to take their capital off the table (by withdrawing it from the fund).

Indeed, these considerations suggest that, given its requirements that disclosure and requests for consent be directed at the fund, the current doctrine has become a proverbial round hole for the institutional square pegs to which it now applies. Accordingly, one might reasonably conclude that the obligations advisers owe their separate constituencies (institutions versus the investors in them) will not conflict because, quite simply, they are wholly different types of obligations. These considerations also suggest two components of a reformed investment-adviser regulatory regime. In particular, the changing landscape of advisory clients and the intermediation employed by unitary investors highlights that regulation should focus on the *ultimate* recipient of advisory services much more than the instrumentalities and mechanisms—such as private funds—through which advisory services have come to be provided. In other words, regulation should reflect that the range of protections the Advisers Act provides are unnecessary in the context of clients that are intermediating institutions and that, in those circumstances, an "antifraud-only" regime may be most suitable. Conversely, those protections may still be appropriate for individual or smaller investors who place assets in the intermediating institutions. An overlay to these considerations is the circumstance that advisers' activities for those who directly contract for advisory services (for example, a hedge fund, rather than its investors) should remain the subject of certain types of fiduciary obligations, namely, those pertaining to participation in the securities markets.

The implication of this analysis is that, in the context of investment adviser regulation, where an adviser manages a private fund, multiple beings and entities should collectively comprise the client to which the full range of the adviser's obligations are owed. Each of those subclients would effectively share with the other the full range of the Advisers Act's protections in connection with the adviser's activities managing the assets that the investors have contributed to the fund. Some of the adviser's

148. *See supra* notes 27–30 and accompanying text.

obligations would be owed to the fund, and others would be owed to the investors, based on their different statuses in the private-fund context. In this way, investors would be protected from multiple angles: they would have the disclosure that would allow them to evaluate the services provided by the adviser and would be entitled to consent to those transactions requiring "client" consent. The fund itself, however, would be deemed the client for purposes of the adviser's actions relating to investing and reinvesting the fund's assets. Accordingly, the adviser would retain the obligation to achieve "best execution" in entering into securities transactions and would be required to uphold fiduciary obligations in connection with its (or related parties') trading in the same or similar securities or instruments.

B. Conflicting vs. Coordinated Interests

The approach this Article proposes, in which advisers would have client-like obligations to the private funds they manage as well as to those funds' investors, may seem quite problematic at first blush. Any service that a professional provides is typically provided to a single person or entity. That is, in most professional contexts, the obligations owed to the client and the activities to be performed on his or her behalf typically are not subdivided among multiple disparate subclients. When, for example, a lawyer represents a client that is a corporation or other entity, numerous parties such as the corporation's executives and directors may be involved in the representation or speak on behalf of the corporation in connection with the representation.[149] Ultimately, however, the lawyer's obligations are owed only to the corporation and not to any of those individuals.[150] A similar analysis logically applies to other professionals, from architects to consultants to roofers to psychiatrists, though, to be sure, only in some contexts are the professional's obligations fiduciary in nature or the client-professional relationship imbued with special features, such as the attorney-client privilege or doctor-patient confidentiality.[151]

Moreover, professional relationships that do not follow the unitary client model highlight the intuitive concerns arising from an agent's attempt to serve two masters. The U.S. auditing profession provides one prominent example of this other paradigm, a by-product of the mandatory audit requirement that federal securities laws impose on

149. *See* Carl A. Pierce et al., Professional Responsibility in the Life of the Lawyer 400 (2011).
150. *See id.*
151. *See, e.g.*, Sonja R. West, *The Story of Us: Resolving the Face-Off Between Autobiographical Speech and Information Privacy*, 67 Wash. & Lee L. Rev. 589, 619 (2010) ("It is . . . generally accepted that certain relationships embody an implied promise of confidentiality. These relationships include an individual's dealings with her doctor, her banker, her clergy member, or her lawyer.").

public companies.[152] In the mandatory audit system, auditors' formal clients are the companies that engage them to perform the mandatory audit and whose boards of directors (through independent audit committees) manage the audit relationships.[153] The audit system also imposes on auditors an "obligation to serve an unspecified 'investing public,'" even though that investing public "neither hires, fires, nor controls the auditors."[154] However, the requirement that auditors, in effect, serve two masters places them in an untenable position that, among other things, renders true auditor independence impossible.[155] If a company's auditor has a type of fiduciary responsibility to the public, then to whom, as among the investing public, company management, shareholders, and creditors, shall the auditor owe its allegiance given that the interests of those constituencies will not often be aligned? Presumably, the auditor, as agent, cannot serve both masters faithfully.[156]

The concern that an adviser's having dual client allegiances will necessarily lead to the too-many-masters problem can perhaps be most readily addressed by the fact that, as contemplated in this Article, the adviser would owe the masters *two different kinds of obligations*. One way of thinking about this two-tiered division of obligations is to regard the adviser as providing two distinct types of client services: direct advisory services (to the fund, as the legal owner of the fund's investments) and indirect advisory services (to the investors, as the beneficial owners of those investments). To be sure, those distinct services would not be completely separate, in that they would be symbiotic and part of the same larger enterprise. But the point is simply that there is nothing important about the structure of the typical client-professional relationship or the assumed impossibility of an agent's serving two masters that is conclusive about the viability of implementing a two-tiered client structure in the investment advisory context.

Of course, even if one accepts from a theoretical perspective that the fiduciary and other obligations owed by an investment adviser in the private-fund context can or should be owed to multiple parties, there

152. *See* Sean M. O'Connor, *Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence*, 45 B.C. L. REV. 741, 820–27 (2004).

153. *See* Sean M. O'Connor, *Strengthening Auditor Independence: Reestablishing Audits as Control and Premium Signaling Mechanisms*, 81 WASH. L. REV. 525, 570–75 (2006).

154. *Id.* at 525; *see id.* at 571 ("[T]he statutory audit . . . put auditors in an untenable position serving many masters, while being controlled (*e.g.*, hired, fired, and paid) by the party that is in fact the agent to be audited."); *see also* United States v. Arthur Young & Co., 465 U.S. 805, 817–18 (1984) ("By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client . . . . [and] owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public.").

155. *See* O'Connor, *supra* note 153, at 572.

156. *See id.* (citing Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449, 449 (2002)).

remains the question of whether that approach would be workable in practice—that is, whether investment advisers realistically would be able to regard different "things" as their client for purposes of different obligations and requirements under the Advisers Act. Although the answer to that question must, at least in part, remain to be seen, the practices of investment advisers today suggest that, from the perspective of advisers themselves in connection with their day-to-day activities, the new approach should not present undue challenges. That is simply a product of the fact that the current doctrine, under which the fund is regarded as the client for all purposes, is sufficiently ill suited to how advisers generally run their businesses that, for many purposes, advisers have tended to regard their investors as "clients," notwithstanding that doctrine.

To be sure, investment advisers understand that, under the Advisers Act and under most states' investment-adviser regulatory regimes, the funds they manage are *technically* their clients. Yet when they speak of their "clients," they are almost always referring to the investors in those funds. The investors, after all, are the persons to whom an adviser must "sell" its investment strategy, as well as the ones whom the adviser must keep happy through solid performance, lest the investors determine to withdraw their capital and seek better investments elsewhere. Investors, in other words, are the persons to whom advisers regard themselves as providing their services, much like a client of any other professional is the person who engages the professional and to whom the professional provides its services. For investment advisers, the fund simply cannot be in that role, given that the fund is usually a creature of the adviser's own creation, formed entirely for the purpose of allowing the adviser to invest the assets of others. It has no real purpose or meaning apart from that facilitating function. As a result of advisers' somewhat purposeful confusion about the identity of their clients, then, it would be a short leap for them to regard their investors as clients in connection with at least some of their duties as advisers. Yet that leap would be significant, creating efficiencies by eliminating doubt and confusion among advisers as to whether *for regulatory compliance purposes* their obligations are appropriately directed to the fund or, rather, to its investors.

The framework this Article proposes, then, would transfer from the fund to its investors the sorts of protections under the Advisers Act that the investors would have enjoyed had they placed capital with the fund's adviser directly. It would reflect the changes in investment advisers' businesses over the past several decades, from one in which advisers had numerous discrete clients to one in which, for efficiency and flexibility reasons, they came to aggregate clients' assets into intermediating entities—hedge funds and other private funds—with each "client" owning his or her pro rata portion of the fund, based on the amount of capital contributed, as it has appreciated or depreciated over time. There is nothing about that change in the means of providing advisory services that calls for depriving those who have their assets at risk from regulatory protections designed for advisory "clients," however those protections should be revised or amended over time.

V. Further Refinements

There are, as one might suppose, some fairly apparent objections to this Article's reconceptualization of "client." One of these objections centers on the notion that providing regulatory protections to private-fund investors is unnecessary, given the financial sophistication standards they are required to meet in order to invest. The second arises from this Article's proposal that fund investors be deemed clients for certain purposes and is based on the long-standing and oft-recited notion that an investment adviser's services are necessarily personal to its clients, tailored to each client's particular needs and circumstances. A fund's investors, after all, almost certainly will not all have the same investment objectives and requirements. This Part will discuss each of these objections in turn.

A. Existing Regulatory Protections

This Article's proposal may appear to be little more than a straw man. In particular, one imagines that advisory clients of an earlier era were generally persons of means whose need for investing advice was perhaps greater than that of those whose assets were more meager. That assumption is consistent with the growth of private funds in the past several decades and the circumstance that many private-fund investors are those who, absent the intermediation provided by those pooled investment structures, would likely enter into asset management arrangements directly with investment advisers. Or, put another way, investments in private funds, like the direct client-adviser relationships they have supplanted, tend to be pursued by those who are better off and more financially sophisticated as compared with the public in general. If that is the case, the question is obvious: Why do wealthy investors such as those who invest in private funds need the protections of the Advisers Act or any other laws and regulations governing investment advisers?

The short answer is that they may not. For example, if the financially sophisticated persons who engage an investment adviser directly were not entitled to the regulatory protections—whatever those protections may be—to which less sophisticated advisory clients were entitled, then arguably those persons should similarly not be entitled to the protections in connection with their investments in private funds managed by the adviser. However, such a distinction based on wealth or sophistication has not, since the beginning, been embodied in the

Advisers Act. Rather, under the Advisers Act, investment advisers become subject to regulation under that Act based on their activities managing assets, regardless of the wealth or sophistication of the persons who own those assets.[157]

The determination that clients' financial sophistication does not matter for regulatory purposes is simply a policy matter. Upon additional reflection and debate, it may indeed be the case that the best model for investment adviser regulation is one in which clients' (and investors') financial sophistication (however that might be measured) is taken into account, with the more financially sophisticated clients (and investors) beyond the purview of regulatory protection. That sort of extensive analysis is beyond the scope of this Article. This Article's argument is simply that, to the extent that policy governing investment advisers' relationships to their clients does not contemplate a distinction among clients based on wealth or financial sophistication or any other metric, then neither should advisers' relationships to the investors in the funds that they manage reflect any such distinction. Put another way, the current difference in regulatory treatment as between direct clients and fund investors is merely form over substance. What that "substance" is, however, is always up for debate.

There is an obvious retort to this argument, however, which is that, in fact, a client's move from a direct advisory relationship (and the regulatory protections it involves) to an indirect relationship through investing in a private fund involves a change of substance as well as form. That assertion is based on the securities laws governing the issuance of securities: Hedge funds and other private funds, like any other issuers, must offer their partnership interests, shares, units, or other securities in compliance with federal and state securities laws.[158] Whereas some issuers wish to offer their securities publicly and therefore must register those securities under the Securities Act of 1933, hedge funds and other private funds, by definition, offer their interests privately.[159] The particular

157. *See* 2004 Proposed Rule, *supra* note 47, at 45,173 ("While provisions of the Securities Act . . . provide exemptions from registration under that Act for securities transactions with persons . . . that have such knowledge and experience that they are considered capable of fending for themselves and thus do not need the protections of the applicable registration provisions, the Advisers Act does not. . . . The Advisers Act is intended to protect all types of investors who have entrusted their assets to a professional investment adviser.").

158. In particular, at the federal level, section 5 of the Securities Act provides,

> Unless a registration statement is in effect as to a security, it shall be unlawful for any person . . . to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security . . . or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale . . . .

15 U.S.C. § 77e (2010). Any issuer not complying with section 5 needs to meet the requirements of an exemption from registration set forth in section 4 of the Securities Act. *See id.* § 77d.

159. The particular exemptions from registration under the Investment Company Act on which

requirements to which they must adhere are set forth in the private-placement safe harbor of Regulation D under the Securities Act.[160]

Under section 506 of Regulation D, an issuer is deemed to be making a private offering of securities—and, therefore, will not be subject to the registration requirements of the Securities Act—if, among other things, the offering is made only to "accredited investors" and no more than thirty-five non-accredited investors.[161] If a prospective investor is not "accredited," then the issuer must provide to the investor a disclosure document containing generally the same type of information about the issuer and its finances and operations as would be contained in a registration statement if the issuer were required to register the securities under the Securities Act.[162] The theory underlying these requirements is that there is no policy basis for applying the protections of the Securities Act to wealthy investors because those investors are either sophisticated or able to engage competent financial professionals to assist them.[163]

Accordingly, the laws and regulations pursuant to which private funds are required to offer their interests provide that unless a prospective private-fund investor has a certain net worth or income level, the fund must provide to the investor the sort of disclosure that publicly traded companies, including mutual funds, are required to supply to their investors. Because those requirements are specific to issuers of securities, and because direct advisory relationships generally do not involve the issuance of securities,[164] the requirements do not apply to direct advisory relationships—meaning that direct advisory clients do not need to qualify as accredited investors, nor, therefore, are they entitled to receive a disclosure document in the event they do not meet the accredited investor standards. As a result of these requirements, then, one conclusion (again, a retort to the form-over-substance argument

hedge funds and most other private funds rely require that the sales of the funds' securities be made in a manner not involving a public offering. *See* 15 U.S.C. § 80a-3(c)(1), (7) (2010).

160. 17 C.F.R. §§ 230.501–508 (2011).

161. *See* 17 C.F.R. §§ 230.501(e)(1)(iv), 230.506. As defined in Regulation D, "accredited investors" include individuals (that is, natural persons) whose net worth (combined with that of her spouse) exceeds $1,000,000 (not including the value of the individual's primary residence) or whose income in the two most recent years exceeded $200,000 (or joint income with her spouse exceeded $300,000) and who expects generally the same income level in the current year. *See* 17 C.F.R. § 230.501(a)(5)-(6).

162. *See* 17 C.F.R. §§ 230.502(b), 230.506.

163. *See* Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole*, 35 DEL. J. CORP. L. 151, 169 (2010).

164. There are some exceptions to this. For example, largely for tax reasons, some direct advisory relationships have been established using a partnership or LLC, with the advisory client being the only investor in the entity. For all practical purposes, it is a direct advisory arrangement. Nonetheless, the client buys a security when it contributes its capital to the entity, and the entity therefore must comply with the securities laws in accepting that capital.

presented above) might be that this additional layer of regulation renders it somehow safer or more protective for investors to place their capital in a private fund managed by their adviser of choice rather than to enter into a direct advisory relationship with that adviser.

This prospect, too, may be discounted. As others have pointed out, the private-placement rules under Regulation D do not provide any particular substantive protections. Rather, they provide the framework for an "antifraud-only" private-placement market, in which "issuers are constrained primarily by the dictates of antifraud rules prohibiting intentional wrongdoing."[165] To be sure, the requirement that issuers not intentionally mislead their investors or otherwise engage in intentional misconduct vis-à-vis their investors may seem to be some measure of protection. However, there is some doubt as to whether it amounts to much. Indeed, a few commentators have been particularly critical of the antifraud-only nature of the private-placement market, at least insofar as individual investors are participants. One claim is that, although an antifraud-only regulatory structure may be suitable for institutional investors, individual investors need more protections.[166] Another claim is that the section 506 offering has become, in the words of one state regulator, "a favorite vehicle for fraudulent transactions."[167] At the heart of those concerns is the anxiety, voiced by other commentators, that Regulation D's accredited-investors requirement means only that private-placement investors will be wealthy; it does not mean they will be sophisticated.[168]

For present purposes, more important than the perceived inadequacies with the regulatory protections afforded by the private-placement markets is that antifraud obligations required of issuers in those markets are obligations to which all other participants in the securities markets are subject as well.[169] Therefore, they provide no particular protections that investors would not have if, instead of participating in, say, a private fund's offering, they invested in the public

165. Johnson, *supra* note 163, at 197.

166. As Jennifer Johnson has noted, "[A]ntifraud-only markets may be acceptable for institutional players, but they are not designed for individual investors. . . . While such individuals may in fact qualify as accredited investors under the wealth standard formulated in 1982, there is a growing recognition that such individuals need some protection from the schemes of the unscrupulous." *Id.* at 197–98.

167. *Id.* at 188. Johnson further notes that "over half of the complaints state regulators receive involve securities fraud resulting from nonpublic offerings directed to senior citizens." *Id.* at 189.

168. *See* Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291, 299 (1994) (arguing that the logic that accredited investors will "have the bargaining power or sophistication to demand and obtain" thorough disclosure about an issuer without legal action "breaks down" for accredited investors whose "status stems from their income level or net worth").

169. *See, e.g.*, 15 U.S.C. § 77a (2010) (setting forth a Securities Act prohibition on fraudulent interstate securities transactions).

securities markets or sought advice from a broker-dealer—or entered into a direct advisory relationship with the fund's investment adviser. To sharpen that point: The applicability of the securities laws to an investor's indirect placement of assets with an investment adviser through a private fund produces no regulatory protections that were not already there to begin with. Arguably, however, it does result in *less* regulatory protection as compared with entering into a direct advisory relationship, in that, in the latter context, the adviser is obligated to provide ongoing disclosure (on at least an annual basis) and subject to consent and certain other substantive requirements that are not part of the private-placement regulatory regime.

That realization does not dispose of the prospect that the rules governing private funds' offerings *could* provide additional protections to investors. Much like the discussion above regarding whether clients' wealth or sophistication should matter for purposes of the Advisers Act's regulatory scope, this prospect is simply a matter of policy. Accordingly, just as the Advisers Act can be amended and revised to reflect new analyses and conclusions regarding whether wealthy clients should be given the Act's protections, so could the rules governing how private funds offer their securities be amended to reflect new conclusions about the extent to which individual investors require additional protections in connection with their evaluating and buying those securities. In theory, the securities laws could be structured such that investors in private placements would be entitled to an array of regulatory protections, such as extensive disclosure about the issuer or possibly specified voting and consent rights.[170] Certainly that could give one who invests in a private fund an equivalent degree of regulatory protection, as compared with that person's entering into direct advisory arrangement.

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170. Such a change would bring regulation of private funds closer to the regulatory system governing mutual funds and other regulated funds, a prospect that perhaps raises the further question of whether the best approach for addressing regulatory problems associated with private funds might be to eliminate the concept of a private fund. That is, perhaps all investment vehicles—regardless of the number or financial sophistication of their investors—should be required to register under the Investment Company Act. That approach, however, does not seem desirable, largely because of the operational efficiency and investment flexibility permitted by freedom from Investment Company Act regulation. That efficiency and flexibility has value in the financial and capital markets, promoting market liquidity and price discovery, reducing market volatility, and providing portfolio-diversification tools. *See* Dan Awrey, *The Limits of EU Hedge Fund Regulation*, 5 LAW & FIN. MKTS. REV. 119, 119 (2011). In light of these considerations, this Article proceeds on the basis that private funds serve important functions in the financial markets and that tailored regulatory changes such as those this Article proposes can address the concerns arising from institutionalization while preserving the flexibility and efficiency that characterizes private funds.

B. Personalized and Tailored Advice

A second possible objection to the approach advocated in this Article is based on the longstanding and widely shared notion that an investment adviser's relationship to each of its clients is personal, with the adviser tailoring its investment advice to suit each client's particular investment needs and goals. As discussed above, this notion is as old as the Advisers Act itself and has endured thanks in part to the Supreme Court's recognition and apparent endorsement of it. The 1985 case *Lowe v. SEC*[171] contains perhaps the strongest affirmation. That case involved a company, Lowe Management Corporation, whose registration as an investment adviser was revoked by the SEC after the firm's president and primary shareholder, Christopher Lowe, was found to have engaged in a variety of fraudulent activities, including misappropriating client funds and stealing from a bank.[172] In addition to revoking the firm's registration, the SEC had ordered Mr. Lowe not to associate with any investment advisers going forward.[173] Despite all of that, Mr. Lowe proceeded to publish a newsletter relating to securities investments, which from time to time he distributed to subscribers.[174] In response, the SEC sued Mr. Lowe, seeking to enjoin him from publishing his newsletter on the basis that, by doing so, he was "engaged in the business of advising others 'as to the advisability of investing in, purchasing, or selling securities.'" In other words, the SEC believed he was acting as an investment adviser and, by virtue of using the mails in connection with his business, was in violation of the registration requirement of the Advisers Act.[175]

In reversing the Second Circuit's decision in favor of the SEC, the Supreme Court held that Mr. Lowe's activities fell within an exclusion in the Advisers Act's definition of "investment adviser" for a publisher "of any bona fide newspaper, news magazine, or business or financial publication of general and regular circulation," notwithstanding Mr. Lowe's inauspicious history and that he published his newsletter only sporadically and not according to a regular publication schedule.[176] The Court's reasoning centered in large part on its observation, based on its understanding of the Advisers Act's origins and legislative history,[177] that the Act was "designed to apply to those persons . . . who provide

171. 472 U.S. 181 (1985).
172. *Id.* at 183.
173. *Id.*
174. *Id.* at 184–85.
175. *Id.* at 184 (citation omitted).
176. *Id.* at 208–11.
177. The Court noted that the Act's "legislative history plainly demonstrates that Congress was primarily interested in regulating the business of rendering personalized investment advice." *Id.* at 204.

personalized advice attuned to a client's concerns,"[178] and was not intended to encompass those who published materials that were not personalized or tailored to any particular person's needs or to any particular portfolio and that were not tied to specific market activity or events.[179]

One apparent inference from *Lowe*, then, is that when each "client" receives investment advice as one of several investors in a private fund sponsored by the adviser—and thereby receives exactly the same advice as each other investor in the fund—it is difficult to argue that the advice is in any way "personal" to the client or tailored to his or her particular circumstances. This concern would seem to be particularly pronounced in light of a number of statements in the Act's legislative history that the *Lowe* Court recited. For example, the Court pointed to a 1939 report of the SEC ("SEC Report"),[180] prepared at Congress's direction for the purpose of making recommendations as to the regulation of investment companies and investment advisers. This Report documented a belief held by at least some in the investment advisory industry that investment advisers' mandate was to serve "individuals and institutions with substantial funds who require continuous supervision of their investments and a program of investment to cover their *entire economic needs*."[181] The Court additionally pointed out that industry representatives perceived a distinction between the "functions" of "investment counselors" (in other words, investment advisers) and those of investment companies or, as they were sometimes called, investment trusts (that is, public investment funds). For support, the Court quoted the views of one such representative, who testified that "the ordinary investment trust . . . . takes no cognizance of [an investor's] total financial position in investing his money for him, and . . . gives [the investor] no judgment in the matter whatever."[182] Not only, then, was investment advisers' "true function" to "give advice in connection with the specific

178. *Id.* at 207–08.

179. *Id.* at 208–11.

180. SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 76-477 (1939).

181. *Lowe*, 472 U.S. at 192–93 (emphasis added) (citing SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 76-477, at 25 (1939) (internal quotation marks omitted)).

182. *Id.* at 193 n.34 (quoting SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 76-477, at 26–27 (1939) (testimony of James N. White of the investment advisory firm Scudder, Stevens & Clark)). The Court further quoted Mr. White's reaction to the statement that an investment trust differs from an investment "counselor" in that it "does not give the advice with the peculiar, particular, specific financial condition of the individual [investor] and what he hopes to accomplish, for what purpose." *Id.* In implied agreement, Mr. White responded, "Might I also add that in a number of cases at least . . . the investment trust managers do not consider their funds as a proper repository for all of an individual's capital. It is not [only] that it doesn't consider only his personal peculiarities and needs, but it does not give him a complete financial program." *Id.*

condition of a particular individual,"[183] but it was also seen to be providing advice as to *all* of that individual's investments.

Based on *Lowe*, one might conclude that fund investors cannot be considered advisory clients because one necessary characteristic of client status is ongoing receipt of investment advice formulated specifically for the particular client and her entire investment portfolio, in light of her financial circumstances and goals. Indeed, in 2006 the D.C. Circuit embraced this conception of investment advisory services in reaching its conclusion in *Goldstein v. SEC*.[184] The D.C. Circuit invalidated the SEC's attempt to effectively change the definition of "client" to mean fund investors (rather than the fund itself) solely for purposes of a registration exemption under the Advisers Act on which many hedge fund managers had relied to avoid being regulated by the SEC.[185] Relying in part on *Lowe*, the *Goldstein* court concluded that a hedge fund's investors cannot be considered clients of the fund's investment adviser.[186]

The long-standing principle that investment advice is necessarily personalized and tailored to the client gives rise to perhaps the most formidable objection to the reformulation of "client" that this Article proposes. However, when more closely evaluated, it becomes apparent that the objection is hollow. To see this requires delving into how the principle came to be. A good place to start is the 1939 SEC Report on which the *Lowe* Court relied. The Report comprised a survey of investment counsel and their services at the time and was intended to "indicate[] the growth, development, and magnitude of the investment counsel business and point[] out some of the problems which appear[ed] to be present or inherent therein."[187] The survey expressly did not encompass any advisers who provided investment advice "solely through

183. *Id.* The Court also quoted the testimony of Charles M. O'Hearn, vice president and director of Clarke, Sinsabaugh & Co., before a Senate subcommittee during hearings on the bill that became the Advisers Act:

> [The investment adviser profession] is a personal-service profession and depends for its success upon a close personal and confidential relationship between the investment-counsel firm and its client. . . .
>
> . . . .
>
> Judgment of the client's circumstances and of the soundness of his financial objections and of the risks he may assume. Judgment is the root and branch of the decisions to recommend changes in a client's security holdings.

Id. at 196 (emphasis omitted) (quoting *Senate Hearings*, *supra* note 76, at 713–16).

184. 451 F.3d 873 (D.C. Cir. 2006).

185. The SEC's change effectively meant that those investment advisers were required to register as investment advisers under the Advisers Act (and, therefore, to be subject to the SEC's regulation) because the exemption turned on an adviser's having fewer than fifteen "clients." *Id.* at 876.

186. *See id.* at 880.

187. SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 76-477, at 1 (1939).

publications distributed to a list of subscribers and did not furnish specific advice to any client."[188]

To gather data for the Report, the SEC asked investment advisers to complete a questionnaire seeking basic information about their firms, such as their form of organization, number of employees, and types of clients, and about their activities, such as the nature of their services, their affiliations with "investment trusts and investment companies," their other business activities, the extent of their control over client accounts, their "investment policies," the "type, number, and size" of their clients' accounts, and the business experience of their officers and directors.[189] The SEC primarily based its Report on the answers provided by the 394 advisers who completed the questionnaire.[190] However, the Report additionally included statements of representatives of certain investment advisory firms who had testified regarding the "status, functions, general problems, and possible regulation[] of investment counsel organizations" at a February 1938 "public conference" that the SEC had sponsored.[191]

Consistent with *Lowe*, the SEC Report reports that one function of investment advisers is to provide investment advice "on a personal basis."[192] Among other supporting evidence, the Report cited the testimony of one investment adviser representative, who had replied in the affirmative to the SEC's asking whether investment advisory services arose both to provide "a disinterested, impartial appraisal of the intrinsic merits of a particular investment" an individual might be considering, and to determine "whether that was the type of investment that would fit into [the individual's] general personal investment program."[193] Indeed, the SEC questioner surmised (with approval from the representative) that the personalized advice provided by "legitimate" investment advisers is what distinguished them from "individuals who are professed tipsters,"[194] whose activities served to undermine the investment advisory profession and to support the call for investment adviser regulation. Drawing on its understanding that investment advice was, or at least could be, specially formulated for each client, the SEC was able to draw a distinction between the good and the bad in the investment advisory profession. On one hand was the adviser who "desires to give that impartial scientific professional advice to persons who are trying to plan

188. *Id.*

189. *Id.* at 2.

190. *See id.*

191. *Id.*

192. *Id.* at 23; *see also id.* at 30 ("[I]n fact, the contract or relationship between investment counsel and client is a personal one . . . .").

193. *Id.* at 24–25.

194. *Id.* at 25.

their economic situation in the light of accomplishing various results, making provision for old age, education, and so forth," and, on the other hand, were those advisers seeking to make a quick buck for themselves by recommending a particular stock to anyone who would listen.[195]

That distinction is reminiscent of the distinction drawn by the *Lowe* Court, where those providing "personalized" advice relating to securities were deemed investment advisers, while those providing stock recommendations to *unlimited subscribers* were not so deemed.[196] Admittedly, the distinction highlighted in the SEC Report (legitimate advisers versus "professed tipsters") is one between legitimate and illegitimate advisory activities, whereas the distinction made in *Lowe* (investment advisers versus publishers) is one between two legitimate professional activities. For present purposes, that difference does not matter. The important point is that both in legislative history and in case law, advisers are seen to provide personalized and tailored advice not necessarily because that is the defining characteristic of providing investment advice but rather because it is a characteristic, present in at least some investment advisory relationships, that is the exact *opposite* of "advice" provided to *anyone who will listen*. However, finding that advice spread far and wide is not really investment advice need not exclude *impersonal* advice from the category of investment advice, so long as that advice is not provided to the *public at large*. History has heavily influenced the perception that an advisory relationship has to be tailored to the specific needs of the client who receives it, but the perception is merely that: a perception. When we view the meaning of the term "personal" more broadly, as meaning not public or available to all, it ceases to constitute an obstacle to the reconceptualization of "client" this Article proposes.

Indeed, that is how the SEC itself seems to view "personal," in light of some of its interpretations of what constitutes giving investment advice. Although the *Lowe* holding removed bona fide publications of general and regular circulation from the menu of the ways in which one may be deemed to be providing investment advice, the holding did not implicate another form of publication that the SEC continues to view as investment advice: the issuance of research reports on particular companies.[197] The issuers of such reports, which are the product of an

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195. *Id.*

196. *See supra* notes 177–79.

197. *Cf.* Regulatory Flexibility Agenda, 59 Fed. Reg. 58,626, 58,630 (1994) ("The [SEC] Division of Corporation Finance is considering recommending that the Commission propose rules intended to ensure that investors who read . . . *research reports[] and other investment advice* regarding specific securities will receive adequate disclosure when issuers, underwriters and dealers have paid for the published investment advice." (emphasis added)); Charterhouse Tilney, SEC No-Action Letter, 1993 WL 277798, at *5–6 (July 15, 1993) (setting forth that the SEC staff would not require a non-U.S. broker-dealer that furnished research reports to "major U.S. institutional investors" to become

analyst's evaluation of subject companies, typically do not distribute them in the manner of bona fide publications (as defined in *Lowe*) and hence cannot avail themselves of the *Lowe* doctrine.[198] Rather, those who publish research reports typically make those reports available for purchase by investors who, for their part, purchase any given report based on their interest in the company the report covers. Accordingly, investors select which publications they receive in light of their personal investment needs and forego the others. However, it cannot be said that these types of research reports are in any way "personal" to their ultimate consumers: every buyer of a particular report receives exactly the same content. Yet the SEC deems the issuers of research reports to be "investment advisers" to the same extent as a financial planner providing customized advice regarding all aspects of its clients' portfolios.[199] That may seem incongruent with the Advisers Act's legislative history, focusing as it does on personalized advice as the defining characteristic of an investment adviser, and *Lowe's* heavy reliance on that definition.

Lowe and the SEC Report's history have obfuscated the matter, encouraging the perception that investment advice somehow needs to be tailored to each particular client. Indeed, one need look no further than the definition of "investment adviser" under the Advisers Act to realize that such an interpretation cannot be correct. Under the Advisers Act, an investment adviser is anyone who,

> for compensation, engages in the business of advising others, either directly *or through publications or writings*, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, *issues or promulgates analyses or reports concerning securities*.[200]

Under that definition, the issuance of publications and reports constitutes giving investment advice (unless those reports or publications fall within the publisher's exemption that *Lowe* articulated). But it is difficult to comprehend how providing advice through reports and publications is consistent with the notion that investment advice has to be personalized and tailored, unless "personalized" and "tailored" mean something different from what the *Lowe* and *Goldstein* courts assumed they mean—or unless, despite the oft-cited testimony to the contrary,

registered with the SEC as an investment adviser where, among other things, the broker-dealer distributed the reports in a manner designed not to induce transactions in the securities described in the report).

198. These issuers are often able to avoid registration as investment advisers, however. In the U.S. investment industry, research reports are typically the product of research conducted by registered brokerage firms that, given their registration status, can rely on an exemption from investment adviser registration specifically for registered broker-dealers. *See* 17 C.F.R. § 275.202(a)(11)-1 (2011).

199. *See supra* note 197 and accompanying text.

200. *See* 15 U.S.C. § 80b-2(a)(11) (2010) (emphasis added).

"personalized" and "tailored" are not particularly relevant concepts in determining whether someone is providing investment advice. The latter possibility garners further support from the fact that the definition of investment adviser quoted above also contemplates that investment advice need not even be "direct," but instead can be provided through publications and reports.[201]

From a pragmatic perspective, moreover, it has to be the case that an investment adviser need not provide advice as to all of its clients' portfolios. Given the range and possibilities of investment strategies and objectives, investment advisers, like any professional, necessarily develop and focus on—and market—particular strengths. That different investment advisers cover different areas of the investment universe is only desirable, in that it permits specialization and the development of expertise. Arguably, that fact by itself makes it wholly inappropriate for a single investment adviser to advise its clients on all aspects of their portfolios, given the well-accepted premise that investors should diversify their holdings. Even outside the fund context, such as advisory arrangements made directly between clients and advisers, an adviser's advice will fall within a limited spectrum of investments. Consistent with that reality, the client will not have placed all of her assets in the account the adviser manages. If advisers ever were defined by their provision of all-encompassing investment advice, the world has simply become too complex for that to be the case today.

In short, there is nothing about investment advice or advisers' fiduciary duties under the Advisers Act that requires that the advice be personalized or tailored or otherwise specially designed for each particular recipient of the advice. Accordingly, it is consistent with the extant investment-adviser legal and regulatory regime for fund investors to be deemed advisory clients, notwithstanding that the advice each of them receives in connection with their investment is identical to the advice afforded every other investor. That possibility, additionally, eliminates concerns that typically arise in the multiple-client context in which advisers are obligated to provide personalized advice to each separate client. In the latter context, there typically arise concerns that the adviser may have the opportunity or incentive to favor certain clients over others, particularly if the fee arrangements among clients differ. When each client is to be treated the same as each other client, and each

201. This analysis also suggests that statements to the effect that investment advisers necessarily advise their clients as to the entirety of their portfolios, which are scattered through the legislative history and the SEC Report, should carry little weight. It is not just that such pronouncements are contrary to fact and the SEC's current view of the issue. Rather, if an investment adviser qualifies as such simply by virtue of its issuing publications and reports about securities, that adviser virtually ipso facto is not providing comprehensive advice to its clients.

client is aware of that fact, the thorny problem of how best to dissipate possible conflicts of interest dissolves.

Conclusion

The institutionalization phenomenon extends beyond the context in which it is typically evaluated—the relationship of investors to corporate issuers. It pervades relationships in the financial industry, particularly that between investment advisers and their clients. This Article has demonstrated that the growth of private funds in the past few decades has institutionalized the provision of investment advisory services and led to the intermediation of the relationship between advisers and those who, in a previous era, would be their clients but who, today, are investors in the funds they manage. However, as this Article has also shown, regulation of investment advisers has not kept up with those developments, to the detriment of individuals and smaller investors who seek advisory services. This Article has argued that investment adviser regulation should expressly acknowledge the institutionalization of advisory clients, through entitling private-fund investors to certain rights held by those deemed clients under the Advisers Act and its rules. Through the broader understanding of the nature and evolution of investment adviser regulation entailed by those changes, such regulation would, one hopes, continue to further investor protection—the original and arguably primary mandate of securities regulation.

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