

2010

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Recommended Citation

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 (2010), <https://digitalcommons.law.uw.edu/faculty-articles/9>

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MOVING BEYOND THE CLAMOR FOR “HEDGE FUND
REGULATION”: A RECONSIDERATION OF “CLIENT” UNDER
THE INVESTMENT ADVISERS ACT OF 1940

ANITA K. KRUG*

I. INTRODUCTION

THE Investment Advisers Act of 1940 (the Advisers Act)¹ regulates investment advisers and requires some investment advisers to become registered with the SEC. Registered investment advisers must comply with the substantive provisions of the Advisers Act.² The Advisers Act, like its companion statute, the Investment Company Act of 1940 (the Investment Company Act),³ was a final component of the post-Depression overhaul of the securities regulatory system and a product of the heightened and broadened interest among the public in investing in public securities.⁴ In the eyes of Congress, the public’s expanding investment activities provided opportunities for people who advised investors on securities to engage in activities that were not in the investors’ best interests—whether because the advisers’ advice was less than objective or because the advisers were merely “tipsters” seeking to promote interest in certain securities for their own personal benefit.

For those in the then-nascent investment advisory industry, the Advisers Act was perceived as an incursion of federal power into the “close personal and confidential relationship between the investment-counsel firm and its client.”⁵ In the wake of the recent upheaval in the financial markets and the perception that hedge funds helped cause it, however, the

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1. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (2006).

2. Under the Advisers Act, an “investment adviser” is someone who “for compensation, engages in the business of advising others . . . as to the advisability of investing in, purchasing, or selling securities.” *Id.* § 80b-2(a)(11).

3. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64.

4. See SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES: INVESTMENT COUNSEL, INVESTMENT MANAGEMENT, INVESTMENT SUPERVISORY, AND INVESTMENT ADVISORY SERVICES, H.R. DOC. NO. 76-477, at 5 (2d Sess. 1939) [hereinafter SEC REPORT].

5. *Investment Trusts and Investment Companies: Hearings 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, Sin-sabaugh & Co., Investment Counsel) (speaking against S. 3580, a “bill proposed

1940 description of investment advisers betrays a transformation of the investment advisory industry, from one in which clients engaged advisers to counsel them on their overall investment needs to one in which hedge fund investors are drawn to hedge fund managers' proprietary strategies.

Emblematic of that evolution, prevailing doctrine and jurisprudence do not, in many respects, countenance that investment advisers may aggregate assets into hedge funds, private equity funds, and other private funds and manage those funds, rather than manage numerous separate client accounts.⁶ Moreover, to the extent prevailing doctrine contemplates those aggregated arrangements, it regards the fund itself, rather than its investors, as the "client" of the adviser, in a nod to the formality that the fund (as opposed to its investors) is the direct recipient of the investment advice provided by the fund's investment adviser.⁷

By denying client status to hedge fund (and other private fund) investors, the current doctrine has had the effect of under-regulating investment advisers that manage private funds, particularly because those advisers do not owe fund investors the fiduciary duties that they owe to their "clients"—the funds themselves. In addition, and counterintuitively, that doctrine arguably impedes efficiency in asset allocation and, ultimately, capital formation. Both effects are potentially significant, considering the billions of dollars invested in private funds managed by U.S. investment advisers and heightened investor worries in the aftermath of the Madoff fraud and other high-profile fraud cases. Beyond those effects, the current doctrine gives rise to theoretical and practical anomalies and creates uncertainties for both investors and investment advisers. Further, although Congress may be expected to eliminate the exemption from Advisers Act registration on which many investment advisers to private funds

for the regulation of the investment-counsel profession," because, among other things, it was "against public interest").

6. That oversight is due, at least in part, to the circumstance that, in the early years of the investment advisory industry, investment advisers' clients tended to be individuals who directly engaged the advisers for their services. See SEC REPORT, *supra* note 4, at 8-9 (noting that SEC's 1936 survey of investment advisory firms showed that "individual or personal accounts represented about 83% of all the accounts administered" by responding advisers); see also *Senate Hearings, supra* note 5, at 723 (statement of Dwight Rose, President, Investment Counsel Association of America) (explaining that "sole function" of firms with ICAA membership was "to render to clients, on a personal basis, competent, unbiased, and continuous advice regarding the sound management of their investments"); *id.* at 715 (statement of Charles M. O'Hearn, Vice President & Director, Clarke, Sinsabaugh & Co., Investment Counsel) (noting that his firm's clients were "men and women of means who are very critical in their examination of our performance" and who, "[i]f they disapprove[d] of our activities," would "cancel their contracts with us").

7. See, e.g., *Goldstein v. SEC*, 451 F.3d 873, 879 (D.C. Cir. 2006) (concluding that hedge fund investors are not appropriately deemed "clients" under Advisers Act in part because "[a]n investor in a private fund may benefit from the adviser's advice (or he may suffer from it) but he does not receive the advice *directly*"); see also *infra* notes 30-52 and accompanying text (discussing cases explaining nature of investment advisers' relationships to their clients).

(or “hedge fund managers,” as they are often called in the hedge fund context) rely,⁸ that change, as presently contemplated, would not adequately ameliorate these concerns and perhaps would even delay the day when regulators address them.

This Article argues that, from both theoretical and pragmatic perspectives, a better approach would be for law to regard private fund investors as clients of the managers of those funds for all purposes under the investment advisory regulatory regime. In making these arguments, it dissects the doctrinal and historical underpinnings and sources of the current doctrine—legislative history and case law, in particular, but also SEC interpretations and rule changes. In light of the policy considerations—including investor protection—that gave rise to the Advisers Act, the growth of the investment advisory industry and private funds’ role in it, and lessons learned from recent turmoil in the financial markets, a doctrine that regards private fund investors as the clients of the funds’ managers is more coherent and better policy.

Part II discusses the current regulatory regime governing investment advisers, including the exemption from investment adviser registration that many large fund managers have relied on to avoid SEC regulation, which considers each fund a single client. Reviewing prominent cases on investment adviser regulation and obligations, Part II also traces the origins of the doctrine that the person who is the direct recipient of an investment adviser’s services is to be regarded as the client of that adviser—which, in turn, has been employed to support the doctrine that a fund (rather than its investors) is the adviser’s client. Part III surveys some of the implications and incongruities arising from that doctrine, including the effective under-regulation of large investment advisers and augmentation of agency costs and other inefficiencies. It also discusses how recent and likely legislative changes are unlikely to remedy those deficiencies. Part IV discusses the misunderstanding of the adviser-client relationship and the misinterpretation of precedent evident in recent, prominent cases supporting the current doctrine. It further shows that current doctrine is contrary to—or at least gains no support from—the legislative history of the Advisers Act. Part V focuses on an alternative doctrine, one in which fund investors are deemed clients for purposes of investment advisers’ regulatory obligations. That Part posits both that this alternative doctrine alleviates incongruities in current regulation and that it is consistent with fiduciary principles.

II. THE FUND-CLIENT DOCTRINE

Investment advisers may advise individuals and institutions—such as pension plans, foundations, and endowments—separately from one another. In these so-called “separate account” arrangements, an individual or institution generally places assets in an account held by a custodian of

8. See 17 C.F.R. § 275.203(b)(3)-1(a)(2)(i) (2009).

that individual's or institution's choosing and gives investment authority to the investment adviser that will manage those assets, effectively handing to the adviser the "keys to the car" for investment purposes only. The terms and conditions of the advisory relationship are generally contained within an investment advisory agreement to which only the individual or entity and the adviser are parties.

Alternatively, investment advisers may manage capital on an aggregated basis. In those circumstances, individuals and entities "pool" their assets in a single investment vehicle, such as a partnership or an offshore company. The investment adviser then enters into an investment advisory agreement with the pooled investment vehicle—known as a "fund" in common parlance—rather than with any of its investors (or, if also serving as the fund's general partner or managing member, enters into a partnership or LLC agreement with *all* of the investors).

Some of those funds, including so-called "mutual" funds, are "public," in the sense that they become registered as investment companies under the Investment Company Act and, by virtue of doing so, may offer their interests publicly and become obligated to comply with the full range of substantive regulations set forth in that Act. Other funds, such as so-called "hedge" funds and private equity funds, are "private," meaning that they rely on exemptions from having to register as "investment companies" under the Investment Company Act. Or, more precisely, these funds comply with one of the exclusions from the definition of "investment company" set forth in Sections 3(c)(1) through 3(c)(7) of the Investment Company Act.⁹ In the case of both private funds and registered investment companies, under relevant statutes, regulations, and case law, the fund itself, rather than its investors, is deemed the client of the investment adviser that manages the fund.

A. *The Advisers Act and SEC Regulation*

The Advisers Act embodies the principle that the fund is its adviser's client. That principle—the "fund-client doctrine," for the sake of expediency—can be seen most readily in one of the Advisers Act's exemptions permitting certain investment advisers to remain unregistered, regardless of how much capital the advisers manage. In particular, pursuant to the so-called "private adviser exemption" of Section 203(b)(3) of the Advisers Act, an investment adviser that has fewer than fifteen "clients" and does not hold itself out publicly as an investment adviser does not need to become registered with the SEC as an investment adviser.¹⁰ Section 203 further provides that, for purposes of determining whether an adviser has fewer than fifteen clients, corporations, limited partnerships, LLCs, trusts,

9. See 15 U.S.C. § 80a-3(c)(1)-(7) (2006) (listing securities issuers that are excluded from definition of "investment company" under Investment Company Act).

10. See 17 C.F.R. § 275.203(b)(3)-1(a)(2)(i).

and other organizations to which an adviser provides advice—such as investment funds—are the “clients” of the adviser that advises them.¹¹

The fund-client doctrine was not always settled doctrine, however. Prior to 1980, the Advisers Act, either in Section 203(b)(3) or otherwise, did not specify whether corporations, limited partnerships, LLCs, trusts, and other entities that an adviser managed could be considered the adviser’s clients, or whether the adviser needed to view the investors in those entities as its clients.¹² A 1977 decision of the United States Court of Appeals for the Second Circuit could have proposed an answer but did not. In particular, in *Abrahamson v. Fleschner*,¹³ the Second Circuit held, among other things, that general partners to investment partnerships who, in that role, provided investment advice to the partnerships, were “investment advisers” under the Advisers Act. In the original draft of the court’s opinion, the court stated that those general partners were investment advisers “to the limited partners” of the partnerships.¹⁴ Those four words were not included in the final published opinion, however. That the opinion did not commit itself to either interpretation of “client” meant that the question would persist and, given the two versions of the opinion, arguably become more pointed.

In 1980, however, Congress amended Section 203(b)(3) to add this guidance:

11. *See id.* To be sure, that exemption is controversial, a target of the lack of regulatory oversight of hedge fund managers that observers and policymakers widely perceived in the aftermath of the market turmoil that began in 2008. Accordingly, throughout 2009 and into 2010, members of Congress and the Obama Administration have proposed various amendments to the Advisers Act that would eliminate the private adviser exemption, at least for U.S.-based investment advisers and certain non-U.S. investment advisers. *See, e.g.*, Private Fund Investment Advisers Registration Act of 2010 (proposed by Sen. Christopher Dodd (D-CT) in March 2010 as part of a comprehensive financial regulatory reform proposal, the Restoring American Financial Stability Act of 2010, 111th Cong. (2010) [hereinafter Senate Bill]); Private Fund Investment Advisers Registration Act of 2009, H.R. 3818, 111th Cong. (2009) (based on the Obama Administration’s July 2009 proposal on financial regulatory reform and proposed by Representative Paul Kanjorski (D-PA) in October 2009); Private Fund Transparency Act of 2009, S. 1276, 111th Cong. (2009) (proposed by Sen. Jack Reed (D-RI) in June 2009); Hedge Fund Adviser Registration Act of 2009, H.R. 711, 111th Cong. (2009) (proposed by Representatives Michael Castle (R-DE) and Michael Capuano (D-MA) in January 2009). An amended version of Representative Kanjorski’s bill was included in the financial regulatory reform legislation that the House of Representatives passed in December 2009. *See* Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009) [hereinafter House Bill]. As discussed in Part III, the elimination of the private adviser exemption would not, without more, discredit the doctrine that a hedge fund manager’s client is the fund rather than the fund’s investors. *See infra* notes 101-06 and accompanying text.

12. *See Goldstein*, 451 F.3d at 878-79.

13. 568 F.2d 862 (2d Cir. 1977).

14. *See* Robert C. Hacker & Ronald D. Rotunda, *SEC Registration of Private Investment Partnerships After Abrahamson v. Fleschner*, 78 COLUM. L. REV. 1471, 1484 n.72 (1978).

For purposes of determining the number of clients of an investment adviser under [the private adviser exemption], no shareholder, partner, or beneficial owner of a business development company . . . shall be deemed to be a client of such investment adviser unless such person is a client of such investment adviser separate and apart from his status as a shareholder, partner, or beneficial owner.¹⁵

The legislative history suggests that the amendment's failure to refer to entities other than business development companies was to have no implications as to whether other types of entities may also warrant the same treatment. Specifically:

[W]ith respect to persons or firms which do not advise business development companies, the second amendment to Section 203(b)(3) (the attribution of client status to a shareholder, partner or beneficial owner) is not intended to suggest that each shareholder, partner or beneficial owner of a company advised by such a person or firm should or should not be regarded as a client of that person or firm.¹⁶

That nothing should be read into the fact that the amendment by its terms applied only to advisers of business development companies is supported by the fact that the amendment was part of a legislative package intended to help business enterprises, "particularly small growing and financially troubled enterprises, . . . more readily raise needed capital."¹⁷

The SEC finally resolved this ambiguity in 1985, adopting 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.¹⁸ Con-

15. Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, § 202, 94 Stat. 2275, 2290 (1980) (codified as amended at 15 U.S.C. § 80b-3(b)(3) (2006)).

16. H.R. REP. NO. 96-1341, at 38 (1980), reprinted in 1980 U.S.C.C.A.N. 4800, 4844.

17. *Id.* at 1. In highlighting that Congress appeared to contemplate that "investment companies," as opposed to the investors in those companies, were appropriately considered clients of their advisers, the Court in *Goldstein* pointed to, among other things, Congress's 1970 amendment to Section 203(b)(3), which provided that investment advisers to registered investment companies could not rely on the private adviser exemption. The Court reasoned that the "prohibition would have been unnecessary if the shareholders of investment companies could be counted as 'clients.'" *Goldstein*, 451 F.3d at 879. For further discussion of the *Goldstein* case, see *infra* notes 107-22. This argument ignores that Congress could have adopted the prohibition in full recognition of the ambiguity relating to the meaning of "client." That is, in seeking to require any adviser that advises a registered investment company to become registered as an investment adviser under the Advisers Act, Congress may have wanted to close any possible loopholes or to avoid interpretive questions rather than to propound any view of whether investors in registered investment companies were or were not to be deemed clients.

18. See 17 C.F.R. § 275.203(b)(3)-1(a)(2)(i) (2009).

versely, the rule also specified that a limited partner would not be counted as a client of the partnership's general partner (or other adviser to the partnership) if the partnership's interests were "securities" (a condition that is usually met), the advice the adviser provided to the partnership was "based on the investment objectives of the limited partners as a group,"¹⁹ and the adviser was not the "alter ego" of a registered investment adviser.²⁰ Rule 203(b)(3)-1, then, expressly made the private adviser exemption available, without question, to advisers to investment limited partnerships, so long as those partnerships were not registered under the Investment Company Act.

The SEC grounded the rule on the notion that an investment adviser to an investment fund manages the fund based on the investment objectives of fund investors as a group, rather than on their respective individual investment objectives.²¹ Implicitly recognizing that, notwithstanding the partnership's being the subject of the investment advice provided by its general partner or other adviser, the partnership's assets comprised that of its limited partners, the SEC nodded—in a three-sentence footnote—to what protections might be available to limited partners given that under the rule limited partners, to the extent that they met the rule's conditions, would not be afforded the protections afforded to investment advisory clients.²² "Additional protections," the release notes, "will be provided by general partnership law," which, for example, might specify certain fiduciary duties that a general partner might have to the partnership's limited partners.²³ In addition, "under general partnership law, a general partner is liable for partnership debts."²⁴

Of course, by its terms, the rule pertained specifically to investment limited partnerships. That attention to partnerships may have been a product of the historical view of partnerships and corporations. Partnerships traditionally—and, perhaps, by definition—have been viewed as ag-

19. Definition of "Client" of Investment Adviser for Certain Purposes Relating to Limited Partnerships, 50 Fed. Reg. 8740, 8740 (Mar. 5, 1985) (to be codified at 17 C.F.R. pt. 275) [hereinafter 1985 Release]. The SEC further noted that this requirement "would prevent a general partner, in contravention of [S]ection 208(d) of the Advisers Act, from using the partnership to do what it could not do directly itself, namely, provide individualized investment advice to 15 or more clients without registering as an investment adviser." *Id.* at 8741.

20. *Id.* at 8740-41. The rule also provided that the possibility of meeting those three conditions would not be available as to a limited partner that, "separate and apart from his status as a limited partner," was an "investment advisory client" of the partnership's adviser or a "related person" of the adviser. *Id.* at 8742. Accordingly, an adviser had to deem a limited partner a client, notwithstanding Rule 203(b)(3)-1, if the adviser provided the limited partner investment advice to transfer the partner's assets among limited partnerships or other investment advisory services.

21. *Id.* at 8741.

22. *See id.* at 8741 n.17.

23. *Id.*

24. *Id.*

gregates of individuals, rather than as separate and distinct legal personalities traditionally deemed characteristic of corporations.²⁵ That view may have been the basis for the SEC's pronouncement in a 1976 "no-action" letter that *if* an investment partnership had been organized by its general partner or other adviser, "the members of such partnership would probably each be counted in determining how many clients the adviser was serving."²⁶ The message was that the SEC could, if it wished, view a partnership, like a corporation, as a distinct legal entity. But because a partnership was also, quite literally, a group of partners, it would be reasonable to take a different view if the need arose.²⁷

More importantly, the release suggests that the SEC intended the principle it was announcing to extend to investment pools organized as corporations and possibly other types of entities—or, more precisely, that it *already* applied to those other entities. It appears that the SEC deemed the question of who counts as a client as it pertained to those other entity structures not to be in question: in setting out its rationale for regarding a partnership as its adviser's client, the SEC noted that "[a]n investment company organized as a corporation, rather than each of its stockholders, is generally regarded as the client of the company's investment adviser."²⁸ In any event, with the 1985 release settling the question of whether a fund was its adviser's client, fund advisers had the confirmation they needed both to rely on an exemption from registration as investment advisers under the Advisers Act and to direct their fiduciary obligations to the fund rather than to the fund's investors.²⁹

25. See OTTO VON GIERKE, COMMUNITY IN HISTORICAL PERSPECTIVE 198-208 (Antony Black ed., Mary Fischer trans., Cambridge Univ. Press 1990) (1868); OTTO VON GIERKE, NATURAL LAW AND THE THEORY OF SOCIETY 1500 TO 1800, at 45-46 (Ernest Barker trans., Beacon Press 1957) (1913). Under modern doctrine, however, partnerships are generally regarded as entities that are separate and distinct from their partners. See, e.g., UNIF. P'SHIP ACT § 201(a) (1997) ("A partnership is an entity distinct from its partners.").

26. Ruth Levine, SEC No-Action Letter, 1976 WL 12210, at *2 (Dec. 15, 1976).

27. Cf. Hacker & Rotunda, *supra* note 14, at 1478.

This apparently conflicting position, which recognizes the hedge fund partnership as a legal entity but regards each limited partner as a separate client, reflects a long and unsettled debate as to whether the law should view a partnership as an aggregate of legally distinct individuals or as a single entity. In other contexts the law treats a partnership as an entity for some purposes and an aggregate for others; the Commission staff appears to follow this functional approach.

Id.

28. 1985 Release, *supra* note 19, at 8741.

29. In 1997, the SEC extended Rule 203(b)(3)-1 to encompass legal entities other than partnerships. See Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1633, 62 Fed. Reg. 28,112 (May 22, 1997). In that year, the SEC also reaffirmed the analysis in which it grounded Rule 203(b)(3)-1, noting that a "client of an investment adviser typically is provided with individualized advice that is based on the client's financial situation and investment objectives" and that, "[i]n contrast, the investment ad-

B. *Case Law and the Fund-Client Doctrine*

At virtually the same time that the SEC proposed amending the Advisers Act rule to include its interpretation of “client” for purposes of Section 203(b)(3) of the Advisers Act, the Supreme Court, in *Lowe v. SEC*,³⁰ appeared to support the logic behind the rule: an investment adviser’s client achieves that status by virtue of directly receiving personalized advice from the adviser. As elaborated further in Part IV, although the *Lowe* analysis helped fuel the argument that the fund-client doctrine is the appropriate framework for the fund-adviser relationship, any reliance on *Lowe* for that purpose is misplaced.

Evaluating whether publishers of materials containing investment-related commentary were “investment advisers” as defined under the Advisers Act, the *Lowe* Court emphasized that a defining characteristic of investment advisers is their tailoring their advice to suit their clients’ needs: “The [Advisers] Act was designed to apply to those persons engaged in the investment-advisory profession—those who provide personalized advice attuned to a client’s concerns”³¹ By contrast, the petitioners’ publications were impersonal—they were not tailored to the particular investment needs and goals of the persons who read them—and had not developed “into the kind of fiduciary, person-to-person relationships that were discussed at length in the legislative history of the [Advisers] Act and that are characteristic of investment adviser-client relationships.”³² Accordingly, the Court believed that the petitioners could not be considered investment advisers and thus were not required to become registered as such under the Advisers Act.³³

Lowe’s emphasis on personalized and direct advice as a defining characteristic of an investment advisory relationship derived in part from both the legislative history of the Advisers Act and *SEC v. Capital Gains Research Bureau, Inc.*,³⁴ a 1963 Supreme Court case that articulated the fiduciary nature of investment advisers’ relationships to their advisory clients. At issue in *Capital Gains Research Bureau* was whether an investment adviser, Capital Gains Research Bureau (CGRB), that profited off of its investment recommendations to clients by trading in recommended securities was obligated to disclose to clients that it was doing so, in light of the conflicting

viser of an investment company need not consider the individual needs of the company’s shareholders when making investment decisions, and thus has no obligation to ensure that each security purchased for the company’s portfolio is an appropriate investment for each shareholder.” Status of Investment Advisory Programs Under the Investment Company Act of 1940, Investment Advisers Act Release No. 22,579, 62 Fed. Reg. 15,098, 15,102 (Mar. 31, 1997) [hereinafter 1997 Release].

30. 472 U.S. 181 (1985).

31. *Id.* at 207-08.

32. *Id.* at 210.

33. *See id.* at 211.

34. 375 U.S. 180 (1963).

interests it had in making its recommendations.³⁵ At the basis of that question was, in turn, the question of whether CGRB's trading practices "operate[d] as a fraud or deceit upon any client or prospective client within the meaning of the [Advisers] Act."³⁶

The SEC had sought an injunction pursuant to which CGRB would need to disclose to clients its practices of trading in recommended securities.³⁷ The U.S. District Court for the Southern District of New York had denied the SEC's request on the basis that the Advisers Act used the terms "fraud" and "deceit" "in their technical sense" and that the SEC had not shown "an intent to injure clients or an actual loss of money to clients."³⁸ The Court of Appeals for the Second Circuit, sitting en banc, affirmed the district court's denial of injunctive relief in a five-to-four decision, accepting the district court's interpretation of the Advisers Act's antifraud provision.³⁹ However, the dissenting judges countered that the "common-law" doctrines of fraud and deceit that the majority had embraced "grew up in a business climate very different from that involved in the sale of securities" and argued instead for a broader interpretation of those terms as used in the Advisers Act.⁴⁰

The Supreme Court determined to hear the case to settle the question of whether Congress intended the Advisers Act's proscriptions on "fraud" and "deceit" to be read narrowly and technically or whether they should be given a "broad remedial construction" that would extend to an adviser's failure to disclose material facts.⁴¹ The Court sought guidance from the history of the Advisers Act—"the last in a series of Acts designed to eliminate certain abuses in the securities industry, abuses which were

35. *See id.* at 183. CGRB sent a monthly report to subscribers who paid an annual subscription price. *See id.* From time to time, prior to recommending a security in a report, CGRB would purchase the security. *See id.* After CGRB had distributed the report, the price of the security would increase (presumably as a consequence of subscribers' buying the security for their own accounts, based on the report's recommendations), and CGRB would sell its holdings of the security immediately thereafter, realizing a profit. *See id.*

36. *Id.* at 181 (internal quotation marks and citation omitted).

37. *See id.*

38. *Id.* at 184 (internal quotation marks and citation omitted).

39. *See id.* at 184-85. Summarizing the Second Circuit's analysis, the Court noted that

[t]he majority concluded that no violation of the Act could be found absent proof that "any misstatements or false figures were contained in any of the bulletins"; or that "the investment advice was unsound"; or that "defendants were being bribed or paid to tout a stock contrary to their own beliefs"; or that "these bulletins were a scheme to get rid of worthless stock"; or that the recommendations were made "for the purpose of endeavoring artificially to raise the market so that [CGRB] might unload [its] holdings at a profit."

Id. at 185 (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 306 F.2d 600, 608-09 (2d Cir. 1962)).

40. *Id.* (internal quotation marks and citation omitted).

41. *See id.* at 185-86.

found to have contributed to the stock market crash of 1929 and the depression of the 1930s.”⁴² It observed that one purpose behind the Advisers Act, as well as the Securities Act of 1933 and the Securities Exchange Act of 1934, “was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.”⁴³ It also cited the SEC’s 1935 report on the activities of investment advisers and investment companies that “culminated in the [A]dvisers Act,” which:

reflects the attitude—shared by investment advisers and the Commission—that investment advisers could not “completely perform their basic function—furnishing to clients on a personal basis competent, unbiased and continuous advice regarding the sound management of their investments—unless all conflicts of interest between the investment counsel and the client were removed.”⁴⁴

The Court also looked to the Committee hearings on the Advisers Act, during which various investment advisers had testified about the nature of their businesses and beliefs that investment advisers should, in providing their services, be influenced only by their clients’ best interests. In the Court’s characterization, “the Committee Reports indicate a desire to preserve ‘the personalized character of the services of investment advisers,’ and to eliminate conflicts of interest between the investment adviser and the clients.”⁴⁵

From this, the Court concluded that the Advisers Act embodied “a congressional recognition ‘of the delicate fiduciary nature of an investment advisory relationship,’ as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.”⁴⁶ In light of investment advisers’ status as fiduciaries, the SEC need not “establish all the elements required in a suit against a party to an arm’s-length transaction.”⁴⁷ Rather, fiduciaries have an obligation to disclose all material facts to their clients and be careful to avoid misleading them.⁴⁸

42. *Id.* at 186.

43. *Id.*

44. *Id.* at 187 (citing SEC REPORT, *supra* note 4, at 28).

45. *Id.* at 191 (quoting H.R. REP. NO. 76-2639, at 28 (3d Sess. 1940)).

46. *Id.* at 191-92 (quoting 2 LOSS, SECURITIES REGULATION 1412 (2d ed. 1961)).

47. *Id.* at 194.

48. The Court noted that this interpretation of an adviser’s duty is not inconsistent with common-law fraud doctrine, as the Second Circuit dissenting judges had suggested:

There has . . . been a growing recognition by common-law courts that the doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of

Congress, in empowering the courts to enjoin any practice which operates "as a fraud or deceit" upon a client, did not intend to require proof of intent to injure and actual injury to the client. Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation "enacted for the purpose of avoiding frauds," not technically and restrictively, but flexibly to effectuate its remedial purposes.⁴⁹

In the Court's view, an adviser's clients should be given the opportunity "to evaluate such overlapping motivations, through appropriate disclosure, in deciding whether an adviser is serving 'two masters' or only one, 'especially . . . if one of the masters happens to be economic self-interest.'"⁵⁰ Accordingly, the Court held that the Advisers Act "empowers the courts . . . to require an adviser to make full and frank disclosure of his practice of trading on the effect of his recommendations."⁵¹ Based on that conclusion, it further concluded that CGRB, because it traded on "the market effect of [its] own recommendation," may have an incentive to recommend a particular security "because of its potential for short-run price increase in response to anticipated activity from the recommendation" rather than because the security evinced "potential for long-run price increase."⁵²

Capital Gains Research Bureau, in its focus on the fiduciary role of advisers and the importance of disclosure of conflicts, appears to presume and embrace a notion of investment advisory services as services provided pursuant to a personalized and direct relationship between investment advisers and their clients. As discussed below, however, that notion draws from an analysis of the history of the Advisers Act that simply does not speak to the propriety or impropriety of the principle that a fund, rather than its investors, is the client of its investment adviser. Accordingly, despite the importance of that case in establishing the nature and contour of investment advisers' fiduciary duties and disclosure obligations, it, like *Lowe*, cannot inform an analysis of the fund-client doctrine.

III. IMPLICATIONS OF THE FUND-CLIENT DOCTRINE

A. *Inconsistent and Deficient Regulation of Investment Advisers*

Lowe and *Capital Gains Research Bureau* provide the basis for the SEC's conclusion that the client of an adviser to an investment fund is the fund

such intangibles as advice and securities, and that, accordingly, the doctrines must be adapted to the merchandise in issue.

Id.

49. *Id.* at 195 (quoting 3 SUTHERLAND, STATUTORY CONSTRUCTION 382 (3d ed. 1943)).

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

51. *Id.* at 197.

52. *Id.* at 196.

itself, rather than any of the fund’s investors: as between the fund and its investors, it is the fund that is the direct recipient of “personalized” advisory services from the adviser. That conclusion has important implications for the adviser’s compliance with its fiduciary obligations and, to the extent it is registered as an investment adviser, its obligations under the Advisers Act. In particular, if the fund is the adviser’s client, the fund is also the subject of the adviser’s fiduciary obligations and, as a corollary, the party to which the adviser is required to disclose conflicts of interest and other material facts relating to the advisory relationship. To appreciate the near absurdity of that result, one need look no further than *Capital Gains Research Bureau*. Under the principles articulated in that case, had CGRB’s clients been investment funds, rather than individuals, CGRB would have owed its obligation to disclose its trading practices and conflicts of interest to the fund, rather than any of the investors in the fund.

To be sure, that result may be more appropriate if the fund is under the control of someone other than the adviser or its affiliates, such as another investment adviser that, for example, might place portions of the fund’s assets with multiple, unaffiliated investment advisers. In those situations, the investment adviser’s disclosure to the “fund” arguably means disclosure to the fund’s independent adviser or other control person, who would make decisions based on that disclosure, such as whether to continue or to terminate the advisory relationship. In the world of hedge funds and other private funds, however, a prevalent model is for the adviser providing the disclosure also to have control of the fund, either as its “sponsor”—that is, the person responsible for organizing and operating the fund—and/or as its general partner or manager.⁵³ In those circumstances, the adviser’s disclosure obligation is technically *an obligation to disclose information to itself*. The persons who have decisionmaking authority—that is, who can decide whether or not to act on the disclosure—are the investors. But under the *Capital Gains Research Bureau* doctrine, the investors have no right to receive that disclosure; rather, only the fund has that right.

This anomaly permeates the Advisers Act, which generally speaks in terms of the obligations an adviser has to its “clients” rather than to the persons to whom the adviser markets its funds and who ultimately become investors in those funds. The following discussion sets forth three examples of the investor protection concerns associated with that result.

1. *Advisory Services Termination Penalties*

It is common for the terms under which hedge funds offer interests to investors to specify that investors may withdraw their capital from the fund (or, for funds with share capitalization structures, redeem their shares)

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

only periodically—monthly, quarterly, or even annually. It is also common for investors to be “locked” into the fund for a certain period—perhaps one to three years—after they invest, during which the investors may not withdraw any capital or may do so only if they are willing to be subject to an “early withdrawal fee,” which is typically a certain percentage of the value of the investors’ withdrawal proceeds. Those restrictions on withdrawals mean that investors may be unable to terminate an adviser’s management of their assets for substantial periods, even though they may desire to do so.⁵⁴

Additionally, funds’ fee terms often specify that the fund pays a “management fee” (a fee based on the amount of assets in the fund) to the fund’s adviser monthly or quarterly, with the fee for each period charged and paid at the beginning of the period.⁵⁵ Where a fund pays the fee “in advance” in this way, the fund’s adviser typically will not (and is not required to) refund to the fund any portion of the fee paid to the adviser as to capital that investors withdraw mid-period. The result is that, by subjecting withdrawing investors to the management fee based on the amount of capital invested as of the beginning of the period—even though the investors may have withdrawn a portion of that capital before period-end—the adviser is compensated for services that it ultimately will not provide.

However, if the fund’s investors, rather than the fund, were the adviser’s “clients,” the Advisers Act would preclude these outcomes, as they would be deemed to violate the Advisers Act’s antifraud provisions.⁵⁶ Turning first to a client’s ability to terminate advisory services, the SEC reasons that an adviser’s continuing to provide services to a client should depend on “the client’s having trust and confidence in the adviser and a willingness to continue the advisory relationship,” rather than the client’s inability to terminate the services because of contractual restrictions.⁵⁷ In-

54. See, e.g., Matthew Lynn, *Hedge Funds Will Be Ruined by Withdrawal Limits*, BLOOMBERG NEWS, Jan. 5, 2009, <http://www.bloomberg.com/apps/news?pid=20601110&sid=au6xA2tJWSOw> (noting that “funds have placed limits on withdrawals that investors can make” and citing recent examples of “funds limiting withdrawals”).

55. “Management fees” are typically asset-based fees that are calculated, as to each investor, on the basis of the investor’s investment in the fund at the beginning (or end, as to funds paying management fees “in arrears”) of the relevant quarter or month or other period as to which the management fee is to be calculated.

56. Specifically, the SEC views these practices as violating Section 206(2) of the Advisers Act, which makes it unlawful for an adviser “to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.” See Robert D. Brown Inv. Counsel, Inc., SEC No-Action Letter, 1984 SEC No-Act. LEXIS 2661, at *2, *4 (July 19, 1984) (citing 15 U.S.C. § 80b-6(2)) (concluding that “a contract for investment supervisory services purporting to bind a client for a period of one year without a right to terminate except annually would violate [S]ection 206 of the Investment Advisers Act of 1940”).

57. *Id.* at *3.

deed, denying a client the ability to terminate the contract when the client would otherwise do so, from the SEC's perspective, "would be fraudulent and deceptive because the contract might lead the client to believe that he is not entitled to terminate the contract when fiduciary principles indicate that he has that right."⁵⁸ Similarly, the SEC has deemed it fraudulent and deceptive for an adviser to refuse to refund fees paid by an advisory client in advance for the period in which the client terminated the adviser's services.⁵⁹ That practice, in the SEC's view, would require clients to "pay[] for advisory services which they do not wish to and will not receive," which also could "inhibit [a client's] decision to terminate the advisory relationship, even though he may wish to seek advisory services elsewhere."⁶⁰

Because fund investors do not have client status under the Advisers Act, these antifraud principles do not apply to the contracts pursuant to which they invest in the fund. Fund investors may be unable to terminate the adviser's management of their assets when they would like to and may be required to pay fees for periods during which they had no assets under the adviser's management. That is not a product of anything relating to the nature of the services provided, other than that the fund, and not the investor, is the direct recipient of those services.

2. *Client Consent*

Under Section 206(3) of the Advisers Act, an adviser may not buy a security from, or sell a security to, a client without "disclosing to such client in writing before the completion of such transaction the capacity in which [the adviser] is acting and obtaining the consent of the client to such transaction."⁶¹ That consent requirement, which applies on a transaction-by-transaction basis,⁶² follows from the prospect that, in causing a client to enter into a transaction with the adviser, the adviser has obvious

58. *Id.* at *4.

59. See Consultant Publ'ns Inc., SEC No-Action Letter, 1975 SEC No-Act. LEXIS 191, at *2-3 (Jan. 29, 1975) ("[A]ny advisory contract which does not provide in substance for a pro rata refund of a prepaid investment advisory fee would raise serious questions and could, in our opinion, violate the antifraud provisions of Section 206 of the Advisory Act.").

60. Churchill Mgmt. Corp., SEC No-Action Letter, 1974 SEC No-Act. LEXIS 2422, at *3 (May 30, 1974); see also Nat'l Deferred Compensation, Inc., SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2453, at *3 (Aug. 31, 1987) ("An adviser may not fulfill its fiduciary obligations if it imposes a fee structure penalizing a client for deciding to terminate the adviser's service or if it imposes an additional fee on a client for choosing to change his investment.") (citation omitted).

61. 15 U.S.C. § 80b-6(3) (2006).

62. See Opinion of Director of Trading and Exchange Division, Relating to Section 206 of the Investment Advisers Act of 1940, Section 17(a) of the Securities Act of 1933, and Sections 10(b) and 15(c)(1) of the Securities Exchange Act of 1934, Investment Advisers Act Release No. 40, 1945 WL 26361, at *2 (Feb. 5, 1945) ("[T]he requirements of written disclosure and of consent contained in [Section 206(3)] must be satisfied before the completion of each separate transaction.").

conflicts of interest.⁶³ Although it may seem that advisers should never engage in such “principal” transactions with their clients, under certain circumstances those transactions may further client interests.

Among other things, it may be in the interests of multiple funds an adviser manages for those funds to transact with one another, such as when, due to the timing of capital inflows and outflows or for other reasons, one fund has too little of a particular position that another fund has in excess, in each case as dictated by the funds’ respective investment strategies.⁶⁴ Having one fund buy the security from the other fund may, in some circumstances, result in lower transaction costs, as compared with the funds’ buying or selling the security in the open market.⁶⁵ However, if the adviser or its affiliates holds in excess of 25% of the interests of one of the funds, this type of “cross” transaction is deemed to be a principal transaction under Section 206(3), requiring client consent.⁶⁶ In other circumstances, an adviser may be under common control or otherwise affiliated with a registered broker-dealer with whom, due to pricing or other efficiencies, the adviser wishes the funds it manages to transact. The affiliation between the adviser and the broker-dealer makes those transactions principal transactions requiring client consent pursuant to Section 206(3).

If, however, the adviser controls and speaks for the client that needs to provide the consent—for example, a fund that is a party to a cross transaction with another fund in which the funds’ (common) adviser holds a substantial ownership interest—the consent requirement is empty. Not surprisingly, advisers to funds generally realize the impropriety of being both the party that proposes a principal transaction and the party evaluating and providing consent to it. Accordingly, one common approach is for the adviser to appoint a committee of independent investors in the fund to evaluate and, if deemed appropriate, consent to transactions the adviser proposes.⁶⁷ Nothing in the Advisers Act or the rules under the Advisers Act confirms that such an alternative complies with Section 206(3), and advisers using that approach generally do so based on its being the only viable option—both preferable, from a conflicts perspective,

63. See Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Advisers Act Release No. 1732, 17 C.F.R. pt. 276 (July 17, 1998).

64. See Gardner Russo & Gardner, SEC No-Action Letter, 2006 SEC No-Act. LEXIS 482 (June 7, 2006).

65. See *id.* at *15 (describing one adviser’s belief that clients benefit from cross transactions due to lower transaction costs and “minimiz[ing] the impact to the market for those securities”).

66. See *id.* at *8-9 (noting SEC staff’s belief that Section 206(3) “would apply to a cross transaction between a client account and an account of which the investment adviser and/or a controlling person in the aggregate, own(s) more than 25%” but “would not apply to a cross transaction between a client account and an account of which the investment adviser and/or its controlling persons, in the aggregate, own 25% or less”) (footnotes omitted).

67. Given more time, advisers could also arrange for a vote of all fund investors, although the speed at which transactions sometimes must be effected render that approach unworkable.

to the advisers’ consenting on the funds’ behalf and more workable than obtaining a vote of all of the funds’ investors. That the construction of the Advisers Act and its failure to acknowledge the practical applications of its antifraud principles requires advisers to create their own extra-statutory requirements and procedures further highlights the Advisers Act’s deficiencies as applied to hedge fund managers.

Section 206(3) is not the only section giving rise to anomalies involving client consent. The consent of advisory clients is also required by Section 205(a). That section requires advisory contracts to specify that the contract may not be assigned without the consent of the relevant client.⁶⁸ As with the requirement that an adviser obtain the client’s consent to each principal transaction, the fund-client doctrine produces the result that, when the adviser is the general partner or managing member of the fund, consent effectively may be provided by the adviser, in its capacity as the person who controls the fund. As with the principal transaction requirement, in that situation there is no settled or obvious means of complying with the consent-to-assignment requirement.

3. *The “Cash Solicitation Rule”*

The rules under the Advisers Act have similar problems. One example is Rule 206(4)-3, which prohibits an adviser from paying a cash fee to a solicitor in connection with client solicitation activities unless the adviser complies with various requirements.⁶⁹ That rule does not impose a similar requirement as to advisers’ engagements of solicitors to solicit *investors* for *funds* the advisers manage. Perhaps because the Advisers Act and its rules generally do not contemplate that advisers may manage private funds—in addition or as an alternative to managing separate accounts or registered investment companies—the SEC had, at one time, interpreted the rule to apply to advisers’ solicitation of private fund investors.⁷⁰ In 2008, however, the SEC recanted that interpretation, based in part on the D.C. Circuit Court of Appeals’ conclusion regarding the meaning of “client” in *Goldstein v. SEC*.⁷¹

68. See 15 U.S.C. § 80b-5(a) (2006).

69. See 17 C.F.R. § 275.206(4)-3 (2009).

70. See Dana Inv. Advisors, Inc., SEC No-Action Letter, 1994 SEC No-Act. LEXIS 871 (Oct. 12, 1994); Dechert Price & Rhoads, SEC No-Action Letter, 1990 SEC No-Act. LEXIS 1291 (Dec. 4, 1990); Stein Roe & Farnham Inc., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 519 (June 29, 1990).

71. Mayer Brown LLP, SEC No-Action Letter, 2008 SEC No-Act. LEXIS 515, at *3 (July 15, 2008) (citing *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006)) [hereinafter Mayer Brown NAL]. As this Article suggests, reliance on *Goldstein* is not, in at least some respects, persuasive. For a discussion evaluating the *Goldstein* court’s analysis, see *infra* notes 107-21 and accompanying text. Less persuasive still was the SEC’s grounding its new perspective on Rule 206(4)-3 in its assumption that the SEC naturally would have considered the application of the rule to private funds at the time it adopted the rule. See Mayer Brown NAL, *supra*, at *12-13. In particular, the no-action letter notes that the SEC’s releases proposing and adopting the rule

As a result of that interpretation, advisers that engage solicitors to seek out investors for the private funds the advisers manage are not required to, among other things, provide the sorts of disclosures to solicited persons that they would need to provide if those persons were prospective clients in separate account arrangements. Those required disclosures include information about the compensation the adviser is paying the solicitor, the nature of the relationship between the solicitor and the adviser, including the existence of any affiliation, and the amount (if any) of additional fees the client will bear as a result of the solicitation arrangement.⁷² In addition, the adviser and the solicitor need not have a written agreement specifying the terms of the engagement and the compensation to be paid, and the adviser need not seek to ensure that the solicitor has complied with its obligations under the agreement—two other requirements under Rule 206(4)-3.⁷³ While persons who are clients receive the advantages of those protections, those that merely have the “investor” label do not.

The examples above are merely that. Other Advisers Act rules likewise produce results that similarly subvert common sense and militate against investor protection: Rule 204-3 requires registered advisers to provide clients and prospective clients copies of a written disclosure statement, both at the outset of the relationship and, annually thereafter, to provide or offer to provide those disclosure statements.⁷⁴ There is no requirement that those advisers provide disclosure statements to fund investors. Under Rule 206(4)-4, it is a fraudulent act for an adviser to fail to disclose to any “client or prospective client” all material facts relating to the adviser’s disciplinary history; the rule does not require advisers to disclose that information to investors in funds that they manage.⁷⁵ And Rule 206(4)-6 specifies that an adviser would engage in a fraudulent, deceptive, or manipulative act if it were to vote proxies on behalf of client accounts without disclosing to clients its proxy voting policies and procedures and how they may obtain information from the adviser about the proxies it has voted.⁷⁶ The rule does not include obligations owed to investors in funds the adviser manages.

did not suggest that the rule applied to payments to compensate solicitors for soliciting fund investors and, further, the rule is

designed so as to clearly apply to solicitations and referrals in which the solicited or referred persons might ultimately enter into investment advisory contracts with the investment adviser, yet investors in investment pools (as such) do not typically enter into investment advisory contracts with the investment advisers of the pools.

Id. at *5 (citation omitted).

72. See 17 C.F.R. § 275.206(4)-3(b).

73. See *id.* §§ 275.206(4)-3(a)(1)(iii), (2)(iii)(C).

74. See *id.* § 275.204-3.

75. See *id.* § 275.206(4)-4.

76. See *id.* § 275.206(4)-6.

As elaborated below, that advisers need to direct disclosure and their fiduciary and other obligations to an entity that they have created and control is striking in its incongruity with principal-agent and fiduciary theory. It also renders unsurprising the groundswell of support for regulators’ and observers’ recommendations, in light of the recent financial market turmoil, that advisers to large investment funds be required to register under the Advisers Act. That groundswell was based more on a reaction to current events than an adequate appreciation that the fund-client doctrine was—and remains—problematic for reasons well beyond its allowing a group of advisers to escape SEC regulation.

B. *Agency Costs and Resource Misallocation*

Principal-agent theory also suggests that, as between a fund and its investors, investors are the more appropriate client of the fund’s investment adviser. That argument rests on principles of fiduciary duty theory and, in particular, the supposition that efficiency is created through an investment adviser’s treating fund investors as clients and, as such, owing its fiduciary duties to them. More specifically, through an economic lens, agency cost theory supports this Article’s argument that fund investors should be the clients of the fund’s adviser and, concomitantly, the beneficiaries of the adviser’s fiduciary obligations.

Agency cost theory provides a useful framework for describing and informing myriad principal-agent relationships. However, scholarship addressing the nature of the firm has employed agency cost analysis most vigorously, elucidating it in the process. The classic explanation for the firm’s existence is that economic activity takes place within firms when the costs from conducting economic activity in a centralized structure under common direction are lower than the costs of conducting that activity through transacting in the open market.⁷⁷ That was Coase’s historic insight,⁷⁸ to which Adolf Berle and Gardiner Means contributed their insight that coordinating economic activity within the firm comes at a price, which is the costs created by the myriad principal-agent relationships that the firm comprises.⁷⁹

Under agency cost theories, organizations are seen as “webs of express, implied, and metaphorical contracts among individuals with conflicting interests,” and so agency cost theories “focus on the problems of shirking and monitoring that stem from information asymmetries within the organization’s component relationships.”⁸⁰

77. See Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 634 (2004).

78. See generally Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937).

79. See generally ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

80. Sitkoff, *supra* note 77, at 635.

Using the vocabulary of agency in economic rather than legal parlance, agency problems are caused by the impossibility of complete contracting when one party (the agent) has discretionary and unobservable decision-making authority that affects the wealth of another party (the principal). When the agent's effort is unobservable, ex post enforcement of the ex ante bargain, no matter how detailed it may be, is impractical . . . unless there is a perfect correlation between the agent's effort and the project's observable profits, in which case a good or bad return would conclusively show the level of the agent's effort, it will be difficult for the principal to prevent shirking by the agent.⁸¹

Understanding organizational forms under the agency cost theory involves studying the myriad principal-agent relationships that comprise those forms.⁸² Part of the research necessitated by agency costs theories relates to evaluating what mechanisms might reduce agency costs—the costs incurred for principals to monitor agents and to mitigate the shirking that may arise from the fact that agents have information that principals do not.⁸³

That is where fiduciary duty principles become relevant, as one of the mechanisms for minimizing those oversight costs.⁸⁴ It is only one possible mechanism, however. Others include incentive-based compensation structures and disclosure requirements.⁸⁵ Because fiduciary duties add additional costs to any principal-agent relationship, those other mechanisms may be more appropriate in any particular circumstance than imposing fiduciary duties.⁸⁶ That raises the question of what relationships are most appropriate for imposing of fiduciary duties, given the costs that accompany them.

Under economic theory, default fiduciary duties are most appropriate in the context of indefinite, unspecified obligations, where the agents' obligations are to act "with due care" or "prudently" and where the relation-

81. *Id.* at 636 (footnotes omitted).

82. *See id.* at 637.

83. *See, e.g.*, Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304 (1983) (observing, in organizational context, that controlling "agency problems in the decision process is important when the decision managers who initiate and implement important decisions are not the major residual claimants" and that "effective control procedures" are needed to prevent managers from acting adversely to residual claimants' interests).

84. *See, e.g.*, Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 217 ("[F]iduciary duties compensate for the owner's inability directly to observe, evaluate, and discipline the manager's performance.").

85. *See* Sitkoff, *supra* note 77, at 637-38 and accompanying notes.

86. *See, e.g.*, Ribstein, *supra* note 84, at 212 ("[I]n many situations where fiduciary duties might seem to have benefits because of one party's vulnerability, the costs of fiduciary duties outweigh the benefits."). The costs of fiduciary duties are myriad. Among other things, fiduciary duties may weaken extralegal motivation for good performance and voluntary cooperation. *See id.* at 233-35.

ship is long-term in nature and requires expertise of the agents that the principals likely do not have.⁸⁷ In these circumstances, agents often have broad discretion in pursuing their activities, and asymmetry of information between an agent and its principal may be great.⁸⁸ As a result, either principals are not readily able to detect wrongdoing, or their engaging in monitoring activities is "prohibitively costly."⁸⁹ Imposing fiduciary duties as the liability rules that govern those relationships may be the most cost effective approach in achieving effective oversight and evaluation of an agent's activities.⁹⁰

Agency cost theories have been particularly emphasized in scholarship in the corporate law context, spawning models of contract design, corporate structure, and policy formulation. Perhaps because agency cost analysis derives from organizational forms whose "core relationships . . . are generally open-market transactions rather than intra-firm transfers,"⁹¹ that analysis has provided a particularly useful, and widely accepted, analytical framework for evaluating the relationships between a firm's shareholders and managers.⁹² In that analysis, a firm's directors are the agents, and its shareholders, who hold the residual economic interest in the firm, are the principals.⁹³ Because of the nature of the relationship between directors and shareholders and the information asymmetries that imbue it, fiduciary duties are a primary mechanism for minimizing agency costs that shareholders would otherwise bear.⁹⁴

87. That default fiduciary duties may be more appropriate in some contexts as compared with others does not speak to whether contracting parties should be able to limit or waive default fiduciary duties.

88. See Ribstein, *supra* note 84, at 217.

89. Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1049 (1991).

90. The liability rule that imposes a fiduciary duty on an agent need not be the product of any contractual arrangement. Rather, by assuming the role of a particular type of agent, the law imposes the fiduciary obligation. See Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 825-26 (1983).

91. Sitkoff, *supra* note 77, at 635.

92. See George S. Geis, *Business Outsourcing and the Agency Cost Problem*, 82 NOTRE DAME L. REV. 955, 976-77 (2007) (tracing use of agency cost theories in evaluating manager and shareholder relationships); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 312-13 (1976).

93. Under some interpretations, shareholders may not in all circumstances be the sole residual interest holders, such as during periods in which the corporation is nearing insolvency or is insolvent. See, e.g., Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1512 (1993) ("Several courts have held that once the corporation becomes insolvent, directors owe a fiduciary duty to creditors."). That corporate law regards the entity itself as a representative of the holders of the residual interests, whoever they may be, highlights the malleability of corporate law—and, therefore, also highlights the rigidity of the fund-client doctrine.

94. This is not to say that the fiduciary duties to which directors are usually subject are as robust as those to which other fiduciaries are subject. Among other things, the standard is generally more stringent for trustees, given that trust benefi-

That analytic framework not only informs and explains corporate structural decisions and organization, however. It also lends itself to informing the relationships of fund investment managers to the investors in the funds they manage. As with shareholders in a firm, fund investors are entitled to the residual economic interest in the fund. Moreover, a typical investment advisory relationship has the general characteristics of relationships as to which fiduciary duties may be appropriate mechanisms for reducing agency costs: broad discretion and information asymmetry. More particularly, the relationship is usually intended to be long-term in nature, it requires that the investment adviser exercise skill and expertise—and, indeed, the client's assessment of the adviser's skill and expertise is usually the predicate to his or her entering into the relationship—and the adviser's activities in carrying out its obligations to the client generally are not particularly transparent to the client, given the adviser's desire to avoid disclosing its proprietary strategies or because the client may not understand or appreciate the basis for any particular investment decisions the adviser makes. That the nature of the relationship between client and adviser gave rise to responsibilities that were fiduciary in nature permeated *Capital Gains Research Bureau*, the Court emphasizing the "trust and confidence" that clients place with advisers and that, given the status of the client vis-à-vis and adviser, the adviser is obligated to disclose conflicts that may impair the advice the adviser gives and the investment decisions it makes.⁹⁵

When the "client" is a fund controlled by the adviser rather than the party that is ultimately the beneficiary of the adviser's investment advice, as fund investors are, the fiduciary analysis loses normative power. Most obviously, as between a fund and an investor in that fund, it is the investor whose capital is at risk as the adviser pursues investment activities on the fund's behalf. It is the investor who decides whether to place assets with the adviser, even if that placement is in the fund rather than in a separately owned and managed account. It is the investor who, in light of the information he or she has about the fund and its adviser, determines whether to place additional capital in the fund or whether, instead, to withdraw that capital and place it in another fund or otherwise with another adviser where it may be used more effectively, generate better returns, or be subject to less risk. In short, it is the investor who needs to be able to assess how best to allocate his or her resources to further his or her investment objectives.

Accordingly, the investor also has the primary interest in ensuring that the adviser pursues its activities in a manner that furthers investors'

ciaries are "locked into the relation," whereas corporate shareholders are generally free to sell their shares based on their assessment of the corporation's directors. See Frankel, *supra* note 90, at 825-26.

95. See *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 190 (1963). For further discussion of *Capital Gains Research Bureau*, see *supra* notes 46-52 and accompanying text.

collective best interests. In other words, because the investors bear the agency costs arising from the investment adviser’s activities on the fund’s behalf, the investors are concerned with reducing agency costs, whether through monitoring, incentive-creation, or imposing fiduciary obligations. Because of the implications of those concerns for efficiency in asset allocation and capital formation, legal doctrine surrounding the relationship of advisers to their clients should acknowledge those concerns and seek to ameliorate them.

C. *Inadequacy of Recent and Impending Regulatory Changes*

Recognizing that the duties that fund advisers owe to clients under the Advisers Act generally are owed to the funds rather than to the funds’ investors, the SEC in 2007 adopted a rule under the Advisers Act—Rule 206(4)-8—to clarify that the antifraud provisions of the Advisers Act prohibit hedge fund (and other fund) managers from defrauding fund investors.⁹⁶ The SEC was prompted to adopt the antifraud rule in the wake of *Goldstein v. SEC*, in which the D.C. Circuit Court of Appeals vacated the SEC’s changes, in 2004, to the rules under the Advisers Act that had required many hedge fund managers to become registered under that Act (2004 Amendments).

The 2004 Amendments had provided that, for purposes of determining whether an adviser to a hedge fund or certain other private funds could rely on the private adviser exemption to avoid registration under the Advisers Act, the adviser needs to count each investor in those funds, rather than each fund, as a separate client.⁹⁷ For all other purposes of the Advisers Act, however, the meaning of “client” was to remain the same—that is, for those other purposes, advisers were to regard each fund as a client. The SEC had adopted this rule not as a first step toward extending advisers’ obligations under the Advisers Act to fund investors (a project for

96. See 17 C.F.R. § 275.206(4)-8 (2009). The rule prohibits: any investment adviser to a pooled investment vehicle from making an untrue statement of a material fact to any investor or prospective investor in the pooled investment vehicle, or omitting to state a material fact necessary in order to make the statements made to any investor or prospective investor in the pooled investment vehicle, in the light of the circumstances under which they were made, not misleading.

Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756, 44,758-59 (Aug. 9, 2007) (to be codified at 17 C.F.R. pt. 275) [hereinafter 2007 Release]. It additionally prohibits an investment adviser from engaging in deceptive or manipulative acts or practices where no “statements” are involved. See *id.* at 44,759 (citations omitted). The antifraud rule extends beyond transactions involving the offer or sale of securities, reaching all varieties of statements or other communications between managers and investors and prospective investors, regardless of the context. And, in enforcing the antifraud rule (in contrast to Section 10b-5 actions), the SEC need not prove scienter. See *id.*

97. See 17 C.F.R. § 275.203(b)(3)-2(a) (stating that, for advisers to “private funds,” “[f]or purposes of [S]ection 203(b)(3) of the [Advisers] Act (15 U.S.C. § 80b-3(b)(3)), you must count as clients the shareholders, limited partners, members, or beneficiaries . . . of [the] fund”).

which it arguably lacked authority) but, rather, to deprive hedge fund managers of the ability to rely on the private adviser exemption. The result was that the 2004 Amendments would (and, until the D.C. Circuit's decision, did) require most hedge fund managers managing assets exceeding twenty-five million dollars to become registered as investment advisers with the SEC and, therefore, to come within the SEC's regulatory oversight. In evaluating Phillip Goldstein's challenge to the 2004 Amendments and, ultimately, deciding in his favor, the D.C. Circuit opined that the SEC did not have the authority to interpret the meaning of "client" as it had.⁹⁸

The SEC adopted the antifraud rule to prevent a possible interpretation of *Goldstein*—namely that, if for all purposes of the Advisers Act, a private fund adviser's "client" is the fund rather than the fund's investors, advisers to private funds are under no obligation to avoid defrauding or misleading investors. Like the 2004 Amendments, then, the rule was not a product of any attempt to remedy the anomalies of the Advisers Act discussed above but, instead, was a product of happenstance, a "for-the-avoidance-of-doubt" measure⁹⁹ to clarify that advisers should not defraud investors any more than they should defraud funds or other persons or entities considered clients under the Advisers Act.¹⁰⁰

As noted in Part I, Congress is poised to amend the Advisers Act to further regulate investment advisers to hedge funds and other private funds. If it does so, the measure would likely be one component of a comprehensive financial regulatory overhaul undertaken in the aftermath of the severe market downturn. That downturn, accompanied by worries that certain large financial institutions might fail and that those failures could have disastrous effects on economic activity, was blamed, in large part, on the investment and trading activities of large financial institutions, including those within the so-called "shadow banking system,"¹⁰¹ such as private investment funds and unregulated affiliates of brokerage firms and insurance companies.

98. See *Goldstein v. SEC*, 451 F.3d 873, 883-84 (D.C. Cir. 2006).

99. Prior to the SEC's adoption of the antifraud rule, it was already unlawful for fund advisers to defraud investors (or prospective investors) in the funds they managed. See *Abrahamson v. Fleschner*, 568 F.2d 862, 877-88 (2d Cir. 1977) (finding that investors in hedge fund had stated claim for fraud against fund's general partner under Section 206 of Advisers Act). Accordingly, even prior to the adoption of the 2007 antifraud rule, antifraud principles conceivably pervaded aspects of advisers' communications with investors and prospective investors.

100. See 2007 Release, *supra* note 96, at 44,756 (noting that antifraud rule prohibits advisers to "pooled investment vehicles" (including hedge fund managers), whether registered as investment advisers or not, from defrauding fund investors). Advisers Act Rules 206(1) & (2) prohibit advisers from engaging in fraudulent, deceptive, or manipulative acts with respect to clients. See 17 C.F.R. §§ 275.206(4)-1, -2.

101. Mike Konczal, *Shadow Banking: What It Is, How it Broke, and How to Fix It*, THE ATLANTIC, July 13, 2009, available at <http://www.theatlantic.com/business/archive/2009/07/shadow-banking-what-it-is-how-it-broke-and-how-to-fix-it/21038/>.

One probable effect of such an amendment, based on the bills proposed so far,¹⁰² will be to require U.S.-based (and some non-U.S.-based) investment advisers to funds falling within the definition of a “private fund” to become registered as investment advisers with the SEC.¹⁰³ Specifically, the proposals would generally eliminate, as to U.S. hedge fund managers, the private adviser exemption and, therefore, any need to contemplate whether, for purposes of the fewer-than-fifteen-client requirement of that exemption, a hedge fund manager should consider each fund it manages as a client or, instead, should consider each investor in each fund as a client.¹⁰⁴ That type of change, without more, would not affect the fund-client doctrine.

Based on the proposals, however, the amendment would also grant the SEC authority to define terms used in the Advisers Act—presumably including the term “client”¹⁰⁵—thereby permitting the SEC to redefine “client” such that the term would encompass fund investors. Nonetheless, it is more than conceivable that the SEC, if granted that authority, might decline to use it to substantially alter the meaning of “client,” not only given the SEC’s historical endorsement of the fund-client doctrine and the

102. See *supra* note 11.

103. Under both the House Bill and the Senate Bill, a “private fund” would be any issuer that would be an investment company under the Investment Company Act but for the exclusions from that definition provided by Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. See House Bill, *supra* note 11, § 5002; Senate Bill, *supra* note 11, § 402.

104. Most of the proposed amendments, including those contained in the House Bill and the Senate Bill, would also grant the SEC authority to require registered investment advisers to maintain such records and provide such information to the SEC about the private funds they manage as the SEC deems appropriate. See House Bill, *supra* note 11, § 5004; Senate Bill, *supra* note 11, § 404.

105. See House Bill, *supra* note 11, § 5008 (providing that SEC may adopt “rules and regulations defining technical, trade, and other terms used in [the Advisers Act]”); Senate Bill, *supra* note 11, § 406 (granting same authority). In addition, the House Bill contains a provision that would permit the SEC to define terms differently for purposes of different sections of the Advisers Act and expressly references “client” as a term falling within that authority. See House Bill, *supra* note 11, § 5008 (“For the purposes of its rules and regulations, the Commission may . . . ascribe different meanings to terms (including the term ‘client’. . .) used in different sections of this title as the Commission determines necessary to effect the purposes of this title.”). Although the original version of the Senate Bill, proposed in November 2009, contained a similar provision, the revised version, proposed in March 2010, did not. Moreover, the House Bill’s provision arguably would actually limit the SEC’s ability to vitiate the fund-client doctrine. Although the version of the provision originally proposed by Representative Kanjorski contained no limitations on how the SEC may redefine “client,” the final version (which is contained in the House Bill) includes a proviso to the effect that “the Commission shall not ascribe a meaning to the term ‘client’ that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser.” *Id.* With some exceptions (such as where a fund’s general partner is its investment adviser), hedge funds typically enter into advisory contracts with their advisers. For further discussion of the implications of these relationships for the fund-client doctrine, see *infra* notes 133-38 and accompanying text.

case law deemed to support it,¹⁰⁶ but also because the SEC at that point would have achieved the goal it was seeking when its rulemaking placed the definition of “client” in the spotlight in 2004. In other words, that hedge fund managers may soon need to become registered with the SEC under the Advisers Act presumably would render less urgent Congress’s and the SEC’s reconsideration of the fund-client doctrine.

IV. THE FUND-CLIENT DOCTRINE AS DISTORTED POLICY

In Part II, this Article discussed the settled principle that, for purposes of an adviser’s obligations to its clients, investment funds the adviser manages, rather than investors in those funds, are deemed to be the adviser’s clients. In this Part, it argues that the fund-client doctrine is based on a misunderstanding of both the Advisers Act and the landmark cases discussed above.

A. Goldstein’s Analysis of “Client”

A misunderstanding of the Advisers Act is evident, most recently and prominently, in the D.C. Circuit’s decision in *Goldstein*. As an initial matter, in *Goldstein*’s analysis of the Advisers Act, the court, in looking to whether the SEC’s construction of the Advisers Act was reasonable, noted (quite logically) that the determination of reasonableness “‘depends,’ in part, ‘on the construction’s ‘fit’ with the statutory language, as well as its conformity to statutory purposes.’”¹⁰⁷ However, the court then proceeded to assume, rather than establish, conclusions about the text of the Advisers Act.

In particular, in a detour lacking factual predicate, the court perfunctorily asserted that “the Commission’s interpretation of the word ‘client’ comes close to violating the plain language of the statute.”¹⁰⁸ Not pausing to cite support for that statement, the court continued, noting that “[a]t best it is counterintuitive to characterize the investors in a hedge fund as the ‘clients’ of the adviser.”¹⁰⁹ Leaving unspecified what, exactly, made that characterization “counterintuitive,” the court went on to observe:

The adviser owes fiduciary duties only to the fund, not to the fund’s investors. Section 206 of the Advisers Act makes it unlawful for any investment adviser—registered or not—to engage in any transaction, practice, or course of business which operates as

106. See 1997 Release, *supra* note 29, at 15,102; 1985 Release, *supra* note 19, at 8741 (observing that when “an adviser to an investment pool manages the assets of the pool on the basis of the investment objectives of participants as a group, it appears appropriate to view the pool—rather than each participant—as a client of the adviser”); see also *Goldstein v. SEC*, 451 F.3d 873, 880 (D.C. Cir. 2006).

107. *Goldstein*, 451 F.3d at 881 (quoting *Abbott Labs. v. Young*, 920 F.2d 984, 988 (D.C. Cir. 1990)).

108. *Id.*

109. *Id.*

a fraud or deceit upon any client or prospective client. In *SEC v. Capital Gains Research Bureau, Inc.*, the Supreme Court held that this provision created a fiduciary duty of loyalty between an adviser and his client. In that case, the duty of loyalty required an adviser to disclose self-interested transactions to his clients. The Commission recognizes more generally that the duty of loyalty requires advisers to manage their clients’ portfolios in the best interests of clients, and imposes obligations to fully disclose any material conflicts the adviser has with its clients, to seek best execution for client transactions, and to have a reasonable basis for client recommendations.¹¹⁰

With that, the court repeated the truism that advisers owe duties to their clients but did not add any insight as to who or what should be considered clients.

The court sought to bolster its statutory analysis with more pragmatic considerations, namely that regarding investors as clients inevitably will produce conflicts: “[i]f the investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, then the adviser will inevitably face conflicts of interest”—much as a lawyer or an accountant to a corporation would also have conflicts of interest if that person were deemed also to represent the corporation’s shareholders.¹¹¹ Based on that, the court concluded that “[i]t simply cannot be the case that investment advisers are the servants of two masters in this way”¹¹²—without considering that, under the Advisers Act, perhaps *only* the investors might be considered the adviser’s clients.¹¹³ Punctuating that discussion, the court turned to the SEC’s argument against what it saw as the private adviser exemption’s exaltation of form over substance. In particular, the SEC had contended that hedge funds’ form of organization was “merely ‘legal artifice,’” employed to protect advisers “who want to advise more than fifteen clients and remain exempt from registration.”¹¹⁴ To this, the court responded that “form matters in this area of the law because it dictates to whom fiduciary duties are owed.”¹¹⁵ However, by failing to provide any analysis of *why* form dictates to whom duties are owed, the court essentially concluded that form matters because it does.

Beyond its analysis of the Advisers Act, the *Goldstein* court looked to legislative history of that statute, particularly the *Lowe* Court’s evaluation of it, as it informed that Court’s understanding of the term “client.”¹¹⁶ The *Goldstein* court began by noting that the *Lowe* Court, in holding that “pub-

110. *Id.* (internal quotation marks and citations omitted).

111. *Id.*

112. *Id.*

113. For further discussion of this suggestion, see *infra* Part V.C.

114. *Goldstein*, 451 F.3d at 882 (internal citations omitted).

115. *Id.*

116. *See id.* at 880.

lishers of certain financial newsletters were not ‘investment advisers,’” had espoused “a similar conception of the adviser-client relationship” as the one the SEC had recited in adopting Rule 203(b)(3)-1 in 1985.¹¹⁷ In support of that conclusion, the *Goldstein* court noted *Lowe’s* statements that the “existence of an advisory relationship depended largely on the character of the advice rendered” and that investment advisers “provide personalized advice attuned to a client’s concerns.”¹¹⁸ It then pointed out that the *Lowe* Court “thought it significant that the Advisers Act repeatedly referred to clients, which signified to the Court the kind of fiduciary relationship the Act was designed to regulate.”¹¹⁹ On the basis of this, the *Goldstein* court asserted: “This type of direct relationship exists between the adviser and the fund, but not between the adviser and the investors in the fund. The adviser is concerned with the fund’s performance, not with each investor’s financial condition.”¹²⁰

To be sure, *Goldstein* professed not to “read too much into” *Lowe’s* understanding of the Advisers Act’s history, given that the *Lowe* Court’s task was not to interpret “client” but to construe an exception to the definition of “investment adviser” under the Advisers Act.¹²¹ Still, to the extent the *Goldstein* court read *anything* into the *Lowe* Court’s analysis of the legislative history, its doing so was misguided. The *Lowe* Court’s survey of the legislative history of the Advisers Act simply permitted that Court to embrace one of the distinctions evident in that history: that an adviser’s providing advice through impersonal publications not relating to any particular portfolio or client was different from providing advice as to a particular portfolio or client.¹²² But, as discussed in more detail below, that distinction does not support or otherwise inform the conclusion the *Goldstein* court drew from it, namely that the client of an adviser providing investment advice as to a particular portfolio is the direct owner of the portfolio (e.g., a hedge fund) rather than the owner’s beneficial owners (e.g., the hedge fund’s investors).

117. *Id.* (internal citations omitted).

118. *Id.* (citing *Lowe v. SEC*, 472 U.S. 181, 208 (1985)). The *Goldstein* court additionally noted, citing *Lowe*, that “fiduciary, person-to-person relationships [are] characteristic of the investment adviser-client relationship.” *Id.* (internal quotation marks and citation omitted).

119. *Id.* (internal quotation marks and citation omitted).

120. *Id.*

121. *See id.*

122. *See Lowe*, 472 U.S. at 182, 190-91 (noting that publications at issue did not “fit within the [Advisers] Act’s central purpose because they do not offer individualized advice *attuned to any specific portfolio* or to any client’s particular needs” and that 1930s study by SEC on “investment counsel, investment management, investment supervisory, and investment advisory services” had stated that Advisers Act “was intended to exclude any person or organization which was engaged in the business of furnishing investment analysis, opinion, or advice solely through publications distributed to a list of subscribers and did not furnish specific advice to any client with respect to securities”) (emphasis added) (internal quotation marks and citation omitted).

B. *Legislative History of the Advisers Act*

The Advisers Act was part of a suite of statutes enacted in the wake of the Depression to regulate the securities industry, with the intent of preventing in the future the abuses that were seen to have contributed to the Depression, protecting investors, and maintaining confidence and integrity in the markets.¹²³ The provisions of the Advisers Act originated in a study of “investment counsel” and investment advisory services prepared by the SEC, at the direction of Congress (the SEC Report).¹²⁴ The SEC Report chronicled the history of investment advisory services, noting their rapid growth from 1929 through 1936 as a result of the “demands of the investing public, which required supervision of its security investments after its experience during the depression years.”¹²⁵

As discussed above, the fund-client doctrine is supported by an interpretation of legislative history—such as those in *Capital Gains Research Bureau* and *Lowe*—pursuant to which one provides investment advice (and, therefore, is an investment adviser) when that advice is “personalized” and direct. That interpretation, however, ignores that, at the time the Advisers Act was enacted, investment advisers were forming pooled investment entities so as to manage the assets of numerous clients who had selected a particular adviser based not on individualized advice but, rather, on the particular strategy the adviser was known for pursuing. Then, as now, at least some clients chose advisers for their “secret sauces” rather than to receive all-encompassing financial advice.¹²⁶ To the extent that *Capital Gains Research Bureau* requires advisers to provide relevant disclosure to “clients,” whether the client has placed its assets in a separate account to be managed by the adviser or in a pooled entity containing other clients’ assets should not matter. In other words, if the adviser owes a duty to someone whose assets the adviser manages directly (through a separate account arrangement), why not also to someone whose assets the adviser manages indirectly (through a pooled structure)? The Advisers Act’s legislative history does not answer this question and neither does *Capital Gains Research Bureau*.

In the post-Depression years, the pooled entities that, effectively, were aggregations of clients were fairly clearly distinguishable from investment funds that were to be the subject of the Investment Company Act—registered investment companies. The latter, which would be subject to the encompassing regulation of the Investment Company Act, regulation from which smaller, privately offered investment funds (such as hedge funds)

123. See 1 THOMAS P. LEMKE, GERALD T. LINS & A. THOMAS SMITH, REGULATION OF INVESTMENT COMPANIES 2-1 to 2-8 (2009).

124. See SEC REPORT, *supra* note 4.

125. *Id.* at 5.

126. *Lowe* misunderstood the legislative history in suggesting that persons were properly considered investment advisers, subject to regulation as such, only if they provided their clients advice as to all of their assets or investment needs.

would be expressly exempted,¹²⁷ were characterized not only by their availability to the general public but also by the absence of a relationship between the advisers managing the funds and the funds' investors.¹²⁸ This distinction was pronounced in some of the testimony before Congress, as advisers criticized what they saw as Congress's failure to understand the difference between an investment adviser's relationship with its clients, which would be governed under the Advisers Act, and a publicly offered investment fund's relationship to its many investors. As a representative of the Investment Counsel Association of America noted, "the personal confidential relationship existing between the investment counsel and his client [is] so very different from the commodity of investment trust shares which investment trusts [are] engaged in selling, that any legislation to regulate these two different activities should be incorporated in separate acts."¹²⁹ Privately offered funds formed by advisers to aggregate clients were too different in purpose and origin, in terms of the advisers' relationships with their investors, to assume that they were merely smaller and more secretive versions of mutual funds and other registered investment companies.

More specifically, aggregating clients in private funds was, in the understanding of investment advisers and, presumably, Congress, a mechanism permitting advisers to pursue their investment strategies more efficiently—to assist clients who, by themselves, could not have placed sufficient assets with an adviser to make the client's engagement of the adviser worthwhile.¹³⁰ The pooled-asset structure served both clients' and advisers' goals and permitted clients to obtain the services they sought and

127. See 15 U.S.C. §§ 80a-3(c)(1) (2006) (providing exemption from definition of "investment company" for purposes of Investment Company Act's registration requirements for funds that do not offer their securities publicly and do not have more than 100 beneficial owners).

128. See *Senate Hearings*, *supra* note 5, at 743 (statement of Rudolf P. Berle, General Counsel, Investment Counsel Association of America) (arguing against "coupling" of "the proposals for the regulation of investment advisers" with "the proposals for the regulation of investment companies" in part because of differences in relationships of each to their clients or investors). As one witness before Congress noted, investment companies generally have "no personal contact whatsoever" with their investors, whereas a "highly personal relationship is of the very essence" of investment advisers' roles vis-à-vis their clients. *Id.*

129. *Investment Trusts and Investment Companies: Hearings Before a Subcomm. of the H. Comm. on Interstate and Foreign Commerce*, 76th Cong. 92 (1940) (statement of Dwight Rose, Investment Counsel Association of America); see also *Senate Hearings*, *supra* note 5, at 718 (statement of Charles M. O'Hearn, Vice President & Director, Clarke, Sinsabaugh & Co., Investment Counsel) ("[W]e believe that the investment counsel profession is quite distinct from the investment trust business and from the business of others who give investment advice; therefore we believe that we should not be lumped with investment trusts or others when regulatory legislation for them is considered.").

130. See, e.g., *Senate Hearings*, *supra* note 5, at 700, 702 (statement of James N. White, Scudder, Stevens & Clark, Investment Counsel) (describing private funds that Scudder, Stevens & Clark had formed "to make investment counsel available to the small investor" and that were "commingled funds of the [firm's] small clients").

advisers to lower their costs of managing smaller clients’ assets. Courts’ and regulators’ overlooking this history and their step-wise misinterpretation of judicial precedent and perpetuation of the misguided doctrine based on those misinterpretations produced the fund-client doctrine. However, aside from those miscues, there is scant foundation for the fund-client doctrine.

V. THE INVESTOR-CLIENT DOCTRINE

A. *Toward a More Coherent Approach*

The fund-client doctrine should be abandoned. At the most basic level, a doctrine that regards investors as clients (an “investor-client doctrine,” for ease of reference) promotes the internal coherence of the Advisers Act. As discussed above, it is a fund’s investors who have the discretion to place assets with the fund’s investment adviser (through investing in the fund) and to act on disclosure provided by that adviser. The obligations the Advisers Act prescribes for registered investment advisers are generally for the benefit of the advisers’ “clients.” However, under the Advisers Act, a fund’s investors do not have client status. The result is that myriad provisions of the Advisers Act and the rules under the Advisers Act that require certain disclosures be made to clients and that otherwise are intended to further client protection entirely miss what arguably should be their targets—the investors themselves. Instead, many of advisers’ obligations under the Advisers Act, by their terms, require advisers to disclose pertinent information to entities that the advisers themselves formed and often control completely.¹³¹

Under the investor-client doctrine, the provisions of the Advisers Act and the rules under the Advisers Act make sense: the prohibition in Section 206(3) of the Advisers Act of transactions between an adviser and its clients unless the adviser obtains the client’s informed consent would require that the adviser, in order to effect this type of “principal” transaction with a fund that it manages, obtain the consent of the investors (or of a group of investors) in that fund. Likewise, Section 205(a)’s requirement that an advisory contract specify that the adviser may not assign it without the relevant client’s consent would, in the context of an advisory contract between an adviser and a fund that it manages, require that the investors

131. Of course, even under the fund-client doctrine, investors and the fund’s adviser could agree that the investors will have the rights of “clients” under the Advisers Act, including the right to receive the disclosures that the adviser is obligated to provide its clients. *Cf.* UNIF. P’SHIP ACT § 22(b) (1914) (“Any partner shall have the right to a formal account as to partnership affairs . . . [i]f the right exists under the terms of any agreement . . .”). However, as between the adviser and investors, the adviser is more likely to be aware of what those disclosure and other rights are. Because the adviser would arguably not realize any benefit from becoming obligated to direct its disclosure and other advisory duties to fund investors, the adviser would not have any particular incentives to address the point in discussions with prospective investors.

in the fund supply their consent to the assignment, perhaps through a procedure requiring the assent of a majority in interest of those investors.

In addition, in soliciting investors for the funds they manage, advisers would need to adhere to the conflicts disclosure and other requirements set forth in Rule 206(4)-3 (the “cash solicitation rule”) under the Advisers Act, and, in supplying written disclosure documents to clients pursuant to Rule 204-3, the adviser would need to provide those statements to investors—again, the only persons in a position to act on that disclosure. Similarly, the disclosure obligations under Rules 206(4)-4 (regarding an adviser’s disciplinary history) and 206(4)-6 (regarding an advisor’s proxy voting practices and procedures) would be owed to investors rather than to the fund in which they have invested and that is controlled by the adviser providing the disclosure.

Supplementing the effect that, under the investor-client doctrine, information that investment advisers are obligated to provide clients would be provided to those in the best position to act on it, by regarding investors as the principals of the adviser acting as agent and the subject of the adviser’s fiduciary obligations, the investor-client doctrine would promote efficiency in investors’ asset allocation decisions. It would also further investor protection, a particular concern in light of the size of the hedge fund industry and the assets directed toward it and concerns about adviser misconduct, which have only become more pronounced in recent years and particularly in light of adviser misconduct that has been recently and prominently publicized.¹³²

Despite these ameliorative pragmatic considerations, however, the argument that private fund investors should be considered clients of the investment advisers that manage those funds may seem to strike at what has seemed to be a basic principle of investment adviser-client relationships. In particular, it undermines the notion that one’s client is someone who has directly engaged that person to provide certain specified services. It also invites the possibility that it could subject investment advisers to conflicts between the interests of the funds they manage and the investors in those funds. The remainder of this Part discusses those concerns in turn.

B. *The Meaning of “Client”?*

Someone’s having the status of client typically involves that person’s entering into a contractual relationship with the professional or other ser-

132. See, e.g., Abha Bhattarai, *Back in Court, Ex-Fugitive Is Sent to Prison*, N.Y. TIMES, July 4, 2008, at C4; Bloomberg News, *Chicago Hedge Fund Manager Indicted*, N.Y. TIMES, June 17, 2009, at B2; Matthew Goldstein & David Henry, *Bear Scandal: A Widening Probe*, BUS. WEEK, July 7, 2008, at 22; Danny Hakim, *A Hedge Fund Executive Is Guilty of Securities Fraud*, N.Y. TIMES, Apr. 15, 2009, at B1; Zachary Kouwe, *Hedge Fund Manager Who Invested Heavily With Madoff Agrees to Cede Control*, N.Y. TIMES, May 20, 2009, at B3; Reuters, *Arthur Nadel Is Indicted on Charges of Investor Fraud Totaling \$360 Million*, N.Y. TIMES, Apr. 29, 2009, at B7.

vice provider of which he or she is a client. Here, accountants, lawyers, interior decorators, architects, and personal trainers, among other professionals, come to mind as fitting within this model. So, too, would an investment adviser typically regard as its client the person with whom it has entered into an investment advisory agreement and to whom it directs the investment advisory services it provides under the agreement. The investor-client doctrine rejects that model and suggests that one can become a “client” by virtue of buying an interest in a private fund and without entering into any engagement agreement with the adviser providing (albeit indirectly) the advisory services to that person. However, as discussed below, employing the meaning of “client,” as traditionally understood, to counter the investor-client doctrine reads too much into the word.

This Article has shown that one’s having the status of a client of an investment adviser is important not because it defines what type of services the adviser will provide to that person but rather because it dictates the duties the adviser will owe to that person in providing them. Those duties will be fiduciary in nature. But fiduciary duties are myriad, their nature and extent subject to different interpretations. For example, some observers maintain that fiduciary duties are “default terms the parties would have negotiated if they had unlimited resources” for bargaining and others assert that fiduciary duties are principles grounded in the status of the fiduciary obligee vis-à-vis the obligor.¹³³ Others assert that the heart of a fiduciary relationship is affirmative, in the sense that a “fiduciary’s obligation [is] to adopt the principal’s goals, objectives, or ends,”¹³⁴ while others cast it as negative, as a restraint on discretion and “abuse of power.”¹³⁵

Regardless of the lens through which fiduciary duties are evaluated, however, the conclusion based on that evaluation is that fiduciary obligations, whether waivable or not, apply to the relationships between investment advisers and their clients. Even the propositions that fiduciary duties are “appropriate only where the owner delegates open-ended power to the manager” and are “cost-justified only where the owner lacks cheaper methods of monitoring and controlling her agent”¹³⁶ point to the applicability of default fiduciary obligations, at least insofar as the client grants discretionary authority to the investment adviser, as is the case with both investment funds and investors in those funds. After all, it is precisely in the context of a discretionary investment advisory relationship that an “owner” hands over to another control over the owner’s property and does not

133. See Arthur B. Laby, *The Fiduciary Obligation as the Adoption of Ends*, 56 BUFF. L. REV. 99, 100 (2008).

134. *Id.* at 103.

135. See, e.g., Ribstein, *supra* note 84, at 217 (describing fiduciary duties as “a particular type of constraint on agents’ conduct”); see also Frankel, *supra* note 90, at 811, 825 (noting that “[t]he extent of the fiduciary duty varies with the degree of potential abuse of power stemming from the relation” and that “[i]f the entrustor can protect himself from abuse of power, there is no need for the intervention of fiduciary law”).

136. Ribstein, *supra* note 84, at 217.

typically have the adviser's "special knowledge" regarding investment decisions that would otherwise enable the owner to monitor the adviser.

However, taking as a given that the business of providing investment advice carries with it fiduciary responsibilities (whether or not adviser and client should be able to contractually modify or waive those responsibilities) has no implications for the argument that investors in a fund, rather than the fund, should be considered clients of the fund's investment adviser. Any such implications would need to arise from the fact that the investor-client doctrine changes the relationship between fiduciary and principal. In particular, under the fund-client doctrine, an adviser's relationship with its client (the fund) is a product of contract—usually a contract directly between the investment adviser and the fund.¹³⁷ The investor-client doctrine, however, severs the contractual relationship between adviser and client.

An adviser's not having a contractual relationship with its would-be client (the investor) raises the question of whether the investors are able to make the adviser their agent and, beyond that, their fiduciary. A fiduciary, after all, is an agent of the principal it serves. But this question is readily addressed by the fact that fiduciaries need not have any direct relationship with the principals they serve. Case in point are corporate directors, who owe their duties to the corporation on behalf of shareholders in their capacities as residual claimants, and trustees, who owe their duties to the trust's beneficiaries, even though the shareholders have no direct contractual relationship with the directors, and the trust beneficiaries need not have any direct contractual relationship with the trustee.

Fiduciary theory is consistent with the notion that fund investors are, as between the fund and its investors, more appropriately deemed the clients of the fund's adviser. Beyond fiduciary theory and analysis, of course, remains the circumstance that, under the fund-client doctrine, funds are their advisers' "clients" only because the adviser determined, perhaps based on efficiency rationale, to aggregate into a single account individuals and institutions for whom it might otherwise manage assets on a separate account basis, with each such individual and institution having a separate agreement with the adviser and, therefore, regarded as a client.¹³⁸ A doctrine that regards that distinction as meaningful reflects an unwarranted elevation of form over substance.

137. In some cases, the fund is organized as a partnership or an LLC and the investment adviser is also the fund's general partner or managing member, and the adviser's relationship with and obligations to the fund derive from the partnership agreement or LLC agreement among the adviser (its capacity as general partner or managing member) and investors (in their capacities as limited partners or members). In those circumstances, the advisory contract is a component of a comprehensive agreement that constitutes the client (the fund), to which investors are also parties merely in their capacities as limited partners or members of the client.

138. See *supra* note 130 and accompanying text.

C. *Dueling Clients?*

Another question the investor-client doctrine raises is whether it may lead to conflicts of interest as between a fund an adviser manages and to the fund’s investors. This question, raised by *Goldstein*, largely rests on the premise that, under the investor-client doctrine, the adviser would be a fiduciary both to the fund and to its investors. In the view of the *Goldstein* court, that prospect would be a recipe for conflicts:

If the investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, then the adviser will inevitably face conflicts of interest. Consider an investment adviser to a hedge fund that is about to go bankrupt. His advice to the fund will likely include any and all measures to remain solvent. His advice to an investor in the fund, however, would likely be to sell. For the same reason, we do not ordinarily deem the shareholders in a corporation the “clients” of the corporation’s lawyers or accountants.¹³⁹

From the perspective of fiduciary theory, however, *Goldstein*’s use of lawyers and accountants in its analogy is not entirely apt, given the nature of investment advisory services at the time of and subsequent to the enactment of the Advisers Act. Investment advisers, particularly those managing funds, often do not provide the type of complete analyses of their clients’ financial needs that, for example, financial planners might.¹⁴⁰ Rather, many investment advisers simply develop and deploy particular investment strategies. Because of that, they attract clients not through promising to look after all facets of their clients’ financial circumstances but, rather, through the strategies they pursue and the returns those strategies have generated.

Accordingly, although it would be problematic for a lawyer to regard both a corporation and its shareholders as his or her client, the same problem need not arise in the investment advisory context. Rather, in the investment advisory context, a comparison to corporate directors, again, is more appropriate: first, although a director owes duties to the corporation’s shareholders, the director also arguably owes duties to the corpora-

139. *Goldstein v. SEC*, 451 F.3d 873, 881 (D.C. Cir. 2006) (citation omitted).

140. The fiduciary task force of the Financial Planning Association has defined a “financial planner” as “generally refer[ing] to providers who undertake the *financial planning process* for clients based upon their long-term goals.” JOHN P. MORIARTY AND CURTLAN R. McNEALY, FPA FIDUCIARY TASK FORCE, REGULATION OF FINANCIAL PLANNERS DATABASE, APPENDIX G1: FINAL REPORT ON FINANCIAL PLANNER STANDARDS OF CONDUCT 7 (2007). The “financial planning process,” for its part, is defined as the “process which typically includes, but is not limited to, these six elements: establishing and defining the client-planner relationship; gathering client data including goals; analyzing and evaluating the client’s financial status; developing and presenting financial planning recommendations and/or alternatives; implementing the financial planning recommendations; and monitoring the financial planning recommendations.” *Id.*

tion—the corporation being, in essence, a manifestation of the shareholders, considered collectively. This concept works because the duty that a director owes to shareholders is a duty predicated on the shareholders' status as such and not otherwise. Similarly, an investment adviser's duty to the investors in a fund the adviser manages is predicated on the investors' status as investors and not otherwise.

This is no different from an investment advisory client that is not a fund investor but that instead has simply placed assets in a custodial account for the investment adviser to manage (in a separate account arrangement). The investment adviser seeks to achieve good performance for the account, but to the extent that performance is not good, the adviser has no obligation to advise the client to terminate the advisory contract. Rather, its obligations are to abide by the investment advisory contract between the adviser and the client and to manage the account assets in accordance with that agreement—which often requires specified levels of disclosure of performance, periodic communication, and other mechanisms to ensure that the client has sufficient information to evaluate whether the arrangement should continue.

Second, in the context not only of hedge funds and other private funds, but also mutual funds and other registered funds, the investment adviser to the fund has, in important respects, assumed the role traditionally performed by corporate directors or other forms of management. That is, a fund's service providers—particularly the investment adviser, generally the fund's *raison d'être*¹⁴¹—have come to assume the fiduciary role of “management” that, in operating companies, boards of directors traditionally have assumed. Mutual fund boards of directors provide an illuminating illustration of the point. In evaluating the extent to which mutual fund directors should play a role in shareholder derivative litigation, as in the operating company context, courts have been known to show deference to independent directors' judgment.¹⁴² However, among the considerable differences between mutual funds and operating companies are that mutual fund directors arguably have fewer incentives to assume strong fiduciary roles and likely perceive—whether accurately or not—mutual fund shareholders as more able to evaluate their investments (in light of the ample information required to be disclosed to them) and

141. See William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1423 (2006) (“[F]unds almost always owe their very existence to investment advisers, which create the funds and shepherd them through their formation and incubation.”).

142. See *id.* at 14; Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1026-31 (2005). As some have noted, there are persuasive reasons to think that, in fact, shareholders do not evaluate and monitor their mutual fund investments or, to the extent they do so, act on those analyses. See Langevoort, *supra*, at 1035-36.

more able to act on that evaluation (in light of mutual funds' lenient liquidity terms) as compared with their operating company counterparts.¹⁴³

In the *public* fund context, then, an ideology of "consumer sovereignty" has plausibly been elevated above one of fiduciary obligation.¹⁴⁴ In light of that, and the fact that a mutual fund (like a hedge fund or other private fund) has its origins in the particular investment strategy of the investment adviser that determined to sponsor or create the fund in the first place, mutual fund directors are showing themselves less as vigilant watchdogs for shareholder interests than as a mutual fund's voice in the event of blatant misconduct by the fund's investment adviser, to whom they are otherwise deferential.¹⁴⁵ After all, even though the adviser typically does not have a relationship with the fund's investors, the fund, as with the adviser's strategy, is effectively the adviser's product. If funds' investment advisers have supplanted the roles of independent directors, then that bolsters the analogy between the duties owed by a corporation's directors to both the corporation and its shareholders and the duties owed by a fund's investment adviser to both the fund and its investors. That analogy, in turn, bolsters the conclusion, contrary to that of the *Goldstein* court, that fiduciary theory does not present undue difficulties for the investor-client doctrine.¹⁴⁶

Even reaching a different conclusion on that point, however, does not flout the investor-client doctrine because the obligations investment advisers owe funds, once investors are deemed clients, need not be *fiduciary* in nature. Despite an analogy between corporate directors and investment advisers, an investment adviser's owing its duties to the investors in the funds it manages, as the investor-client doctrine would have it, at least sug-

143. *See id.* at 1037-40.

144. *Id.* at 1019.

145. *See id.* at 1041-43; *see also* Birdthistle, *supra* note 141, at 1451 (arguing that, in mutual fund context, managerial power theory of executive compensation has greater relevance than optimal contracting approach, due in part to circumstance that "investment advisers are more powerful than [operating company] executives, and mutual fund boards of trustees are weaker than operating company boards of directors").

146. A related question is whether it is consistent with fiduciary principles for a fund's investment adviser to, effectively, circumvent the fund and direct its obligations instead toward the fund's beneficial owners. For this question, too, it is helpful to look to the fiduciary duties owed by directors and trustees. Directors are fiduciaries to shareholders, but that fact has no bearing on the separate and distinct legal status of the corporation. *See* Deborah A. DeMott, *The Figure in the Landscape: A Comparative Sketch of Directors' Self-Interested Transactions*, 62 L. & CONTEMP. PROBS. 243, 270 n.129 (1999) ("It is . . . not necessary to argue that the corporation is not a distinct and identifiable entity as a step in an argument that directors' decisions should be made to further the interests of shareholders.") (internal quotation marks and citation omitted). More importantly, it has no implications for whether directors' actions in furtherance of their duties to shareholders must also further the corporation's interests. *See id.* at 270 ("[T]he corporation's distinct identity, separate from its shareholders, [does not] entail that directors may exercise discretion to further interests at odds with those of shareholders.").

gests the *Goldstein* court's concern that those advisers may be confronted with conflicts of interest. That is, if the adviser owes fiduciary duties both to investors and to the fund in which they hold interests, which of the two constituencies should take precedence in the event a conflict *were* to arise?

That concern assumes that the duties an adviser owes to the fund need be of the same kind as, and therefore at risk of competing with, those that it owes to the investors. An adviser under any circumstances owes duties to the funds it manages—it cannot be otherwise—even though those funds are not in a position to act independently of the adviser, whether based on disclosure the adviser provides or otherwise. That is, the adviser is in control of the funds' investment activities and, as such, is responsible for the funds' earning profits or suffering losses as a result of those activities. Whether a fund's profits outweigh its losses in any period, or vice versa, directly affects the fund's investors. Indeed, it is the prospect of, and hope for, profitability that draws investors to investment funds in the first place.

Assuming, then, that the adviser owes duties of some sort to the fund in addition to owing duties to the investors, the most robust interpretation of those duties would be for the adviser to be a fiduciary not only to the investors but also to the fund itself, encompassing duties of loyalty and candor and the full panoply of fiduciary obligations. As discussed above, that arrangement is akin to a corporation's directors' relationships to the corporation and to the corporation's shareholders: both are fiduciary in nature, and yet they are not inconsistent with one another because the directors owe duties to shareholders *qua* shareholders and not otherwise. However, given that the fund does not have decisionmaking capacity apart from that held and exercised by its adviser or its affiliates, there is limited rationale for requiring a fund's adviser to owe client-type obligations to the fund itself, to be a *fiduciary* to the fund. That is, little is gained by the adviser's regarding the fund itself as a "client" to which it owes the array of fiduciary obligations.

Rather, the duties the adviser owes to the fund are based on the duty of care, with the particular standards set forth in the investment advisory agreement between the adviser and the fund. That the adviser must conduct its activities relating to the fund in a manner consistent with a specified level of care merely reflects not only general principles relating to service-provider/client relationships but also the basic tenets of tort law. A service provider, regardless of whether it is a fiduciary, must conduct its service-providing activities in a certain manner, lest it face a suit for breach of contract or negligence premised on the service provider's failure to adhere to the standard of care specified at the outset of the relationship. However, the obligation of a service provider, including one that provides investment advisory services, to act with "due care," however defined, is

not a fiduciary obligation.¹⁴⁷ This recognition that advisers’ obligations to the funds they manage differ from those they owe to the funds’ investors allows the investor-client doctrine to escape the potential for conflicting fiduciary obligations.

VI. CONCLUSION

This Article has argued that the fund-client doctrine is not supported by the history behind investment adviser regulation, by fiduciary theory, or by efficiency considerations. It has postulated that the investor-client doctrine, in addition to being consistent with the history of the Advisers Act and fiduciary theory, better aligns advisers’ obligations with investors’ interests and, by dissolving anomalies in statutory and regulatory provisions governing investment advisers, makes more sense from a policy perspective.

In adopting the Advisers Act, Congress intended for investment advisers to be subject to regulation based on the number of persons (clients) for whom the adviser managed assets.¹⁴⁸ At that time, however, with some exceptions, those “persons” were generally thought to be holders of separately-managed accounts rather than holders of interests in pooled investment entities.¹⁴⁹ As discussed above, as private funds’ roles in the asset management sector have grown, large and small “clients” have increasingly placed assets in funds that advisers sponsor, often as a matter of administrative convenience for both the investors and the advisers.

In a perhaps unwitting nod to that evolution, commentators on hedge fund activities have long expressed dismay that investment advisers to large hedge funds and other private funds are not subject to the same regulation as similarly sized advisers who do not pool assets in funds.¹⁵⁰

147. See Ribstein, *supra* note 84, at 220 (“[A] duty of care should not be regarded as fiduciary in nature.”); see also William A. Gregory, *The Fiduciary Duty of Care: A Perversion of Words*, 38 AKRON L. REV. 181, 188-89 (2005) (noting that “[a] duty of care claim is always a tort action and is always based on negligence” and “can never be a breach of fiduciary duty”). However, a fiduciary relationship also imposes a duty of care on the fiduciary. See Cooter & Freedman, *supra* note 89, at 1047 (observing that “fiduciary relationship exposes a beneficiary/principal to two distinct types of wrongdoing”—malfeasance and nonfeasance—that former is governed by duty of loyalty whereas the latter is controlled by duty of care); see also Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 599 (1997).

148. See 2004 Release, *supra* note 53, at 72,066 (“The intent of Congress in enacting [S]ection 203(b)(3) appears to have been to create a limited exemption for advisers whose activities were not national in scope and who provided advice to only a small number of clients, many of whom are likely to be friends and family members.” (citing 15 U.S.C. § 80b-1 (2006))).

149. See *supra* note 6 and accompanying text.

150. Importantly, this Article’s argument that, as between a fund and its investors, the investors are the appropriate subjects of the adviser’s obligations, does not speak to the broader question of whether default fiduciary obligations are appropriate where an adviser’s client is sufficiently “sophisticated” in financial matters (as investors in hedge funds and other private funds are often presumed to be)

The amendments to the Advisers Act under consideration in Congress would respond to that dismay but would do so through eliminating the private adviser exemption rather than through embracing the investor-client doctrine. Accordingly, they would perpetuate other, similar incongruities throughout the Advisers Act. Policy based on the investor-client doctrine likewise would bring large fund managers within the SEC's regulatory purview, but, as this Article has argued, it would accomplish substantially more than that.

that he or she should be expected to fend for himself or herself. Exploring that question—which is part of the still broader question of what degree of regulation achieves an appropriate balance between investor protection and promoting efficient financial markets and capital formation—is beyond the scope of this Article.