

HARVARD BUSINESS LAW REVIEW

A FEDERAL FIDUCIARY STANDARD UNDER THE INVESTMENT ADVISERS ACT OF 1940: A REFINEMENT FOR THE PROTECTION OF PRIVATE FUNDS

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Introductory Note

The appropriate role of the fiduciary standard in the financial industry has garnered a lot of attention of late. Lawmakers, investors, and industry are all adding their voices to the chorus that will eventually become the regulatory response to the call to harmonize standards of professional conduct within the U.S. financial sector. The debate has pitted investors against industry, brokers against investment advisers, Congress against the President, and the Department of Labor against the Securities and Exchange Commission. However, what has gotten lost in the debate is the astonishing fact that Article III courts have barely begun to interpret one of the oldest federally established fiduciary relationships, that of the investment adviser and its client. More specifically, the judiciary has had scant opportunity to interpret section 206 of the Investment Advisers Act of 1940 beyond the seminal conclusion in SEC v. Capital Gains Research Bureau, which has been interpreted as holding that Congress intended to establish a federal fiduciary duty for investment advisers. However, a quick thumb-through of any treatise on agency law would illuminate the highly nuanced reality of the fiduciary relationship. Nowhere is this nuanced reality brought into sharper relief than when an investment adviser's client is a private fund, such as a hedge fund. There, the client has no eyes with which

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to see, ears with which to hear, or a mind with which to comprehend. When faced with such an impaired principal, the law has taken care to develop doctrines to appropriately allocate benefits and burdens of conduct. This Article identifies such doctrines that have boiled up out of the cauldrons of state common law, and, through their application, addresses how the antifraud provisions of the federal securities laws should be applied to investment advisers advising private funds.

* * *

I. Introduction

From time to time, the U.S. Securities and Exchange Commission (Commission) conducts investigations of, or brings enforcement actions against, investment advisers to private funds. Where these matters involve conflicts of interest between the adviser and its client, the private fund, the Commission¹ must craft its legal theory under sections 206(1)–(3) of the Investment Advisers Act of 1940 (Advisers Act),² taking into consideration the unique agency law doctrines that apply when an adviser acts as an agent for a client that is not a natural person.³ In such a circumstance, the adviser’s client has no eyes with which to see, ears with which to hear, or a mind with which to comprehend. In the usual course where the client is a natural person, the adviser can call up its client, disclose its conflict of interest, and obtain the client’s consent. However, when the client is a private fund, the adviser finds itself in the perverse position of providing disclosure of its conflict of interest to itself as the client’s agent. The Commission has historically taken the position that such disclosure is insufficient under the Advisers Act.⁴ Accordingly, the Advisers Act embodies the notion that imposing legally enforceable fiduciary duties on investment advisers serves as a crucial counterpoint to the informational asymmetries that exist between advisers and their clients.

As this Article progresses, it may be helpful to keep in mind the different standards to which various investment professionals are held. For example, security brokers must recommend “suitable” securities,⁵ whereas investment advisers must act in their clients’ best interest.⁶ The

¹ Generally, there is no private right of action under the Investment Advisers Act of 1940. *See Transamerica Mortg. Advisors v. Lewis*, 444 U.S. 11 (1979). In large part, this explains the relative dearth of case law deeply exploring the fiduciary duty of investment advisers under the statute. Therefore, it is left to the Commission to decide in which forum to bring their section 206 cases, administratively or before an Article III judge.

² Investment Advisers Act of 1940 § 206(1)–(3), 15 U.S.C. § 80b-6 (2012).

³ *See, e.g., In re Paradigm Capital Mgmt., Inc.*, Investment Advisers Act Release No. 3857, 109 S.E.C. Docket 430 (June 16, 2014) (discussing an adviser’s failure to use sufficiently independent conflicts committees where the adverse interest doctrine prevented the investment adviser, as a conflicted fiduciary, from acting on behalf of its client, a hedge fund).

⁴ *See, e.g., id.; In re Eric David Wanger*, Investment Advisers Act Release No. 3427, 104 S.E.C. Docket 3 (July 2, 2012); *SEC v. DiBella*, 587 F.3d 553 (2d Cir. 2009). *But see SEC v. Northshore*, No. 05 Civ. 2192(WHP), 2008 WL 1968299 (S.D.N.Y. 2008).

⁵ *See Duties of Brokers, Dealers, and Investment Advisers*, Investment Advisers Act Release No. 3558, 105 S.E.C. Docket 3092 at n.50 (Mar. 1, 2013) (stating the minimum standard of care owed customers by brokers is suitability).

⁶ *See Transamerica*, 444 U.S. at 17 (“[Section] 206 establishes ‘federal fiduciary standards’ to govern the conduct of investment advisers”) (citing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 n.11 (1977) (“Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers.”));

existence of a financial benefit flowing to an investment adviser as a result of acting on behalf of a client or making a recommendation to a client raises the rebuttable presumption that the investment adviser is not acting in its client's best interest.⁷ If an agent has a conflict of interest in connection with a decision it must make on behalf of its principal, fiduciary law requires the agent to disclose the conflict to its principal and obtain the principal's consent before proceeding.⁸ However, if the principal is a mere legal personality, such as a trust or a limited liability company with no board of trustees or board of directors, the agent is generally the principal's first-line decision maker. To handle the various liability issues arising in this circumstance, state law has developed three important doctrines: (1) the doctrine of imputation;⁹ (2) the adverse interest doctrine;¹⁰ and (3) the sole actor doctrine.¹¹

However, looking to state law on a case-by-case basis to determine liability under the Advisers Act creates an unworkable legal framework, in part because inconsistent application of these doctrines leads to inconsistent liability for similar actions.¹² This Article argues that an investment adviser's liability under section 206—when acting as the agent for a private fund—should be determined under a federally established uniform framework, and should not be contingent upon the application of state fiduciary law.¹³ Accordingly, this Article will briefly address: (1) the structure of the private fund industry; (2) the historical source of fiduciary duty; (3) the source of fiduciary duty for “investment advisers” as that term is defined by the Advisers Act; (4) whether there is a federal fiduciary duty or, instead, a state-by-state application of agency law; and (5) whether and to what extent the state common law adverse interest and sole actor doctrines should be incorporated into the federal fiduciary standard under the Advisers Act.

II. Background: A Primer on the Private Fund Industry and Brief History of Fiduciary Duty

SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191–92 (1963) (“[The Advisers Act] reflects 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 as investment adviser-consciously or unconsciously-to render advice which was not disinterested.”); *see also In re Arlene W. Hughes*, 27 S.E.C. 629 (1948), *aff'd sub nom. Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949) (setting out the Commission's views on essential aspects of fiduciary responsibility, focusing on the burdens of investment advisers when conflicts are present).

⁷ *See* Securities Act Release No. 3043, Exchange Act Release No. 3653, Investment Advisors Act Release No. 40 (Feb. 5, 1945) (Opinion of Director of Trading and Exchange Division).

⁸ *See* RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. c (AM. LAW INST. 2006).

⁹ *See, e.g., Martin Marietta Corp. v. Gould, Inc.*, 70 F.3d 768 (4th Cir. 1995) (applying Maryland law).

¹⁰ *See* RESTATEMENT (THIRD) OF AGENCY § 5.04 (AM. LAW INST. 2006).

¹¹ *See National Turners Bldg. & Loan Ass'n v. Schreitmuller*, 285 N.W. 497, 586 (Mich. 1939).

¹² There are two instances where this is problematic. First, consider the scenario where two advisers act adversely to their clients, two separate private funds, by engaging in conflicted transactions. One adviser organized its fund in a jurisdiction that does not recognize the sole actor doctrine while the other adviser organizes its fund in a jurisdiction that does recognize the sole actor doctrine. In this scenario, as explained in greater detail below, the former adviser would be liable under the Advisers Act while the latter adviser would not, even though they engaged in the same misconduct. Second, if an adviser advised two funds, one organized in a jurisdiction that does not recognize the sole actor doctrine and one organized in a state that does, and the adviser acted adversely to both funds, applying state law would lead to the perverse result that the adviser could be on the hook for conduct directed to one fund and not the other, despite engaging in the same conduct.

¹³ As will be explained below, state fiduciary law could be applied in this circumstance through the operation of state choice-of-law rules or the internal affairs doctrine.

A. Structure of the Private Fund Industry

A unique problem in fiduciary law arises when the principal exists only as a legal entity and with no one other than its agent on which to rely for decision making. The problem under these circumstances is how the principal and agent resolve conflicts of interest, especially in the context of business and investment transactions. Under the Advisers Act, this problem arises out of the relationship between an investment adviser and a private pooled investment vehicle, such as a hedge fund or private equity fund (fund or private fund).¹⁴

Such funds are typically organized as a limited partnership (LP) or as a limited liability company (LLC).¹⁵ LPs are managed by a general partner (GP), and the investors in the fund receive securities in the form of limited partnership interests.¹⁶ Similarly, LLCs are managed by a managing member (manager), and the investors in the fund receive securities in the form of membership interests.¹⁷ Typically, the investment adviser to the fund acts as the fund's GP or manager.¹⁸ The investors, as limited partners or members, are mere passive investors in the fund, with little to no operational control.¹⁹

Managing a private fund places investment advisers in a fiduciary relationship—owing duties of loyalty and care to the fund—under both state and federal law. State law imposes these duties based on the adviser's role as the fund's GP or manager,²⁰ while the Advisers Act imposes this fiduciary relationship between all investment advisers²¹ and their clients,²² funds included.²³

¹⁴ “Private fund” means “an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. § 80a-3), but for section 3(c)(1) or 3(c)(7) of that Act.” Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-2a(29) (2012); *see also* 17 C.F.R. § 275.206(4)-8 (2016) (defining “pooled investment vehicle”).

¹⁵ *See* SEC STAFF, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 9 & n.27 (2003).

¹⁶ *See id.* at 49.

¹⁷ *See id.* at 9 & n.27.

¹⁸ *See id.*

¹⁹ *See, e.g.,* R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 21.1 (2015); *see also* TAMAR FRANKEL ET AL., REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS § 21.01 & n.99 (2015).

²⁰ *See, e.g.,* BALOTTI & FINKELSTEIN, *supra* note 19, at §§ 19.7, 20.9, 21.6.

²¹ Cases have held that GPs and managers meet the definition of “investment adviser.” *See, e.g.,* Abrahamson v. Fleschner, 568 F.2d 862 (2d Cir. 1977); SEC v. Saltzman, 127 F. Supp. 2d 660 (E.D. Pa. 2000); SEC v. Spyglass Equity Sys., Inc., Litig. Release No. 21892 (Mar. 22, 2011) (charging the manager of an LLC primarily under the Advisers Act); *see also* FRANKEL, *supra* note 19, §§ 3.03, 21.01. It is worth clarifying, however, that the adviser breaches its fiduciary duty as the investment adviser to the fund, not as a GP or manager of the fund. Further, it is under this federally-imposed fiduciary relationship that the doctrines of imputed knowledge, adverse interest, and sole actor should be developed, and not under state fiduciary law. Further still, some jurisdictions allow parties to abdicate such duties through freedom of contract. *See* BALOTTI & FINKELSTEIN, *supra* note 19, §§ 19.7, 20.9, 21.6. However, the Advisers Act expressly prohibits such abdication through contract. *See* Investment Advisers Act of 1940 § 215, 15 U.S.C. § 80b-15 (2012).

²² *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963); *see also* FRANKEL ET AL., *supra* note 19, § 13.01. *See generally* Arlene W. Hughes, 27 S.E.C. 629 (1948) (setting out the Commission's views on essential aspects of fiduciary responsibility, focusing on the burdens of investment advisers when conflicts are present), *aff'd sub nom.*, Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949).

²³ Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006) (vacating Rule 203(b)(3)-2 under the Advisers Act and allowing an adviser to treat a single fund, rather than the individual investors, as its client).

Since the investors in a fund are passive, the investment adviser, as GP or manager, is the only person operationally in control of the fund. Thus, if the investment adviser wants to enter the fund into a transaction that would confer a substantial benefit on the adviser, then the adviser is faced with a conflict of interest that must be resolved lest the investment adviser, the agent, breach its fiduciary duty to the fund, its principal.

As a final piece of background material, it is useful to point out the major distinctions between private funds and publicly traded investment companies, such as mutual funds. Registered funds and private funds are similar in that both issue and hold pools of securities. Investors are able to obtain both professional investment management and diversification through investing in these funds. The two types of funds may even engage in the same type of investment strategies and therefore hold similar types of investments.²⁴ However, the similarities in these vehicles rapidly taper off at this point.

Registered funds, more precisely categorized as registered investment companies, are heavily regulated by the Investment Company Act of 1940 ('40 Act).²⁵ In large part, the '40 Act is a federal corporate governance statute, regulating such things as the independence of a registered investment company's board of directors, shareholder votes, and affiliated transactions.²⁶ Furthermore, investment companies must register with the Commission as such under the '40 Act, register their publicly offered securities, and comply with the disclosure and reporting requirements of the federal securities laws.²⁷ Private funds, because they are excluded from the definition of "investment company" by virtue of sections 3(c)(1) and (7), essentially avoid all regulation under the '40 Act.²⁸

B. The Historical Sources of Fiduciary Duty

Before exploring the contours of fiduciary law, it is worth noting what several legal luminaries have said on the topic. The venerable Professor Stanley A. Kaplan, formerly of the University of Chicago Law School, once expressed that "fiduciary duty" was "a concept in search of content."²⁹ Earlier, and only three years after the passage of the Advisers Act, Justice Frankfurter stated that, "[t]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge those obligations? And what are the consequences of his deviation from duty?"³⁰ This section will explore these questions.

State common law is the historical source of the fiduciary duty in the United States.³¹ In

²⁴ See SEC STAFF, *supra* note 15, at 5–7.

²⁵ Investment Company Act of 1940, 15 U.S.C. § 80a (2012).

²⁶ See, e.g., *id.* §§ 10, 16, 12(d), 17, 56.

²⁷ See SEC STAFF, *supra* note 15, at 5–7.

²⁸ See §§ 3(c)(1), (7).

²⁹ See A. A. Sommer, Jr., *Foreword: Fiduciary Duties—The Search for Content*, 9 Loy. U. Chi. L. J. 525, 525 (2015).

³⁰ SEC v. Chenery Corp., 318 U.S. 80, 85–86 (1943).

³¹ See e.g., *Quinn v. Phipps*, 113 So. 419, 421 (Fla. 1927) ("[T]he relation and duties involved need not be legal; they may be moral, social, domestic, or personal. If a relation of trust and confidence exists between the parties (that is to say, where confidence is reposed by one party and a trust accepted by the other, or where confidence has been

general, the common law of the states has and continues to recognize three relationships as giving rise to fiduciary duties: (1) expert relationships; (2) agency relationships; and (3) trustee relationships.³² Each has considerable utility and serves a vital role in society. Primarily, these relationships are an efficient solution for information asymmetries that arise in different ways depending on the relationship in question. However, relying on experts, agents, or trustees places laypersons, third parties,³³ and beneficiaries, respectively, at risk of being abused by those serving in such positions of trust and influence. Legally enforceable fiduciary duties serve as a crucial check on this power. Thus, society benefits from an efficient solution to information asymmetries without the cost of abuse being intolerably high.

Significantly, fiduciaries are distinguished from most other business practitioners in two ways. The typical business practitioner is only subject to a commercial standard of conduct.³⁴ Fiduciaries, however, possess the technical expertise, experience, and specialized knowledge that equip them to render advice with the care of a prudent person vested with such skills. In addition, they are bound by an undivided loyalty to their client. In short, fiduciaries owe their clients a duty of care³⁵ and a duty of loyalty,³⁶ which exceed the typical business practitioner's commercial standard of conduct.

C. *The Historical Source of an Investment Adviser's Fiduciary Duty*

Prior to the passage of the Advisers Act, investment advisers³⁷ were fiduciaries under state common law. As investment experts, investment advisers conferred a benefit on society by bridging the knowledge gap between themselves and the average American over wealth generation and capital formation. Because society viewed generating wealth and forming capital

acquired and abused), that is sufficient as a predicate for relief.”); *see also* *Tibble v. Edison Int'l*, 135 S.Ct. 1823, 1828 (2015) (noting that the fiduciary duty created by the federal Employee Retirement Income Security Act is “derived from the common law of trusts”) (citation omitted).

³² *See* Knut A. Rostad, *Six Core Fiduciary Duties for Financial Advisors*, INST. FOR FIDUCIARY STANDARD (2013); Lorna A. Schnase, *Investment Adviser's Fiduciary Duty*, INST. FOR FIDUCIARY STANDARD (2010); Andrew J. Donohue, Director, SEC Div. of Inv. Mgmt., Keynote Address at IAA/ACA Insight's Investment Adviser Compliance Forum 2010 (Feb. 25, 2010), <https://www.sec.gov/news/speech/2010/spch022510ajd.htm>.

³³ Later, this Article will discuss that agents may also wield considerable power over their principals when their principals are not natural persons.

³⁴ *See* *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963) (stating that a fundamental purpose of the federal securities laws was to replace the default business standard of *caveat emptor* with higher standards of conduct designed to achieve a high standard of business ethics in the securities industry).

³⁵ *See, e.g.*, Fla. Stat. § 518.11(1)(a) (2016) (“The fiduciary has a duty to invest and manage investment assets as a prudent investor would considering the purposes, terms, distribution requirements, and other circumstances of the trust.”); *see also* *United States v. White Mountain Apache Tribe*, 537 U.S. 465, 475 (2003) (“[The] standard of responsibility is ‘such care and skill as a man of ordinary prudence would exercise in dealing with his own property.’”) (citation omitted).

³⁶ *See* RESTATEMENT (THIRD) OF AGENCY § 8.01 (AM. LAW INST. 2006); *see also* *Capital Bank v. MVB, Inc.*, 644 So. 2d 515, 520 (Fla. Dist. Ct. App. 1994); *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (“Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.”).

³⁷ When discussing the term “investment adviser” prior to the passage of the Advisers Act, this Article is referring to the most inclusive categorization of the term and so includes all of the enumerated professions excluded from the Advisers Act's definition. Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. 80b-2(a)(11) (2012).

to be vital to the economy, while recognizing the potential for abuse by unscrupulous investment advisers, state law determined that it was in the public interest to impose fiduciary duties on investment advisers as experts.³⁸

Additionally, it was common for investment advisers to find themselves acting as agents or trustees. When investment advisers were given discretionary authority over an investor's assets, investment advisers entered into a principal-agent relationship with their clients. As agents, investment advisers were then bound by the fiduciary duties developed under state agency law. Furthermore, investment advisers were sought out for their investment expertise to manage trust assets as trustees. There again, investment advisers were bound by the fiduciary duties developed under state trust law. Thus, prior to the passage of the Advisers Act, investment advisers were commonly recognized by the states to be fiduciaries.³⁹

III. The Federal Fiduciary Standard

The Supreme Court has said that when interpreting an act of Congress, it must assume Congress drafts legislation aware of developments in the common law.⁴⁰ Therefore, without reference to legislative history, it can be assumed that Congress was aware of the common law developments that declared investment advisers fiduciaries when it passed the Advisers Act. Since the enactment of the Advisers Act, the Supreme Court has repeatedly held that investment advisers, as defined by section 202(a)(11) of the Advisers Act, are fiduciaries, and that Congress intended to codify this fiduciary duty through section 206 of the Act.⁴¹

While there is no substantive federal common law outlining the scope of this fiduciary duty,⁴² its contours may be informed by state common law. Moreover, a desire to promulgate a broadly applicable fiduciary standard likely precluded Congress from providing specifically for the numerous situations that might arise between an investment adviser and its client. Therefore,

³⁸ See Rostad, *supra* note 32; Schnase, *supra* note 32; Donohue, *supra* note 32. See generally Capital Gains Research Bureau, 375 U.S. at 187–90 (discussing the history of the investment advisory industry).

³⁹ See Rostad, *supra* note 32; Schnase, *supra* note 32; Donohue, *supra* note 32.

⁴⁰ See NORMAN SINGER & SHAMBIE SINGER, 2B SUTHERLAND STATUTES AND STATUTORY CONSTRUCTION § 50:1 (7th ed. 2015) (“Legislatures are presumed to know the common law before a statute was enacted.”); *id.* § 50:4 (“[It is useful] to examine a federal statute with reference to the common law of the various states as it existed when the statute was enacted.”). See generally Miles v. Apex Marine Corp., 498 U.S. 19, 32 (1990) (“We assume that Congress is aware of existing law when it passes legislation.”); *Capital Gains Research Bureau*, 375 U.S. at 195.

⁴¹ See *Transamerica Mortg. Advisors v. Lewis*, 444 U.S. 11, 17 (1979) (“[Section] 206 establishes ‘federal fiduciary standards’ to govern the conduct of investment advisers”) (citing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 n.11 (1977) (“Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers.”)); *Capital Gains Research Bureau*, 375 U.S. at 191–92 (“[The Advisers Act] reflects 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 as investment adviser—consciously or unconsciously—to render advice which was not disinterested.”); see also *Arlene W. Hughes*, 27 S.E.C. 629 (1948) (setting out the Commission’s views on essential aspects of fiduciary responsibility, focusing on the burdens of investment advisers when conflicts are present), *aff’d sub nom. Hughes*, 174 F.2d. *But see* Arthur B. Laby, *SEC v. Capital Gains Research Bureau and the Investment Advisers Act of 1940*, 91 B.U. L. REV. 1051 (2011) (arguing *Capital Gains Research Bureau* did not establish a federal fiduciary duty).

⁴² See *Erie R. Co. v. Tompkins*, 304 U.S. 64, 78 (1938) (holding that there is no substantive federal common law).

the Advisers Act should be interpreted to synchronize section 206 with state and common law rules and maxims⁴³ that are consistent with the purposes of the Act.⁴⁴

There is scant case law on whether the federal fiduciary duty codified in section 206 can be interpreted to synchronize the well-developed state law doctrines regulating fiduciaries, such as those found in the law of agency.⁴⁵ To fill the void, one approach may be to argue that whether an investment adviser is liable under section 206 turns upon the applicable state law for fiduciaries. Accordingly, there are several ways in which federal courts may apply state law. First, a federal court may invoke the internal affairs doctrine,⁴⁶ reasoning that whether or not a particular doctrine applies depends on the state law under which an investment adviser is organized.⁴⁷ Alternatively, when state law claims are heard in federal court under the court's diversity or supplemental jurisdiction, a federal court may apply the appropriate state law according to the choice-of-law rules of the forum state.⁴⁸ However, as explained below, it is untenable to apply state law to a purely federal claim unavailable to private litigants, but instead, available only to a federal agency serving in its law enforcement capacity.

None of the foregoing reasons for applying state law is appropriate when determining liability under section 206. As an initial matter, a violation of section 206 is a federal claim, which can be brought only by the Commission.⁴⁹ Furthermore, it would be manifestly against the express purposes of the Advisers Act for liability under section 206 to be dependent upon state law, as this would yield inconsistent outcomes.⁵⁰ Rather, Congress recognized the important role investment advisers played in the economy, and intended the Advisers Act to apply uniformly to

⁴³ See Singer & Singer, *supra* note 40, § 50:2; see also *Info-Hold, Inc. v. Sound Merchandising, Inc.*, 538 F.3d 448, 455–56 (6th Cir. 2008) (quoting *Carter v. United States*, 530 U.S. 255, 266 (2000) (“[W]e have not hesitated to turn to the common law for guidance when the relevant statutory text does contain a term with an established meaning at common law.”)).

⁴⁴ See *Capital Gains Research Bureau*, 375 U.S. at 191–92 (“[The Advisers Act reflects] 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.”).

⁴⁵ See *SEC v. DiBella*, 587 F.3d 553, 568 (2d Cir. 2009) (addressing consent by a conflicted fiduciary under section 206(2), stating that “[t]hird party disclosure to an agent is not imputed to the principal when the agent is acting adversely to the principal’s interest and the third party has notice of this”) (citing *Arlinghaus v. Ritenhour*, 622 F.2d 629, 636 (2d Cir. 1980)).

⁴⁶ See MARK H. ALCOTT & MARC FALCONE, *BUSINESS AND COMMERCIAL LITIGATION IN FEDERAL COURTS* § 102:6 (Robert I. Haig ed., 3d ed. 2015) (indicating the internal affairs doctrine, *lex incorporationis*, “holds that the relationships within a corporation—those among the corporation, its officers, directors, and shareholders—are governed by the law of the state of incorporation”).

⁴⁷ See, e.g., *Bank of China v. NBM LLC*, 359 F.3d 171, 179 (2d Cir. 2004) (applying New York common law); *Ruberoid Co. v. Roy*, 240 F. Supp. 7, 9 (E.D. La. 1965) (applying the Florida fiduciary law).

⁴⁸ See ALCOTT & FALCONE, *supra* note 46.

⁴⁹ See *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 24–25 (1979) (holding that there is only one private right of action under the Advisers Act for rescinding a contract); see also *id.* at 24 n.14 (“Such relief could provide by indirection the equivalent of a private damages remedy that we have concluded Congress did not confer.”).

⁵⁰ See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191–92 (1963) (“[The Advisers Act reflects] a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline [an] investment adviser—consciously or unconsciously—to render advice which was not disinterested.”); see also *Investment Advisers Act of 1940* § 222, 15 U.S.C. § 80b-18a (2012).

all investment advisers engaged in their profession through interstate commerce, wherever they may be organized.⁵¹ Concluding otherwise would lead to the perverse result that an investment adviser may avoid liability under section 206 by organizing in a state that does not recognize a particular doctrine of fiduciary law, while other investment advisers who engage in the identical conduct would be liable because their state of organization does recognize the doctrine at issue. In other words, Congress could not have intended to allow for investment advisers to engage in regulatory arbitrage. Therefore, a federal court should interpret the federal fiduciary duty under section 206 consistent with the purposes of the Advisers Act, and in so doing, synchronize this fiduciary standard with the appropriate common law rules and maxims developed in the states.⁵²

A. Synchronizing the Federal Fiduciary Standard with the Law of Agency

An issue ripe for interpretation under the fiduciary standard codified in section 206 is whether and to what extent the fiduciary standard under the Advisers Act should be synchronized with state law doctrines of agency law. Resolving conflicts of interest between investment advisers and their clients is especially challenging when their clients are private funds.⁵³ The challenge exists for two key reasons: (1) the investment adviser serves as the agent for the private fund; and (2) there are crucial differences in the management structure of private funds and investment companies.⁵⁴ Unlike investment companies, private funds almost never have boards comprised of independent directors,⁵⁵ nor are they required to obtain shareholder approval of for certain actions.⁵⁶ Instead, as the agent for a private fund, an investment adviser serves as the fund's eyes, ears, and mind. Thus, when an investment adviser has a conflict of interest with a private fund it manages, it is in the perverse position of disclosing its own conflict of interest to itself as the fund's agent. Accordingly, there should be a uniform framework of federal fiduciary law under the Advisers Act to address conflicts of interest between investment advisers and private funds.

Synchronizing the fiduciary standard with the appropriate common law rules and maxims developed in the states is the best way to achieve this goal. When an investment adviser to a private fund has a conflict of interest, the investment adviser is a conflicted fiduciary.⁵⁷ In the states, decades of doctrinal development in agency law have addressed the liability of agents and

⁵¹ See § 201.

⁵² On this point, the Commission's choice of forum should be criticized. So long as the Commission proceeds administratively, it continues to rob our beloved jurisprudence of doctrinal development by preventing Article III courts from interpreting the Advisers Act.

⁵³ See *Goldstein v. SEC*, 451 F.3d 871, 882–83 (D.C. Cir. 2006) (vacating Rule 203(b)(3)-2 under the Advisers Act).

⁵⁴ Investment companies are regulated by the '40 Act and the rules promulgated thereunder. Investment companies are defined in section 3(a) of that Act. Private funds are typically organized and operated in a manner to be excluded from the definition of "investment company" pursuant to section 3(c)(1) or section 3(c)(7) of the '40 Act. 15 U.S.C. §§ 80a-3(c)(1), (7) (2012). Consequently, private funds can avoid the jurisdiction of the '40 Act as long as they comply with the exclusion upon which they rely.

⁵⁵ *Cf.* § 10.

⁵⁶ *Cf.* § 13.

⁵⁷ See *SEC v. DiBella*, 587 F.3d 553, 568 (2d Cir. 2009) (addressing consent by a conflicted fiduciary under section 206(2), stating that "[t]hird party disclosure to an agent is not imputed to the principal when the agent is acting adversely to the principal's interest and the third party has notice of this") (citing *Arlinghaus v. Ritenhour*, 622 F.2d 629, 636 (2d Cir. 1980)).

their principals when the agents act adversely to the interests of their principals.

Agency law addresses a tripartite dynamic.⁵⁸ It is developed around the need to fairly assign liability between principals, agents, and third parties.⁵⁹ As the agent for a private fund, an investment adviser's conduct is either aimed at its principal or third parties. For purposes of the Advisers Act, the agency doctrines that apply when determining liability for an investment adviser's conduct depend on which remaining member of the tripartite the agent is defrauding—the third party or the investment adviser's principal, the private fund.

When an investment adviser is a conflicted fiduciary, there are three relevant doctrines of agency law: (1) the doctrine of imputation; (2) the adverse interest doctrine; and (3) the sole actor doctrine. Under agency law, the default rule is the doctrine of imputation, which states that the knowledge of an agent is imputed to its principal.⁶⁰ Typically, the principal possesses deeper pockets than its agent, thus the doctrine of imputation is asserted against a principal by a third party seeking to be made whole where it has been defrauded or otherwise harmed by the principal's agent. The adverse interest doctrine is an exception to the default rule of imputation and blocks the imputation of an agent's knowledge to its principal where the agent in the particular transaction acts adversely or antagonistically to its principal.⁶¹ The adverse interest doctrine is typically asserted by a principal seeking to avoid liability for its agent's conduct towards third parties by disclaiming its agent's knowledge.⁶² Lastly, the sole actor doctrine treats principal and agent as one if the agent controls the principal's decision-making or is its sole representative, thus reinstating the default rule of imputation where the principal is charged with notice of the agent's conduct.⁶³ Here, the sole actor doctrine would be asserted to collapse the silos of knowledge between a principal and its agent in order to establish notice on the part of the principal.⁶⁴

B. The Law of Agency in Securities Enforcement

An investment adviser becomes a conflicted fiduciary in several ways. For example, an investment adviser faces a conflict of interest when it engages in principal securities transactions with a client.⁶⁵ A principal transaction of this type occurs when the investment adviser directly or

⁵⁸ RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. c (AM. LAW INST. 2006) (“It has been said that a relationship of agency always contemplates three parties—the principal, the agent, and the third party with whom the agent is to deal.”) (quoting 1 FLOYD R. MECHEM, A TREATISE ON THE LAW OF AGENCY § 27 (2d ed. 1914)).

⁵⁹ See, e.g., *In re Sunpoint Sec., Inc.*, 377 B.R. 513, 567 (Bankr. E.D. Tex. 2007) (citing *Janvey v. Thompson & Knight, LLP*, No. 3:03-CV-158-M, 2003 WL 21640573, at *6 (N.D. Tex. July 8, 2003)) (“The imputation rule is designed to protect innocent third parties with whom a dishonest agent deals on a principal's behalf.”).

⁶⁰ See 3 C.J.S. *Agency* § 547 (2015).

⁶¹ See 3 Am. Jur. 2d *Agency* § 250 (2016); see also RESTATEMENT (THIRD) OF AGENCY § 5.04 (AM. LAW INST. 2006).

⁶² RESTATEMENT (THIRD) OF AGENCY § 5.04 (AM. LAW INST. 2006).

⁶³ See *id.* cmt. d., illust. 10.

⁶⁴ See, e.g., *Grassmueck v. Am. Shorthorn Ass'n*, 402 F.3d 833, 838–42 (8th Cir. 2005) (determining that the sole actor doctrine could apply as an exception to the adverse interest doctrine under the law of California, Oregon, Nevada, and Nebraska).

⁶⁵ See *Paradigm Capital Mgmt., Inc.*, Exchange Act Release No. 3857, 2014 WL 2704311 (June 16, 2014); see also *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 189 (1963) (“One activity specifically mentioned and condemned by investment advisers who testified before the Commission was trading by investment counselors

indirectly⁶⁶ enters into a securities transaction with a client for its own proprietary account.⁶⁷ To avoid violating section 206 of the Advisers Act, an investment adviser must: (1) disclose to its client that it is entering into the transaction on a principal basis and (2) obtain consent from the client to execute the transaction despite the investment adviser's conflict.⁶⁸ Furthermore, the investment adviser must provide such disclosure and obtain such consent on a transaction-by-transaction basis.⁶⁹

Significantly, resolving conflicts of interest, such as principal transactions, presents the Commission with a unique enforcement challenge under section 206. Few federal courts have had the opportunity to synchronize the federal fiduciary standard with the appropriate agency law doctrines.⁷⁰ Since not every jurisdiction's agency law doctrines are the same,⁷¹ it is still unsettled which doctrines the federal court would interpret section 206 to include.⁷²

As a consequence, a principal transaction between an investment adviser and a private fund exposes a critical doctrinal gap under the federal fiduciary standard.⁷³ In the securities enforcement context, the Commission brings unlawful principal transaction charges based on the

for their own account in securities in which their clients were interested.”) (internal quotes omitted); Interpretation of § 206(3) of the Investment Advisers Act of 1940, Exchange Act Release No. IA-1732, 1998 WL 400409 at *2 (July 17, 1998).

⁶⁶ See Interpretation of § 206(3), *supra* note 65, at n.3; see also *Paradigm Capital Mgmt.*, 2014 WL 2704311.

⁶⁷ See Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (2012).

⁶⁸ See Interpretation of § 206(3), *supra* note 65.

⁶⁹ See Securities Act Release No. 3043, *supra* note 7.

⁷⁰ See *SEC v. DiBella*, 587 F.3d 553, 568 (2d Cir. 2009) (addressing consent by a conflicted fiduciary under section 206(2), stating that “[t]hird party disclosure to an agent is not imputed to the principal when the agent is acting adversely to the principal’s interest and the third party has notice of this”) (citing *Arlinghaus v. Ritenhour*, 622 F.2d 629, 636 (2d Cir. 1980)). One court, however, has held that section 206(1) and 206(2) charges are not available in cases alleging that a conflicted adviser failed to disclose information to fund investors. See *SEC v. Northshore Asset Mgmt.*, No. 05 Civ. 2192(WHP), 2008 WL 1968299 at *6 (S.D.N.Y. May 5, 2008) (applying *Goldstein v. SEC*, 451 F.3d 871 (D.C. Cir. 2006), and concluding that, with regard to section 206(1) and 206(2) claims, “failure to disclose information or misrepresentations to the [fund entities’] investors cannot form the basis for a claim that [the adviser] breached his fiduciary duties to the [fund entities]”). The staff clearly believes that the *Northshore* decision does not preclude the Commission from charging violations of section 206(1) and 206(2) on these facts because the court never addressed (or even noted) the adverse interest argument in its opinion. See, e.g., *In re Paradigm Capital Mgmt., Inc.*, Investment Advisers Act Release No. 3857, 109 S.E.C. Docket 430 (June 16, 2014).

⁷¹ The presumption of imputed knowledge from agent to principal is generally regarded as a strong presumption. See, e.g., *In re Pitt Penn Holding Co.*, 484 B.R. 25 (Bankr. D. Del. 2012) (applying Delaware law). Further, the presumption of imputed knowledge from agent to principal is generally regarded as conclusive in some jurisdictions. See, e.g., *Freeman v. Super. Ct., San Diego Cty.*, 282 P.2d 857 (Cal. 1955); see also *Neb. Pub. Emps. Local Union 251 v. Otoe Cty.*, 257 N.W.2d 237 (Neb. 1999). The presumption of imputed knowledge from agent to principal is not rebuttable in some jurisdictions. See, e.g., *Kramer-Tolson Motors, Inc. v. Horowitz*, 157 A.2d 625 (D.C. 1960). Yet, the presumption of imputed knowledge from agent to principal is rebuttable in other jurisdictions. See, e.g., *BancInsure, Inc. v. U.K. Bancorporation Inc.*, 830 F. Supp. 2d 294 (E.D. Ky. 2011) (applying Kentucky law); *Mancuso v. Douglas Elliman LLC*, 808 F. Supp. 2d 606 (S.D.N.Y. 2011) (applying New York law); *Kirschner v. KPMG LLP*, 938 N.E.2d 941 (N.Y. 2010). Finally, the presumption of imputed knowledge from agent to principal is generally regarded as subject to the adverse interest exception. See *RESTATEMENT (THIRD) OF AGENCY* § 5.04 note c (AM. LAW INST. 2006) (discussing the application of the adverse interest doctrine across several jurisdictions).

⁷² For evidence of a judicial willingness to apply common law fiduciary duty principles in cases arising under the ’40 Act, see *Rosenfeld v. Black*, 445 F.2d 1337, 1342–43 (2d Cir. 1971), *cert. denied*, 409 U.S. 802 (1972).

⁷³ The same would be true for many other undisclosed conflicts of interest.

investment adviser's failure to: (1) provide meaningful disclosure to, and (2) obtain effective consent from, the private fund. In response to the Commission's charges, the investment adviser would likely argue that, as an agent, its knowledge is imputed to its principal, the private fund. Therefore, the doctrine of imputation would hold that the private fund is presumed to be aware of the investment adviser's conflict of interest.⁷⁴ Nevertheless, and at least one court agrees,⁷⁵ the Commission would argue that the investment adviser's conflict places its interests adverse to those of the private fund, and therefore the adverse interest doctrine would block the imputation of the investment adviser's knowledge to the private fund.

In this scenario, the remaining hurdle for the Commission to overcome is the sole actor doctrine. As noted above, when the agent is the principal's sole decision-maker or representative in a transaction, the sole actor doctrine revives the general rule of imputation. Accordingly, the best argument for the investment adviser to avoid liability under section 206 is to invoke the sole actor doctrine, arguing that as the sole decision-maker and representative of the private fund, knowledge of its conflict is imputed to the private fund. While this argument under section 206 has not been squarely addressed in the federal courts, it is clearly inconsistent with the purposes of the Advisers Act "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."⁷⁶ Therefore, in order to synchronize the federal fiduciary standard under the Advisers Act with common law rules and maxims in light of this purpose, federal courts should interpret section 206 to bar the application of the sole actor doctrine when the private fund is the investment adviser's intended victim.⁷⁷

The maxim that an agent's knowledge is not imputed to its principal when the principal is its agent's victim harmonizes the federal fiduciary standard under the Advisers Act with the purposes of agency law and the management structure of private funds. It is important to keep in mind that agency law doctrines were generally developed to protect innocent third parties.⁷⁸

⁷⁴ See, e.g., *Grasmueck v. Am. Shorthorn Ass'n*, 402 F.3d 833, 838–42 (8th Cir. 2005) (invoking the sole actor doctrine and imputing knowledge of fund's GP to the fund despite the GP acting adversely to the fund).

⁷⁵ See *SEC v. DiBella*, 587 F.3d 553, 568 (2d Cir. 2009) (addressing consent by a conflicted fiduciary under section 206(2), stating that "[t]hird party disclosure to an agent is not imputed to the principal when the agent is acting adversely to the principal's interest and the third party has notice of this") (citing *Arlinghaus v. Ritenhour*, 622 F.2d 629, 636 (2d Cir. 1980)).

⁷⁶ *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191–92 (1963).

⁷⁷ The law of agency presumes imputation even where an agent acts less than admirably, exhibits poor business judgment, or commits fraud against a third party, but not when an agent commits fraud against the principal. See, e.g., *Sec. Inv'r. Protect. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 476 B.R. 715 (S.D.N.Y. 2012), *supplemented* (May 15, 2012), *aff'd sub nom. In re Bernard L. Madoff Inv. Sec. LLC*, 773 F.3d 411 (2d Cir. 2014) (applying New York law); *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 952 (N.Y. 2010) ("The presumption that agents communicate information to their principals does not depend on a case-by-case assessment of whether this is likely to happen. Instead, it is a legal presumption that governs in every case, except where the principal is actually the agent's intended victim."); *Nerbonne, N.V. v. Lake Bryan Int'l Props.*, 685 So. 2d 1029, 1032 (Fla. Dist. Ct. App. 1997) (holding that an agent who defrauded its principal may not benefit from imputation of knowledge of fraud to its principal, and in dicta, discussing that the doctrine imputing an agent's knowledge to its principal when the agent is the sole actor in a transaction with a third party is applicable only to a controversy between the principal and an innocent third party); see also RESTATEMENT (THIRD) OF AGENCY § 5.04 note c (AM. LAW INST. 2006).

⁷⁸ This article does not attempt to explore the propriety of the sole actor doctrine outside of the fiduciary relationship between an investment adviser and its client. Indeed, the sole actor doctrine seems to exist to protect

Courts reasoned that, as between a third party and a principal, the principal was in the better position to monitor the conduct of its agent and therefore should bear the burdens flowing therefrom. However, by virtue of a private fund's structure, the presumption that the principal is in the best position to monitor the conduct of its agent is invalid.⁷⁹ As noted, a private fund does not typically have independent directors to serve as its eyes, ears, and mind. Hence, a private fund does not typically have the means to carry out such a monitoring function or create incentives for the investment adviser to act in its best interest. Thus, imputation to the private fund through the sole actor doctrine should not apply where the private fund is the intended victim.⁸⁰

IV. Conclusion

Experts like investment advisers serve a critical role in our society. Through great effort and sacrifice, these professionals have acquired skills, which, when deployed appropriately, command respect and remuneration. However, information asymmetries beget opportunities for abuse. A well-developed legal framework of fiduciary law is the panacea for private fund clients. As the Commission continues to pursue investment advisers to private funds for failing to disclose their conflicts of interest and obtain effective consent, the Commission ought to bring such cases before an Article III court. And when faced with such a controversy, the courts should recognize the unique structure of private funds and their relationships with their investment advisers, cutting off the application of the sole actor doctrine regardless of the jurisdiction in which the fund was organized.⁸¹

innocent third parties from unscrupulous principals seeking to avoid liability for their agent's conduct. Thus, the sole actor doctrine acquires a different gloss when asserted by a third party as opposed to here, where it is being asserted by an agent taking advantage of its principal.

⁷⁹ Cf. RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. b (AM. LAW INST. 2006).

⁸⁰ It is important to keep in mind that the jurisdiction in which a fund is organized may still affect an investment adviser's liability from the perspective of standing in the shoes of a GP or manager of a private fund. In this context, the GP or manager may owe fiduciary duties to the partnership or LLC depending on applicable state law. However, such claims would be adjudicated against the investment adviser under state law and not under the Advisers Act. Notably, as mentioned above, some jurisdictions allow parties to waive fiduciary duties.

⁸¹ The remaining question is whether the federal fiduciary standard explicated by the federal courts under the Advisers Act should apply across the entire universe of federal law, wherever fiduciaries are found, or just confined to a particular federal statute whereby Congress created a fiduciary standard.