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State Registration of Investment Advisers

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PREFACE

As this course focuses on an introduction to investment adviser regulation, the following information is designed to acquaint the reader with the scope of state jurisdiction over investment advisers and investment adviser representatives and various state registration and post-registration requirements.

A discussion of the various forms of administrative, civil and criminal liability to which investment advisers and investment adviser representatives may be subject under state securities laws is beyond the scope of an introductory program and this narrative. For those interested in that subject matter, an extensive examination of administrative and civil liability of investment advisers and investment adviser representatives is contained in Chapter 35 of PLI's Treatise on Investment Adviser Regulation.

However, it is noteworthy that, in January 2016, state securities regulators endorsed model state legislation to protect vulnerable adults (*eg* persons aged 65 or older and persons subject to adult protective services) from financial exploitation. This model legislation would allow investment advisers and investment adviser representatives to make disclosures concerning requested transactions by clients who are deemed to be vulnerable adults to state securities regulators and to delay requested disbursements from those client accounts without incurring administrative or civil liability for their actions under the relevant state securities law.

INTRODUCTION TO STATE REGULATION

Although the National Securities Markets Improvement Act of 1996 ("NSMIA")[1] left state jurisdiction over broker-dealers and their registered representatives (denominated as "agents" at the state level) virtually undisturbed (except for rules relating to books and records and capital requirements), it significantly altered state and federal jurisdiction over investment advisers. Not only did NSMIA divide investment adviser registration into mutually exclusive universes of federal and state jurisdiction, it also created a national *de minimis* provision, "home state" requirements relating to books and records, net capital and bonding and mandated establishment of an Investment Adviser Registration Depository

1. Public Law 104-296.

("IARD").[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank")[3] made further changes relating to state registration of investment advisers.

No discussion of state regulation of investment advisers is complete without addressing state regulation of investment adviser representatives. There is no requirement for investment adviser representatives to register with the U.S. Securities & Exchange Commission ("SEC") and, unlike agents of broker-dealers who must register with the Financial Industry Regulatory Authority ("FINRA"), there is no self-regulatory organization for investment advisers or investment adviser representatives.[4] Therefore, regulation of investment adviser representatives is solely a state function.

All states have a state agency charged with the administration of the state's securities statute. However, the placement of the administering office within the structure of state government differs widely and usually has historical antecedents. Helpfully, the web site of the North American Securities Administrators Association ("NASAA") maintains links to the web sites of every state securities regulator which provides easy navigation to determine what department of state government is charged with administering that state's securities laws.[5]

Some states have viewed securities regulation akin to banking regulation and have included securities regulation within its banking regulatory structure. Connecticut, Nebraska and Idaho are examples of banking departments having jurisdiction over state securities regulation. Other states have combined financial regulation into one department. Washington, Vermont and Wisconsin are examples where securities regulation is part of a larger department of financial regulation. In other instances, state securities regulation is a function of a state's department of commerce such as Ohio, Tennessee, Minnesota, Hawaii and Utah.

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2. IARD is modeled after the highly successful Central Registration Depository used by federal and state regulators and self-regulatory organizations to register broker-dealers and their agents.
3. Public Law 111-203.
4. In 2012, FINRA made a concerted effort to convince Congress to make it the self-regulatory authority for investment advisers and obliging legislation was introduced. That legislation was fiercely opposed by, among others, the Financial Planning Association and the Investment Counsel Association, and the bill died at the end of the 112th Congress. On April 10, 2014, the *Wall Street Journal* reported that FINRA no longer would seek designation as a self-regulatory organization for investment advisers.
5. A complete list of state securities regulators with contact details can be found at www.nasaa.org.

Some states, such as Virginia and Arizona, view securities regulation as adjunct to the duties of its corporation commission.

There exist a fair number of states where the responsibilities of securities regulation are vested in a statewide elected official, usually a secretary of state (*eg* North Carolina, Indiana, Illinois, Missouri, Massachusetts and Georgia), state auditor (*eg* Montana and West Virginia) or state attorney general (*eg* New York, Maryland, and Delaware). Lastly, some state securities regulators operate as independent agencies of state government. Oklahoma, Alabama and Arkansas are examples of states which follow that model.

NASAA is a non-profit organization whose membership consists of state securities regulators in the U.S., Puerto Rico, U.S. Virgin Islands, Guam and the District of Columbia as well as the securities regulators of the Canadian Provinces and Mexico. Although NASAA promotes uniformity among its members by adopting uniform statutes, model statutory amendments, model rules and model policy statements, it cannot force its members to adopt these pronouncements and therefore, they have no binding legal effect on its member jurisdictions.

UNIFORM STATE SECURITIES ACTS

State securities regulation predates federal regulation of securities by several decades with the first state securities law having been enacted by Kansas in 1911. The first attempt to harmonize state securities laws into a uniform statutory scheme was undertaken by the National Conference of Commissioners on Uniform State Laws ("NCCUSL") with its adoption of the Uniform Sales of Securities Act (1930) but this met with little success.[6]

Evolution of Uniform Securities Acts

The Uniform Securities Act (1956) ("USA 1956") was the second and much more successful attempt by NCCUSL to provide for uniform state regulation of securities, broker-dealers, agents and investment advisers as well as for civil liability and criminal penalties. The USA 1956 was enacted by 37 jurisdictions.[7]

In 1985, NCCUSL undertook an effort to update the USA 1956 to account for changes in the securities industry which had taken

6. Smith, Richard B., "A New Uniform Securities Act," *Wall Street Lawyer* (February 2003), p.8. Only a few states enacted the USA 1930.
7. *Id.*

place in the intervening years. Although adopted by NCCUSL as a uniform act to be recommended for adoption by state legislatures, the Uniform Securities Act (1985) ("USA 1985") never received the endorsement of key organizations such as NASAA and the American Bar Association and it consequently was adopted in only six states.[8]

In 1996, Congress enacted NSMIA which was the first major reallocation of securities regulatory authority between the SEC and state securities regulators since enactment of the Securities Act of 1933 ("1933 Act"), the Securities Exchange Act of 1934 ("1934 Act") and the Investment Advisers Act of 1940 ("Advisers Act").

In light of enactment of NSMIA and the failure of the USA 1985 to be widely adopted, NCCUSL tried again in 2002 to produce a new uniform securities act which would replace the USA 1956 and USA 1985 in their entirety. In the Prefatory Note to the Uniform Securities Act (2002) ("USA 2002") by Professor Joel Seligman,[9] he noted that the USA 2002 had three overarching themes: (1) emphasis on greater uniformity and cooperation among relevant state and federal governments and self-regulatory organizations, (2) consistency with federal preemption provisions in NSMIA, and (3) the facilitation of electronic records, signatures and filing.

Unlike the USA 1985, the USA 2002 was endorsed by NASAA[10] and the American Bar Association.[11] Although enactment of the USA 2002 thus far by 20 jurisdictions[12] is a much better record than the USA 1985, only two of the enacting states (Georgia and Michigan) are included in the ten most populous states in the United States.

Although there are many jurisdictions that still operate under the statutory framework of the USA 1956,[13] an effective discussion of

8. The USA 1985 was the subject of amendments adopted by NCCUSL in 1988. Although Maine enacted the USA 1985, it subsequently enacted the USA 2002, leaving only five jurisdictions with statutory roots in the USA 1985.
9. Professor Seligman served as NCCUSL's Official Reporter for the USA 2002.
10. Endorsed by NASAA Members on January 6, 2003.
11. Endorsed by the American Bar Association on February 10, 2003.
12. Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Maine, Michigan, Minnesota, Mississippi, Missouri, New Hampshire, New Mexico, Oklahoma, South Carolina, South Dakota, U.S. Virgin Islands, Vermont, Wisconsin and Wyoming (effective July 1, 2017).
13. New York's securities law, known as the Martin Act, is most unique. It is not based on the USA 1956 and is probably the only "dealer" statute left with respect to the issuance and distribution of securities. Although the securities laws of California, Florida, Ohio and Texas contain similarities to the USA 1956, they also contain significant differences. NCCUSL had hoped that its undertaking to produce the USA 2002 would induce these states in particular to adopt a uniform

state regulation of investment advisers and investment adviser representatives should reference their treatment under both the USA 1956 and USA 2002.

It also is worth noting that many USA 1956 jurisdictions amended their securities statutes after enactment of NSMIA and adoption by NCCUSL of the USA 2002, particularly in regard to the preemptive features of NSMIA affecting investment advisers. That has resulted in some jurisdictions having a securities statute grounded in the USA 1956 but containing a number of provisions found in the USA 2002.

To aid practitioners, the State Securities Committee of the Business Law Section of the American Bar Association maintains a subcommittee on state liaisons to state securities administrators who periodically update the bar on statutory and interpretive developments under various state securities laws.[14]

STATE REGULATORY JURISDICTION OVER INVESTMENT ADVISERS

NSMIA Establishes Mutually Exclusive Registration

NSMIA enacted Section 203A of the Advisers Act which states that no investment adviser that is regulated or required to be regulated in the state in which it maintains its principal office and place of business shall register with the SEC under Section 203 of the Advisers Act unless the investment adviser (1) had assets under management of not less than $25 million (or such higher figure as the SEC may determine) or (2) is an investment adviser to an investment company registered under the Investment Company Act of 1940 ("1940 Act").[15]

Rule 203A-3(c) under the Advisers Act defined, for purposes of Section 203A, the term "principal office and place of business" as the executive office of the investment adviser from which officers, partners or managers of the investment adviser direct, control and coordinate the activities of the investment adviser. Therefore, if a

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securities act in the form of the USA 2002. To date, this aspiration has not been fulfilled.

14. *See* http://apps.americanbar.org/dch/committee.cfm?com=CL68002. Charles Schwab and U.S. Compliance Consultants have developed a helpful State Registration Fact Sheet available at http://www.uscomplianceconsultants.com/PDF/State%20Registration%20Fact%20Sheets.pdf.
15. 15 U.S.C. §80b-3a(a)(1).

state where the investment adviser maintains its principal office and place of business does not require registration of investment advisers, such adviser remains subject to SEC registration.[16]

Except for fraud and deceit,[17] NSMIA created two exclusive registration universes for investment advisers based primarily upon the investment adviser's amount of assets under management ("AUM").[18] The initial demarcation was $25 million AUM. Less than $25 million AUM placed the investment adviser exclusively under state registration while AUM of $25 million or more placed the investment adviser under exclusive SEC registration. Dodd-Frank revised the demarcation to $100 million AUM [19] but only with respect to those investment advisers required to be registered with a state in which it maintains its principal office and place of business and which would be subject to examination by that state.[20]

There are several categories of investment advisers which remain subject to exclusive SEC registration without regard to AUM. These include an investment adviser that (1) had its principal place of business in a state that did not regulate investment advisers,[21] (2) is an investment adviser to an investment company registered with the SEC under the 1940 Act or a company which has elected to be a business development company under Section 54 of the 1940 Act,[22] (3) is required to register in 15 more states,[23] (4) is a pension

16. At the time NSMIA was enacted, there were several states which did not require registration of investment advisers. Currently, only Wyoming does not require registration of investment advisers and investment advisers that maintain a principal office and place of business in Wyoming must register with the SEC.
17. 15 U.S.C. §80b-3a(b)(2). The SEC and states retain concurrent jurisdiction to investigate and bring enforcement actions against investment advisers and persons associated with investment advisers who engage in fraud or deceit.
18. 15 U.S.C. §80b-3(a)(3); 17 CFR 203A-3. Assets under management mean the securities portfolios with respect to which an investment adviser provides continuous and regular supervisory or management services. *See* also Item 5.F. of Form ADV, 17 CFR 275.279.1.
19. The SEC may establish such higher amount as it deems appropriate.
20. 15 U.S.C. §80b-3a(a)(2)(B). Only New York indicated to the SEC that it did not conduct investment adviser examinations and therefore investment advisers with a principal office and place of business in New York with an AUM of $25 million or more would be subject to exclusive SEC registration.
21. 15 U.S.C. §80b-3a(a)(1). The only state which currently does not regulate investment advisers is Wyoming. This will change on July 1, 2017 when the Wyoming Uniform Securities Act, which is based on the USA 2002, becomes effective.
22. 15 U.S.C. §80b-3a(a)(2)(A).
23. 15 U.S.C. §80b-3a(a)(2)(A); 17 CFR 275.203A-1(d).

consultant with respect to assets of plans having an aggregate value of at least $200 million,[24] (5) provides investment advice to all of its clients through the internet,[25] (6) is eligible for SEC registration within 120 days after the registration becomes effective with the SEC,[26] and (7) is controlling, controlled by or under common control with an investment adviser registered with the SEC.[27]

States Permitted to Require Notice Filings by SEC-Registered Investment Advisers

Even where investment advisers are subject only to registration with the SEC, NSMIA did permit states to require that SEC-registered investment advisers file any document filed with the SEC with each state in which it conducts business for notice purposes only accompanied by a consent to service of process and any required filing fee.[28]

Section 405(a) of the USA 2002 makes it unlawful for a federal covered investment adviser[29] to transact business in the state as a federal covered investment adviser unless it complies with the notice filing requirements or is exempted from compliance.[30] Section 405(b) of the USA 2002 exempts a federal covered investment adviser that does not have a place of business in the state from the notice filing requirement if (1) its only clients in the state are (a) federal covered investment advisers, investment advisers registered under the state's securities laws and broker-dealers registered under the state's securities

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24. 17 CFR 275.203A-2(a).
25. 17 CFR 275.203A-2(e). Under Section 203A(c) of the Advisers Act, the SEC has authority to designate, by rule or order, that certain persons be registered exclusively with the SEC. This exemption is an exercise of that authority.
26. 17 CFR 275.203A-2(c).
27. 17 CFR 275.203A-2(b).
28. Section 307(a) of NSMIA. Generally, this consists of an annual filing of Form ADV and amendments thereto. Administratively, these filings are made through the IARD and are effective with the administrator upon filing. Section 407 of the USA 2002 permits a federal covered investment adviser succeeding to the notice filing of another federal covered investment adviser to file a notice under Section 405 for the unexpired portion of the current notice filing.
29. As used herein, federal covered investment adviser means an investment adviser subject to exclusive registration with the SEC. It is a term used in the USA 2002 to identify the same person.
30. Although the failure to make a notice filing may give rise to civil administrative enforcement under Sections 603 and 604 of the USA 2002, it would not give rise to any private civil cause of action under Section 509 of the USA 2002.

laws, (b) institutional investors, (c) bona fide pre-existing clients whose principal places of residence are not in the state and (d) other clients specified by rule or order issued by the administrator, or (2) in the preceding 12 months, did not have more than five clients resident in that state, exclusive of the clients described in (1) above.

De Minimis Preemption and Enforcement of Home State Rules

NSMIA enacted Section 222(d) of the Advisers Act which preempts the application of state law to an investment adviser that otherwise would be subject to exclusive state registration based upon minimum contacts with residents of a particular state. Generally, an investment adviser will be subject to registration by at least the state in which it maintains its principal office and place of business ("Home State").

This section prohibits a state from requiring registration if the investment adviser (1) does not have a place of business located within that state and (2) in the preceding 12-month period had fewer than six clients who are residents of that state ("National DeMinimis").[31] In contrast with the provisions of Section 222(b) and (c) governing imposition of books and records and capital and bonding requirements, there is no requirement that the investment adviser be registered in its Home State in order for the preemptive provisions of Section 222(d) of the Advisers Act to apply.

For purposes of application of the National DeMinimis, how to count clients becomes important and Rule 222-2 under the Advisers Act states that, for this purpose, the definition of "client" contained in Rule 202(a)(30)-1 shall govern without giving regard to paragraph (b)(4) of that section, including how to count legal organizations. Under SEC Rule 202(a)(30)-1 of the Advisers Act, a corporation, general partnership, limited partnership, limited liability company, certain trusts or other legal organization are counted as a single client provided that investment advice is based on the entity's investment objectives rather than the individual investment objectives of the shareholders, partners, limited partners, members or beneficiaries. If two or more legal organizations have identical owners, they also would be counted as a single client.

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31. A discussion of what constitutes legal residency is beyond the scope of these materials but persons who maintain more than one residence in different states could be viewed as residents of more than one state.

If an investment adviser is registered in its Home State and is in compliance with the Home State's rules relating to books and records and net capital and bonding, the Advisers Act prohibits any other state in which the investment adviser must be registered from imposing any standards relating to books and records or net capital and bonding that exceed those under the Home State's rules. Note that the investment adviser must be registered in its Home State for these federally imposed limitations to apply. If, for instance, an investment adviser is not required to be registered in its Home State in reliance on an exemption and has more than five clients in another state, the federally imposed limitations on books and records and net capital and bonding would not apply since the investment adviser is not registered in its Home State.

State Regulation of Exempt Reporting Advisers under Dodd-Frank

Under Section 203A(a)(1) of the Advisers Act, states are prohibited only from registering investment advisers registered with the SEC under Section 203 of the Advisers Act. Dodd-Frank enacted several exemptions from SEC registration under the Advisers Act. Without an exemption available under state law, these SEC-exempt investment advisers may be subject to state registration because states are not prohibited from regulating them as they are not registered with the SEC (even though they may be required to make notice filings with the SEC as "exempt reporting advisers").[32] Therefore, absent availability of an exemption under state law, an investment adviser that is an "exempt reporting adviser" for SEC purposes *simultaneously* may be subject to (1) state registration and (2) an obligation to file certain reports with the SEC on Form ADV pursuant to federal law.

An example is the exemption from SEC registration under Section 203(m) of the Advisers Act for advisers to private funds with AUM in the United States of less than $150 million ("Private Fund Advisers"). Absent an exemption under state law, these advisers are subject to state registration. NASAA proposed a model exemption from registration under state law for Private Fund Advisers whereby advisers would be exempt from state registration if (1) neither the adviser nor any of its advisory affiliates were subject to a

32. *See* Item 15 of the General Instructions to Form ADV. Exempt reporting advisers are those relying on the exemptions in Section 203(l) or 203(m) of the Advisers Act.

disqualification described in Rule 262 under SEC Regulation A,[33] (2) the adviser filed with the state each report and amendment thereto that it was required to file as an exempt reporting adviser with the SEC under Rule 204-4 of the Advisers Act and (3) the adviser paid any fee that may be specified under state law.

At first blush, this would appear to be an efficient corollary to the relevant SEC exemption. However, the NASAA model exemption imposes further conditions if the Private Fund Adviser advises at least one fund relying on the exemption in Section 3(c)(1) of the 1940 Act that is not a venture fund as defined in SEC Rule 203(1)-1 under the Advisers Act.[34]

Under these circumstances, the exemption is available only if (1) the outstanding securities of the issuer are owned by persons who, after deducting the value of their primary residence, meet the definition of qualified client under Rule 205-3 of the Advisers Act;[35] (2) the issuer discloses the following in writing to each beneficial owner: (a) the fund is the adviser's client, (b) a description of all services, if any, to be provided to individual beneficial owners, (c) all duties, if any, the investment adviser owes to the beneficial owners and (d) any other material information affecting the rights or responsibilities of the beneficial owners; and (3) the adviser obtains, on an annual basis, audited financial statements of each Section 3(c)(1) fund and delivers a copy of such financial statements to each owner of the fund.

Given the characteristics of Section 3(c)(1) funds, it is to be expected that most, if not all of the private funds advised by the adviser who is relying upon the Section 203(m) exemption, will qualify as Section 3(c)(1) funds and therefore, the additional conditions on the availability of the NASAA model exemption will apply. The utility of the exemption could be diminished if one Section 3(c)(1) fund advised by the adviser does not prepare audited financial statements which might be the case with respect to a fund consisting of a small number of beneficial owners. Although some states have

33. 17 CFR 230.262.
34. This exemption applies to pooled private funds of an issuer whose outstanding securities are not owned by more than 100 persons and which is not making and does not presently propose to make a public offering of its securities.
35. Generally, a person who has $1 million of AUM with the adviser, has a net worth (exclusive of his primary residence) of $2 million or is a qualified purchaser under the 1940 Act. The AUM and net worth standards are subject to periodic revision by the SEC in accordance with 17 CFR 275.205-3(e).

adopted the NASAA model exemption for Private Fund Advisers, it does not appear to have gained universal acceptance.[36]

No Self-Regulatory Organization

Although FINRA is the primary self-regulatory organization for broker-dealers, there is no federal or state requirement that investment advisers be members of a self-regulatory organization. During the 112th Congress, FINRA lobbied Congress to pass legislation which would allow it to become the self-regulatory organization for investment advisers and House Financial Services Committee Chair Spencer Bachus introduced draft legislation that would have authorized establishment of a self-regulatory organization for investment advisers.[37] There was much disagreement within the investment adviser and regulatory community as to the need or desirability of a self-regulatory organization for investment advisers and the legislation did not move beyond the committee stage. On April 10, 2014, the *Wall Street Journal* reported that FINRA no longer would seek designation as a self-regulatory organization for investment advisers.[38]

Fiduciary Standard

Although there is no specific statutory language in the Advisers Act, the USA 1956 or the USA 2002 which explicitly states that investment advisers and federal covered investment advisers are deemed to be fiduciaries, federal and state securities regulators, the courts and the industry agree that, based on the U.S. Supreme Court decision in *SEC v. Capital Gains Research Bureau, Inc.*, investment advisers and investment adviser representatives are held to a fiduciary standard as stated in the Congressional report which accompanied introduction of federal legislation that became the Advisers Act.[39]

NASAA has adopted a model rule relating to unethical business practices of investment advisers, investment adviser representatives and federal covered investment advisers which states unequivocally that a person who is an investment adviser, investment adviser

36. For example, Maryland, Washington and Virginia have indicated their adoption of the NASAA model exemption. *See* http://www.nasaa.org/category/regulatory-activity/state-rule-proposals.
37. H.R. 4624, "The Investment Adviser Oversight Act of 2012."
38. Rieker, Matthew, "Finra Backs Off Expanding Oversight," *Wall Street Journal*, April 10, 2014.
39. 375 U.S. 180 (1963).

representative or a federal covered investment adviser is a fiduciary and has a duty to act primarily for the benefit of its clients.[40]

Anti-Fraud Provisions Specifically Relating to Investment Advisory Activities

Section 102 of the USA 1956 and Section 502 of the USA 2002 contain specific anti-fraud provisions applicable to persons who engage in investment advisory activities for compensation whether or not they are registered as investment advisers. Under Section 102(a) of the USA 1956, it is unlawful for any person who receives any consideration from another person primarily for advising the other person as to the value of securities or their purchase or sale, whether through the issuance of analyses or reports or otherwise to (1) engage in any device, scheme or artifice to defraud the other person or (2) engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon the other person.

Section 102(b) of the USA 1956 makes it unlawful for an investment adviser to enter into, extend or renew any investment advisory agreement unless it provides in writing that (1) the investment adviser shall not be compensated on the basis of a share of capital gains upon, or capital appreciation of the funds or any portion of the funds of the client;[41] (2) no assignment of the contract may be made by the investment adviser without the consent of the other party to the contract;[42] and (3) the investment adviser, if a partnership, shall notify the other party to the contract of any change in the membership of the partnership within a reasonable time after the change. Section 102(c) of the USA 1956 makes it unlawful for any investment adviser to take or have custody of any securities or funds of any client if the

40. NASAA Model Rule 102(a)(4)-1 under the USA 1956.
41. This does not prohibit a contract which provides for compensation based upon the total value of a fund averaged over a definite period or as of definite dates or taken as of a definite date. NASAA Model Rule 102(f)-3 under the USA 1956 permits certain performance based compensation.
42. Assignment includes any direct or indirect transfer or hypothecation of an investment advisory contract by the assignor or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor but, if the investment adviser is a partnership, no assignment of an investment advisory contract is considered to result from the death or withdrawal of a minority of the members of the investment adviser having only a minority interest in the business of the investment adviser, or from the admission to the investment adviser of one or more members who, after admission, only will be a minority of the members and will have only a minority interest in the business.

administrator by rule prohibits custody or, in the absence of a rule, the investment adviser fails to notify the administrator that he has or may have custody.

Section 502(a) of the USA 2002 parallels the provisions contained in Section 102(a)(1) of the USA 1956. With respect to Section 102 (a)(2) of the USA 1956, Section 502(b) of the USA 2002 vests in the administrator the authority to adopt rules defining an act, practice or course of business of an investment adviser or an investment adviser representative, other than a supervised person of a federal covered investment adviser, as fraudulent, deceptive, or manipulative, and prescribe means reasonably designed to prevent investment advisers and investment adviser representatives, other than supervised persons of a federal covered investment adviser, from engaging in acts, practices, and courses of business defined as fraudulent, deceptive or manipulative.[43] The USA 2002 does not have a parallel provision to Section 102(b) of the USA 1956 concerning investment advisory contracts but Section 502(c) of the USA 2002 grants the administrator broad authority to adopt rules specifying the contents of an investment advisory contract.[44]

The USA 2002 addresses the issue of custody by investment advisers and investment adviser representatives in Section 411(f). Subject to any applicable preemption provisions in Section 222(d) of the Advisers Act, an investment adviser representative may not have custody of funds or securities of a client except under the supervision of an investment adviser or a federal covered investment adviser. The administrator is authorized by this section to adopt a rule or order that may prohibit, limit or impose conditions on an investment adviser regarding custody of securities or funds of a client.[45]

Transitioning Between Regulatory Regimes

The SEC has adopted specific rules governing investment advisers that must switch from state to SEC registration and vice versa.[46] Generally, if an investment adviser is registered under state law and becomes eligible for registration with the SEC, the investment adviser must apply for registration with the SEC within 90 days of

43. *See* NASAA Model Rule 502(b) under the USA 2002.
44. *See* NASAA Model Rule 502(c) under the USA 2002.
45. NASAA Model Rule 411(f)-1 under the USA 2002.
46. 17 CFR 275.203A-1(b).

filing of its annual updating amendment to Form ADV wherein the investment adviser reports that it is eligible for SEC registration.[47]

A SEC-registered investment adviser is not required to switch to state registration unless its AUM is less than $90 million.[48] If it reports AUM of less than $90 million on its annual updating amendment, the SEC-registered adviser has 180 days from its fiscal year end to withdraw from registration with the SEC by filing Form ADV-W with IARD unless the adviser again becomes eligible for SEC registration within that time period.[49] Once the investment adviser no longer qualifies for registration with the SEC, it must become registered with the applicable states in which it conducts business unless it can rely on an exemption, exclusion or the National De Minimis.

It is important to note that previous registration with the SEC does not guaranty automatic registration at the state level and requirements applicable to state-registered investment advisers are different from federal requirements. For instance, depending on the nature of its business plan, a state-registered investment adviser may be required to demonstrate that it maintains a minimum level of net worth. Compliance with state registration requirements may take some time and a SEC-registered investment adviser that has reason to believe it will need to switch from SEC registration should file for state registration well before it must file Form ADV-W to withdraw from SEC registration. During this time, it is quite possible that the investment adviser will be registered simultaneously with the SEC and state securities regulators.

Specific Anti-Fraud Rules under Advisers Act

Federal covered investment advisers are subject to specific SEC rules requiring them to disclose policies relating to proxy voting,[50] appointing a chief compliance officer,[51] adopting a code of ethics[52] or complying with guidelines relating to political contributions.[53] All of these rules were adopted by the SEC pursuant to the general

47. 17 CFR 275.203A-1(b)(1).
48. 17 CFR 275.203A-1(a)(1).
49. 17 CFR 275.203A-1(b)(2).
50. 17 CFR 275.206(4)-6.
51. 17 CFR 275.206(4)-7.
52. 17 CFR 275.204A-1.
53. 17 CFR 275.206(4)-5.

anti-fraud provision contained in Section 206 of the Advisers Act. Although Section 502 of the USA 2002 contains language similar to Section 206 of the Advisers Act and permits the administrator to adopt rules implementing this anti-fraud provision, NASAA has not adopted Model Rules under that section similar to the foregoing rules adopted by the SEC under the Advisers Act.[54]

One might think that these specific SEC anti-fraud rules may not apply to state-registered investment advisers who would be subject to the anti-fraud provisions of their respective state securities laws, particularly as registration and primary regulatory oversight rests with the states and there has been no adoption of analogous rules at the state level.

However, the SEC has stated that, although investment advisers may be required to register with the states, the antifraud provisions of the Advisers Act continue to apply.[55] Since the aforementioned SEC rules were adopted under the general anti-fraud provisions of the Advisers Act and the SEC has stated that state-registered investment advisers are subject to the anti-fraud provisions of the Adviser Act, the question is whether state-registered investment advisers need to comply with the aforementioned SEC rules.

Even if the SEC would respond to this question in the affirmative, it is the states and not the SEC that conduct compliance examinations on state-registered investment advisers and theoretically would be responsible for checking for compliance with these SEC rules. So, even if the SEC took the view that state-registered investment advisers must comply with its rules on political contributions, appointing a chief compliance officer, establishing a code of ethics and adopting a policy on proxy voting, it does not appear to possess a meaningful method to enforce these rules on state-registered investment advisers since it does not carry out routine compliance examinations on them.

54. The only Model Rules adopted by NASAA under Section 502 of the USA 2002 address (1) Prohibited Conduct in Providing Investment Advice (Rule 502(b)) and (2) Contents of an Investment Advisory Contract (Rule 502(c)).

55. *See* Footnote 126, SEC Release on "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings," Release No. 33-9415, 34-69959 and IA-3624 (July 10, 2013).

STATE REGULATORY JURISDICTION OVER INVESTMENT ADVISER REPRESENTATIVES

Generally, investment adviser representatives of both SEC-registered investment advisers and state-registered investment advisers must be registered with at least one state securities regulator. However, the determination of who must register differs slightly depending on whether the investment adviser representative is employed by, or associated with, a SEC-registered investment adviser or a state-registered investment adviser and whether the client base is institutional or retail.

Investment Adviser Representatives of Federal Covered Investment Advisers

Section 203A(b)(1) of the Advisers Act governs state registration of investment adviser representatives employed by, or associated with, a SEC-registered investment adviser. This section provides that no state may require registration, licensing or qualification as a supervised person of an investment adviser that is registered with the SEC under Section 203 or that is a supervised person for such registrant except that a state may license, register or otherwise qualify any investment adviser representative who has a place of business located in that state or that is not registered under Section 203 because the person is excepted from the definition of an investment adviser under Section 202(a)(11) of the Advisers Act.

The initial determination must be whether the individual is an investment adviser representative upon whom states can impose a registration requirement. For purposes of Section 203A(b)(1) of the Advisers Act, an "investment adviser representative" means a supervised person of the investment adviser who (1) has more than five clients[56] who are natural persons (other than excepted clients) and (2) more than 10% of whose clients are natural persons (other than excepted clients).[57]

However, a supervised person is not an investment adviser representative if the supervised person does not, on a regular basis, solicit, meet with, or otherwise communicate with clients of the

56. A supervised person may rely on 17 CFR 202(a)(30)-1(a)(1) to identify natural persons as clients.
57. An excepted person is a natural person who is a qualified client under 17 CFR 275.205-3(d)(1) which is a natural person with $1 million of AUM or a net worth of more than $2 million (exclusive of primary residence).

investment adviser or provides only impersonal investment advice.[58] Therefore, an individual whose clients are exclusively or primarily institutional clients or who provides impersonal investment advice most likely would not be deemed an investment adviser representative for purposes of Section 203A(b)(1) and therefore the state where the individual had a place of business could not require registration of such individual as an investment adviser representative.

For purposes of Section 203A, the SEC has defined "place of business" as (1) an office at which the investment adviser representative regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients and (2) any other location that is held out to the general public as a location at which the investment adviser representative provides investment advisory services, solicits, meets with, or otherwise communicates with clients.[59] For example, if an investment adviser representative of a SEC-registered investment adviser maintains an office in Pennsylvania but it is known to the general public (*eg* by means of business cards, advertisements, web site content) that the individual is at a specific place across the Delaware River in New Jersey the first Monday of each month in which he engages in any of the aforementioned activities, the individual most likely would be required to be registered as an investment adviser representative in both Pennsylvania and New Jersey.[60]

Investment Adviser Representatives of State Registered Investment Advisers

Individuals employed by or associated with an investment adviser subject exclusively to state registration must register as an investment

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58. Impersonal investment advice consists of written materials or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts.
59. 17 CFR 275.203A(b). Although out of step with the rest of the states, Texas has taken the position that even if an investment adviser representative does not have a place of business in Texas but has Texas clients, he must "notice file" in Texas by filing Form U-4 with IARD and paying the same fee ($285 for an original filing and $275 each year for a renewal filing) as if the individual was registering as an investment adviser representative. *See generally* http://www.ssb.state.tx.us/Dealer_And_Investment_Adviser_Registration/Frequently_Asked_Questions.php#twoB.
60. It should be noted that Section 203A(b)(1) and SEC Rule 203A(b) require a physical presence. Use of fax, email or correspondence from one state into another state does not create the necessary nexus to impose registration as an investment adviser representative, Texas' position to the contrary notwithstanding.

adviser representative in each state in which they conduct business unless exempt from registration (including application of the National DeMinimis). In these instances, the definition of investment adviser representative set forth in Section 102(16) of the USA 2002 is used to determine if an individual is subject to state registration as an investment adviser representative. Although there is no analogous definition in the USA 1956, most states that have enacted investment adviser regulation also have amended their statutes to include a definition of investment adviser representative.

DEFINITION OF INVESTMENT ADVISER UNDER STATE SECURITIES LAWS

USA 1956

An "investment adviser" is defined in the USA 1956 as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities." This definition is identical to the federal definition of investment adviser in Section 202(a)(11) of the Advisers Act.

USA 2002

The definition of "investment adviser" in the USA 2002 is identical to the USA 1956 but the USA 2002 added a separate statement emphasizing that "the term includes a financial planner or other person that, as an integral component of other financially related services, provides investment advice to others for compensation as part of a business or that holds itself out as providing investment advice to others for compensation." Official Comment 17 to Section 102 of the USA 2002 indicates that the second sentence was added to the definition "to achieve functional regulation of financial planners who satisfy the definition of investment adviser" and cites SEC Investment Advisers Act Release 1092.[61] The Official Comment further states that use by a person of a title, designation or certification as a financial

61. 39 SEC Docket 494 (1987); http://www.sec.gov/rules/interp/1987/ia-1092.pdf. For example, *see* Section 25009(b) of the California Corporations Code and Section 101(h)(1) of the Maryland Securities Act.

planner or other similar title alone does not require registration as an investment adviser.[62]

SEC/NASAA Joint Investment Adviser Release 1092 ("IA 1092")

IA 1092 was issued jointly by the SEC Division of Investment Management and NASAA in 1987 to provide uniform interpretation of federal and state investment adviser laws to financial planners and other persons. Given the states' ownership of IA 1092, it is instructive to review its contents in context of the definition of "investment adviser" under state securities laws and under what circumstances state securities regulators would deem a person to come within the definition of investment adviser. IA 1092 focused on three main elements of the definition of investment adviser: (1) in the business of (2) giving advice concerning securities (3) for compensation.

IA 1092 indicates that one can be "in the business" of giving investment advice even if the giving of such investment advice does not constitute the principal business activity or a particular portion of a person's business activities. A person will be deemed to be "in the business" if the person (1) holds himself out to the public as an investment adviser or a person who provides investment advice, (2) receives any separate or additional compensation that represents a clearly definable charge for providing advice about securities, regardless of whether the compensation is separate from, or included within, any overall compensation or receives transaction-based compensation if the client implements the investment advice, and (3) except in rare, isolated and non-periodic instances, provides specific investment advice.

IA 1092 states that a person who provides advice or issues or promulgates reports or analyses which concern securities generally would come within the definition of investment adviser even if such advice does not relate to specific securities. Therefore, persons who provide advice for compensation concerning the advantages or disadvantages of investing in securities in general as compared to other investments would come within the definition of investment adviser. In the context of discussing what constitutes being in the business of an investment adviser, IA 1092 notes that the provision of "specific investment advice" includes a recommendation, analysis or report

62. *Infra* note 66.

about specific securities or specific categories of securities and also includes a recommendation about allocation of assets even if the allocation recommendation includes assets that are not securities.

Receipt of compensation for giving investment advice is a key element of the definition but what constitutes compensation? IA 1092 states that the compensation element is satisfied by the receipt of any economic benefit, whether in the form of an advisory fee or some other fee relating to the total services rendered, commissions, or some combination of the foregoing. It is not necessary that the person who provides the investment advice charge a separate fee for the investment advisory portion of his total services. The compensation element is satisfied if a single fee is charged for a number of different services, including investment advice or issuing of reports concerning securities. Nor is it necessary that the adviser's compensation be paid directly by the person receiving the investment advice. The relevant issue is that the adviser received compensation from some source for the services rendered.

IA 1092 reflects state regulatory concerns over financial planners which may have resulted in the addition of a cautionary alert in the form of the additional sentence to the definition of investment adviser in Section 102(15) of the USA 2002. State regulators want to emphasize that persons who hold themselves out to the public as financial planners and offer clients non-securities products such as life insurance or fixed annuities nonetheless would come within the definition of investment adviser if they received compensation from any source related to the provision of investment advice concerning securities whether it be advice as to a specific security, categories of securities, the advantages or disadvantages of investing in securities or allocation of assets involving, in whole or in part, securities.

Dodd-Frank Study on Financial Planners

In Dodd-Frank, Congress expressed concern over individuals who hold themselves out as financial planners and engage in misleading titles, designations and marketing materials and directed the General Accounting Office to conduct a study of current state and federal oversight structures and regulations for financial planners and identify any gaps in the regulation of financial planners and other individuals who provide or offer financial planning services to consumers.[63] The

63. Section 919C of Dodd-Frank.

GAO report, issued in January 2011, noted that, although there is no definition of financial planner, financial planning generally includes preparing financial plans for clients based on their financial circumstances and objectives and making recommendations for specific actions clients may take, including recommending insurance products, securities and other investments.[64]

State Regulatory Perspective on Financial Planners

The primary state regulatory concern is that a financial planner will seek to avoid registration as an investment adviser in reliance on the use of titles or engaging in a primary line of business not involving securities, such as insurance. The state regulatory perspective is that any person whose business includes the provision of investment advice for which the person receives compensation, as set forth broadly in IA 1092, will be deemed to come within the definition of investment adviser unless an exemption or exclusion otherwise is available.[65] Therefore, every financial planner should read IA 1092 carefully to determine whether registration as an investment adviser is required.

Despite the content of IA 1092 and the fact that it was a joint SEC/NASAA release, some states have prohibited the use of terms like financial planner, investment counselor, financial consultant, money manager, investment manager, investment planner, Chartered Financial Consultant or the abbreviation of "CFP" unless the person is registered as an investment adviser or investment adviser representative, is exempt from registration or is excluded from the definition of investment adviser.[66]

64. "Regulatory Coverage Generally Exists for Financial Planners but Consumer Protection Issues Remain," GAO Report 11-235 (January 2011).
65. Pennsylvania issued a release two years after IA 1092 on Registration of Financial Planners that was similar in content and scope to IA 1092, PSC Bulletin (July 1989); Compendium of Pennsylvania Securities Laws, 2d ed., Positions, p. 101.
66. Revised Code of Washington, 21.20.040(3); Washington Administrative Code 460-24A-040(2). Pennsylvania makes it unlawful to represent that a person is an "investment counsel" or to use that name as descriptive of his business unless a substantial part of his business consists of rendering investment advisory services on the basis of the individual needs of clients. 70 P.S. §1-404(a)(6).

DEFINITION OF INVESTMENT ADVISER REPRESENTATIVE UNDER STATE SECURITIES LAWS

Investment adviser representatives were not subject to state registration under the USA 1956 and therefore, the USA 1956 contained no definition of the term.

The USA 2002 defines "investment adviser representative" as an individual employed by, or associated with, an investment adviser or a federal covered investment adviser and who makes any recommendations or otherwise gives investment advice regarding securities, manages accounts or portfolios of clients, determines which recommendation or advice regarding securities should be given, provides investment advice or holds herself or himself out as providing investment advice, receives compensation to solicit, offer or negotiate for the sale of or for selling investment advice or supervises employees who perform any of the foregoing.

EXCLUSIONS FROM THE DEFINITION OF INVESTMENT ADVISER

USA 1956

Under the USA 1956, the term "investment adviser" does not include (1) a bank, savings institution or trust company,[67] (2) a lawyer, accountant, engineer or teacher whose performance of investment advisory services is incidental to the practice of their profession, (3) a broker-dealer whose performance of investment advisory services is solely incidental to the conduct of the business as a broker-dealer and who receives no special compensation for those services,[68] (4) a

67. The USA 1956 contained no definitions for "bank," "savings institution" or "trust company."

68. Official Comment to Section 102 of the USA 2002 states that the Official Comment to the USA 1956 on this provision quoted an opinion of the SEC General Counsel in Investment Advisers Act Release 2 on the meaning of special compensation, to wit: "[This clause] amounts to a recognition that brokers and dealers commonly give a certain amount of advice to their customers in the course of their regular business, and that it would be inappropriate to bring them within the scope of the Investment Advisers Act merely because of this aspect of their business. On the other hand, that portion of clause [(C)] which refers to 'special compensation' amounts to an equally clear recognition that a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities…The essential distinctions to be borne in mind in considering borderline cases… is the

publisher of any bona fide newspaper, news magazine or business or financial publication of general, regular and paid circulation, (5) a person whose advice, analyses or reports relate only to government securities, (6) a person who has no place of business in the state if (a) his only clients in the state are other investment advisers, broker-dealers, banks, savings institutions, trust companies, insurance companies, investment companies as defined in the 1940 Act, pension or profit sharing trusts or other financial institutions or institutional buyers[69] or (b) during any period of 12 consecutive months, he does not direct business communications into the state in any manner to more than five clients other than those described in (a) whether or not any of the persons to whom communications are directed is then present in the state and (7) any person not within the intent of the definition as the administrator may designate by rule or order.

USA 2002

The USA 2002 retained the exclusions from the definition of investment adviser in the USA 1956 with respect to (1) lawyers, accountants, engineers and teachers, (2) broker-dealers whose performance of investment advisory services are solely incidental to the conduct of the business as a broker-dealer and who receive no special compensation for those services,[70] (3) publishers of newspapers, magazines or newsletters of general and regular circulation, (4) banks and savings institutions,[71] and (5) other persons designated by rule or order of the administrator.

Due to the expansion of state regulation of investment adviser representatives and passage of NSMIA, the USA 2002 included exclusions for a federal covered investment adviser, an investment adviser representative and any person excluded from the definition of investment adviser under the Advisers Act. However, the more important change in the USA 2002 over the USA 1956 is the treatment of investment advisers with no place of business in the state

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distinction between compensation for advice itself and compensation for services of another character to which advice is merely incidental."

69. The USA 1956 contained no definitions for "pension or profit sharing trusts," "financial institutions" or "institutional buyers."
70. *Supra* note 68.
71. Section 102((3) of the USA 2002 contains a definition of "bank." Savings institution is not separately defined but comes within the definition of "depository institution" under Section 102(5) of the USA 2002 which is deemed to be an "institutional investor" under Section 102(11) of the USA 2002.

who deal exclusively with other investment advisers, broker-dealers, investment companies, insurance companies and other financial institutions or only with a *de minimis* number of clients. These exclusions from the definition of investment adviser in the USA 1956 became exemptions from the registration requirement in the USA 2002.

Whether treated as an exclusion or an exemption, the *de minimis* provision contained in the USA 1956 and USA 2002 for investment advisers with no place of business in the state rests upon not having more than a specified number of clients. As indicated previously, determining the number of clients for purposes of the National DeMinimis is governed by Rule 202(a)(30)-1 of the Advisers Act. However, the provisions of that rule would not apply in an examination of whether an exemption or exclusion is available based on state law. Therefore, it is possible that states may count clients differently for state law purposes than set forth in SEC Rule 202(a)(30)-1, particularly with respect to legal organizations, and care should be taken to research the position of the relevant state in this regard.

IA 1092

IA 1092 also discussed the availability of exclusions from the definition of investment adviser and, since IA 1092 was a joint release by SEC staff and state securities regulators (through NASAA), its advices in this regard merit some discussion. With respect to the exclusion for a lawyer or an accountant, IA 1092 states that the exclusion would not be available where a lawyer or accountant holds himself out to the public as providing financial planning, pension consulting or other advisory services as it would not appear that the rendering of investment advisory services was incidental to the practice of law or accounting. Similarly, the exclusion for the broker-dealer or associated person of a broker-dealer would not be available if the person receives special compensation for providing investment advisory services or if the advice was provided by an associated person outside of his scope of employment with the broker-dealer.

EXCLUSIONS FROM THE DEFINITION OF INVESTMENT ADVISER REPRESENTATIVE

Investment adviser representative was not a defined term in the USA 1956 so it contained no exclusions from the definition.

Under the USA 2002, investment adviser representative does not include an individual who (1) performs only clerical or ministerial acts,

(2) is an agent whose performance of investment advice is solely incidental to the individual acting as an agent and who does not receive special compensation for investment advisory services,[72] (3) is employed by, or associated with, a federal covered investment adviser unless the individual has a place of business in the state as that term is defined in the Advisers Act and is (a) an investment adviser representative as that term is defined in the Advisers Act or (b) is not a "supervised person" as that term is defined in Section 202(a)(25) of the Advisers Act, or (4) is excluded by rule or order adopted by the administrator.

STATE INVESTMENT ADVISER REGISTRATION REQUIREMENTS

The USA 1956 makes it unlawful for a person to transact business in a state as an investment adviser unless the person (1) is registered under the state securities act, (2) is registered as a broker-dealer without the imposition of a condition under Section 204(b)(5) thereof[73] or (3) his only clients in the state are investment companies as defined in the 1940 Act or insurance companies. The USA 2002 simply makes it unlawful for a person to transact business in a state as an investment adviser unless the person is registered as an investment adviser or is exempt from registration. The USA 2002 also makes it unlawful for an investment adviser to employ or associate with an individual required to be registered as an investment adviser representative who transacts business in the state on behalf of the investment adviser unless the individual is registered or is exempt from registration.

Successor Registration

Section 407 of the USA 2002 permits an investment adviser succeeding to the current registration of another investment adviser to file an application for registration under Section 401 (initial application) for the unexpired portion of the current registration. An investment adviser that changes its form of organization or jurisdiction of organization may continue its registration by filing an amendment to Form ADV if the change does not involve a material change in its financial condition or management. The amendment becomes effective when filed or on a date designated by the registrant in the amendment filing. The new organization will be deemed the

72. *Supra* note 68.
73. Section 204(b)(5) authorizes the administrator to condition the registration of a broker-dealer upon not transacting business in the state as an investment adviser.

successor to the original registrant. Any predecessor registered under the state securities act must stop conducting its business other than winding down transactions and must file Form ADV-W with IARD within 45 days of filing of the amendment effecting the succession.

Limitation on Association

Section 404(e) of the USA 2002 introduced a new provision making it unlawful for an investment adviser, directly or indirectly, to employ or associate with an individual to engage in an activity related to providing investment advice in the state if the registration of the individual is suspended or revoked or the individual is barred from employment or association with an investment adviser, federal covered investment adviser or broker-dealer by an order issued under the state's securities laws,[74] the SEC, or a self-regulatory organization (*eg* FINRA). The USA 2002, however, provides an investment adviser with an affirmative defense that it does not violate this provision if it did not know and in the exercise of reasonable care could not have known of the suspension, revocation or bar.[75] In addition, where such circumstances exist and are known to the investment adviser, the investment adviser may petition the administrator to modify or waive, in whole or in part, the application of the prohibitions contained in this provision.

EXEMPTIONS FROM INVESTMENT ADVISER REGISTRATION

The USA 1956 did not have any exemptions from investment adviser registration.

Under Section 403(b)(1) of the USA 2002, a person without a place of business in the state that is registered under the securities laws of the state in which the person has its principal place of business is exempt from registration as an investment adviser in that state if its only clients in that state are (1) federal covered investment advisers, broker-dealers registered with that state, or investment advisers registered with that

74. This section does not appear to include a similar order issued by another state securities regulator.
75. Since such actions must be reported by such individuals on Form U-4 and by the regulatory and self-regulatory organizations on Form U-6 and filed with CRD/IARD, it is unlikely that an investment adviser conducting appropriate due diligence on an investment adviser representative could sustain the burden of proof necessary to be able to rely upon this affirmative defense.

state; (2) institutional investors;[76] (3) bona fide preexisting clients whose principal residence is not in the state if the investment adviser is registered under the securities laws of the state in which the client maintains his principal place of residence and (4) any other client exempted by rule or order of the administrator.

Section 403(b)(2) of the USA 2002 also converted the *de minimis* client exclusion in the USA 1956 to an exemption as well as made it conform to the National DeMinimis as imposed by Section 222(d) of the Advisers Act. Therefore, a person without a place of business in the state is exempt from registration as an investment adviser in that state if the person had, during the preceding 12 months, not more than five clients that are resident in the state excluding the clients described in the immediately preceding paragraph.

STATE INVESTMENT ADVISER REPRESENTATIVE REGISTRATION REQUIREMENTS

The USA 1956 did not require registration of investment adviser representatives. The USA 2002 makes it unlawful for an individual to transact business in a state as an investment adviser representative unless the individual is registered under the state securities act or is exempt from registration. The USA 2002 further provides that the registration of an investment adviser representative is effective only while the individual is employed by, or associated with, an investment adviser registered under the state securities laws or a federal covered investment adviser that has made, or is required to make, a notice filing under Section 405 of the USA 2002.

EXEMPTIONS FROM INVESTMENT ADVISER REPRESENTATIVE REGISTRATION

The USA 1956 did not require registration of investment adviser representatives and consequently, it did not include any exemptive provisions. Under Section 404(b) of the USA 2002, an individual who is employed by or associated with an investment adviser that is exempt from registration under Section 403(b) or a federal covered investment adviser exempt from making a notice filing under Section 405 is exempt from registration as an investment adviser representative. The USA 2002 also

76. "Institutional investor" is defined in Section 102(11) of the USA 2002.

authorized the administrator to exempt other investment adviser representatives from registration by rule or order.

DUAL REGISTRATION OF INVESTMENT ADVISER REPRESENTATIVES UNDER STATE SECURITIES LAWS

The USA 1956 did not require registration of investment adviser representatives and consequently contained no provision relating to dual registration. Although the USA 2002 prohibits dual registration of agents of broker-dealers unless otherwise permitted by rule or order of the administrator, it is opposite with respect to investment adviser representatives. Section 404(d) of the USA 2002 permits such individuals to be registered simultaneously with one or more investment advisers or federal covered investment advisers unless otherwise prohibited by rule or order of the administrator.

STATE REGISTRATION PROCESS

NASAA, the Securities Industry Association (now the Securities Industry and Financial Markets Association (SIFMA)) and state securities administrators were pioneers in establishing a national electronic licensing system for state-based securities licenses.[77] The genesis of this effort, which began in the early 1980s, was to harmonize and make uniform the broker-dealer and agent registration application process. Previously, states used various sized forms, had different font requirements, and mandated use of certain color ink in their applications. This was in addition to the great disparity in the amount and type of information requested by each state application.

Central Registration Depository ("CRD")

CRD was conceived as a one-stop electronic licensing function which could be accessed and used by all persons involved in the broker-dealer licensing function. It would process uniform data collected in a uniform manner pursuant to uniform rules in an electronic environment. After determining that CRD was working properly for broker-dealers, its functions were expanded to include agents. This uniformity and electronic processing produced millions of dollars of

77. CRD became the model for similar electronic licensing systems for state licensing of insurance producers and mortgage originators.

savings in compliance costs for the securities industry and improved the regulatory function of state securities administrators.

Investment Adviser Registration Depository

Building on the success of the CRD in reducing regulatory costs, Section 303 of NSMIA permitted the SEC to require an investment adviser to make filings with the SEC through a filing depository designated by the SEC.[78] As a result, the SEC created the Investment Adviser Registration Depository ("IARD") which, like CRD, is run by FINRA. The architecture of the IARD is similar to CRD which is intentional since many brokerage firms have investment adviser affiliates and many associated persons of broker-dealers also are registered as investment adviser representatives.

Similar to CRD, all filings required to be made with the states by SEC-registered investment advisers, state-registered investment advisers and investment adviser representatives are made through IARD. These include filings relating to initial and renewal registration, amendments to Form ADV and Form U-4, registration transfers and withdrawals from registration. Also, the IARD collects all state filing fees and effects electronic fund transfers to various financial institutions designated by the state administrator as the depository for such fees.

Uniform Forms

Following the blueprint of CRD, states and the SEC use Form ADV as the common registration form for investment advisers. All investment advisers must complete Part 1A and state-registered advisers also must complete Part 1B. Part 2A is the narrative, known in the industry as a "brochure," which each investment adviser must give to clients or prospective clients and which provides specific information about the firm. Part 2B is the individual supplement to the brochure which provides specific information about each investment adviser representative. Form ADV-W is used to withdraw from investment adviser registration.

Registration as an investment adviser representative with the states is effected through Form U-4. Form U-4 cannot be filed without the signature and authority of the investment adviser with whom the investment adviser representative is associated. Form U-4

78. 15 U.S.C. §80b-4(c).

also is used for state registration of agents of broker-dealers, many of whom also are registered as investment adviser representatives. Form U-5 is used for withdrawals from registration as an investment adviser representative.

Form U-6 is used exclusively by securities regulators and self-regulatory organizations to report actions taken by such regulators against registrants or former registrants.[79] This information becomes part of the person's CRD or IARD record and is in addition to any affirmative duties such person may have to report the same action as an amendment to Form ADV or Form U-4.

These uniform forms are quite detailed in the information required to be provided and therefore, a discussion of each informational item is beyond the scope of this summary presentation.

Consent to Service of Process

The execution pages for Form ADV contain a separate consent to service of process for investment advisers subject to state registration and federal covered investment advisers subject to state notice filing requirements. By signing Form ADV, the investment adviser and federal covered investment adviser irrevocably appoint the legally designated officers and their successors, of the state in which the adviser maintains its principal office and place of business and any other state in which the adviser may be applying for registration or amending its registration or making a notice filing, as its agents to receive service, and agree that such persons may accept service on its behalf of any notice, subpoena, summons, order instituting proceedings, demand for arbitration or other process or papers and it further agrees that such service may be made by registered or certified mail, in any federal or state action, administrative proceeding or arbitration brought against it in any place subject to the jurisdiction of the United States if the action, proceeding or arbitration:

- Arises out of any activity in connection with an investment advisory business that is subject to the jurisdiction of the United States; and

79. Under Article 4, Section 6 of the FINRA Bylaws, a withdrawing broker-dealer and associated person remain subject to FINRA jurisdiction relating to investigations, fines and sanctions for two years from the date of withdrawal as a broker-dealer or associated person.

- Is founded, directly or indirectly, upon the provisions of:
    - The Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, the Investment Company Act of 1940 or the Investment Advisers Act of 1940 or any rule or regulation under any of these acts; or
    - The laws of the state in which it maintains its principal office and place of business or any state in which it is applying for registration or amending its registration or making a notice filing.

Form U-4 also contains a consent to service of process similar to the consent found in Form ADV but with the request that a copy of any notice, process, pleading or subpoena or other document served be mailed to the current residential address as reflected in Form U-4 or any amendment thereto. Form U-4, however, contains a separate consent concerning the service of any process, pleading, subpoena or other document in any investigation or administrative proceeding conducted by the SEC, the Commodity Futures Trading Commission ("CFTC") or a jurisdiction in any civil action in which the SEC, CFTC or the jurisdiction is a plaintiff or the notice of any investigation or proceeding by any self-regulatory organization against the applicant. In this regard, the applicant consents to personal service being made by regular, registered or certified mail or confirming telegram at the applicant's residential address as reflected in Form U-4 or any amendment thereto.

Examination Requirements

The USA 1956 permits the administrator to adopt a rule to provide for a licensing examination which may be written or oral or both to be taken by any class or all applicants. Section 412(e) of the USA 2002 specifically authorizes that an examination specified by the administrator must be completed successfully by a class of individuals or all individuals. It further enables the administrator to waive by order, in whole or in part, any examination as to any individual and to waive by rule, in whole or in part, an examination as to a class of individuals, in both cases if the administrator determines that the examination is not necessary or appropriate in the public interest or for the protection of investors.

Although the USA 2002 retains the USA 1956 provision permitting the administrator to take action against an applicant or registrant

if such person is not qualified on the basis of factors such as training, experience and knowledge of the securities business, it expressly prohibits the administrator from taking such action where the person has taken and passed any licensing examination required by rule or order of the administrator adopted under Section 412(e) of the USA 2002. This reflects the trend of all states requiring and accepting the Series 65 examination in lieu of an independent examination or qualification process administered by each state on an individual basis.

Absent waiver of the licensing examination requirement, most states will not register an individual as an investment adviser or as an investment adviser representative unless he or she has taken and passed the Uniform Investment Adviser Law Examination (Series 65).[80] If an individual applicant has taken and passed the General Securities Representative Examination (Series 7), then the applicant, in lieu of the Series 65 examination, may take and pass the Uniform Combined State Law Examination (Series 66).

The Series 65 and Series 66 examinations are administered by FINRA on behalf of the states. Qualification by examination remains in effect for purposes of compliance with state securities laws provided that the individual has not experienced a lapse in registration as an investment adviser or investment adviser representative for a period exceeding two years from the date of filing an application for registration. Should this occur, the individual will have to retake the relevant examination or seek a waiver from the administrator.

Unlike agents of broker-dealers, NASAA has endorsed and most states have adopted a uniform examination waiver for individuals holding certain designations and IARD is able to accommodate these examination waivers automatically. The examination requirement is waived for individuals who have been awarded the following designations and, at the time of filing of the registration application, currently are in good standing:[81]

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80. NASAA Model Rule 412(e)-1((g) makes an examination optional for an investment adviser representative who acts only as a solicitor.

81. *See* NASAA Model Rule 412(e)-1 under the USA 2002. Some states, such as Pennsylvania, require that, in addition, the individual cannot have made an affirmative response on Form U-4 indicating certain disciplinary history. Also, Pennsylvania has waived the examination requirement for certified public accountants and attorneys who are licensed and in good standing. Since these are not uniform waivers, they cannot be accommodated by IARD and a waiver request must be filed directly with the Pennsylvania Department of Banking and Securities. *See* 10 Pa. Code §303.032(c).

- Certified Financial Planner (CFP) awarded by the Certified Financial Planners Board of Standards;
- Chartered Financial Consultant (ChFC) or Masters of Science and Financial Services (MSFS) awarded by the American College, Bryn Mawr, Pennsylvania;
- Chartered Financial Analyst (CFA) awarded by the Institute of Chartered Financial Analysts;
- Personal Financial Specialist (PFS) awarded by the American Institute of Certified Public Accountants; and
- Chartered Investment Counselor (CIC) awarded by the Investment Adviser Association.

Use of Senior-Specific Certifications and Professional Designations

State regulators have been concerned about the proliferation in the use of certifications or designations by persons who may be registered investment advisers or investment adviser representatives that are designed to appeal to seniors who may become clients.[82] NASAA adopted a Model Rule on the Use of Senior-Specific Certifications and Professional Designations which makes it a dishonest or unethical practice in the securities business to use:

- A certification or professional designation by a person who has not actually earned it or is otherwise ineligible to use such certification or designation;
- A non-existent or self-conferred certification or professional designation;

82. As an example, Maryland enacted Section 11-305 of its state securities statute which makes it unlawful for any person to use a senior or retiree credential or designation in a way that is or would be misleading in connection with the offer, sale or purchase of securities, acting as a broker-dealer, agent, investment adviser or investment adviser representative or receiving, directly or indirectly, any consideration from another person for advising the other person as to the value of securities or their purchase or sale. The Commissioner is authorized by rule or order to define what constitutes a misleading use of a senior or retiree credential or designation. Other states with similar provisions include California, Florida, New Jersey and Texas.

- A certification or professional designation that indicates or implies a level of occupational qualification obtained through education, training or experience that the person using the certification or professional designation does not have; and
- A certification or professional designation that was obtained from a designating or certifying organization that:
    - Is primarily engaged in the business of instruction in sales or marketing;
    - Does not have reasonable standards or procedures for assuring the competency of its designees or certificate holders;
    - Does not have reasonable standards or procedures for monitoring and disciplining its designees or certificate holders; or
    - Does not have reasonable continuing education requirements for its designees or certificate holders in order to maintain the designation or certification.[83]

If an applicant for registration as an investment adviser or investment adviser representative uses a designation which the administrator believes is a senior-specific designation or professional certification, the applicant most likely will be required to comply with the terms of the NASAA Model Rule or agree not to use such certification or professional designation in that state.

Time Period for Action on an Application

Under the USA 1956, an application for registration as an investment adviser became effective at noon of the 30th day after the application was filed unless the administrator specified an earlier date. The effective date, however, could be prolonged by order of the administrator to noon of the 30th day after the filing of any amendment. Section 406(c) of the USA 2002 reiterates this position but extends the time period from 30 to 45 days.

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83. The rule contains a rebuttable presumption that a designating or certifying organization is not disqualified when the organization has been accredited by the American National Standards Institute, the National Commission for Certifying Agencies or an organization that is on the U.S. Department of Education list entitled "Accrediting Agencies Recognized for Title IV Purposes" and the designation or credential issued therefrom does not apply primarily to sales or marketing.

Where staff of a state securities regulator requests additional information, such as whether the investment adviser previously conducted business in the state or with residents of the state, this request often is used by state regulatory staff to delay effectiveness of registration citing that the responses would be deemed to be an amendment necessary to complete the application and therefore, the 30 or 45 day time period does not run until the amendment is received. Of course, the response filed with the administrator could generate additional requests for information which will re-trigger the 30 or 45 day time period. In other words, an investment adviser registration generally will not be effective absent an affirmative act of the administrator.

SUBSTANTIVE REQUIREMENTS RELATING TO INVESTMENT ADVISER APPLICATIONS

Applications for registration as an investment adviser with a state securities regulator are reviewed for compliance with a number of substantive provisions contained in state securities laws. Although NASAA has adopted model rules implementing all of these substantive requirements, it cannot legally impose these standards on its member jurisdictions.[84] Therefore, it is important to review the securities laws and regulations of each relevant jurisdiction when contemplating filing an application for registration as an investment adviser.

An investment adviser applicant should anticipate that state securities regulatory staff may request that, along with an initial application for registration filed on Form ADV, the applicant also will be expected to demonstrate compliance with the substantive requirements set forth below.

Net Worth and Bonding

Unlike the SEC, the states impose net worth requirements on investment advisers depending on the adviser's plan of business. Net worth means the excess of assets over liabilities as determined by

84. Available at http://www.nasaa.org/wp-content/uploads/2011/07/IA-Model-Rule-Definition-Under-2002-Act.pdf. Although NASAA had adopted similar model rules under the USA 1956, all of the model rules were updated after NCCUSL's adoption and NASAA's endorsement of the USA 2002. Therefore, only references to the NASAA model rules reflecting the provisions of the USA 2002 are included as they provide the most recent guidance from NASAA on these issues.

generally accepted accounting principles ("GAAP"), but excludes as assets: prepaid expenses (except as to items properly classified as assets under GAAP), deferred charges, goodwill, franchise rights, organizational expenses, patents, copyrights, marketing rights, unamortized debt discount and expense, all other assets of an intangible nature, home, home furnishings and automobiles, and any other personal items not readily marketable in the case of an individual; advances or loans to stockholders and officers in the case of a corporation; and advances or loans to partners in the case of a partnership.

An investment adviser registered or required to be registered under state law that has custody of client funds or securities must maintain at all times a minimum net worth of $35,000. An investment adviser that may be deemed to have custody solely due to direct fee deduction or advising a pooled investment vehicle need not comply with the $35,000 net worth requirement if it meets the terms and conditions of certain rules relating to such activities.[85]

Custody is defined as holding, directly or indirectly, client funds or securities or having any authority to obtain possession of them. An investment adviser also will be deemed to have custody if a related person holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them in connection with advisory services the investment adviser provides to clients. Custody also includes any arrangement under which the investment adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the investment adviser's instruction to the custodian.

Furthermore, custody includes any capacity (such as a general partner of a limited partnership or managing member of a limited liability company) that gives the investment adviser or a supervised person legal ownership of, or access to, client funds or securities. Custody will not be imposed if an investment adviser inadvertently receives checks drawn by clients and made payable to third parties if it forwards the check within three business days of receipt and keeps appropriate records.[86]

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85. NASAA Model Rule 411(f)-(1)(b) under the USA 2002.
86. NASAA Model Rule 411(f)-(1) under the USA 2002 is the general rule imposing certain obligations on investment advisers to their clients when they have custody of client funds or securities. It provides two alternatives with respect to certain client reporting obligations where an investment adviser serves as a general partner of a limited partner or a managing member of a limited liability company.

An investment adviser registered or required to be registered under state law that has discretionary authority over client funds or securities but does not have custody of client funds or securities, must maintain at all times a minimum net worth of $10,000.[87] An investment adviser will not be deemed to exercise discretion when it places trade orders with a broker-dealer pursuant to a third party trading agreement if:

- The investment adviser has executed a separate investment advisory contract exclusively with its client which acknowledges that a third party trading agreement will be executed to allow the investment adviser to effect securities transactions in the client's brokerage account;
- The investment advisory contract specifically states that the client does not grant discretionary authority to the investment adviser and the investment adviser in fact does not exercise discretion with respect to the account; and
- A third party trading agreement is executed between the client and a broker-dealer which specifically limits the investment adviser's authority in the client's brokerage account to the placement of trade orders and deduction of investment advisory fees.[88]

An investment adviser who has custody of, or discretion over, client funds or securities and does not meet the minimum net worth requirements may seek a bond in the amount of the net worth deficiency rounded up to the nearest $5,000, provided the bond is issued by a company qualified to do business in the state in a form determined by the administrator and is subject to the claims of all clients of the investment adviser without regard to the client's state of residence.[89]

An investment adviser registered or required to be registered under state law that accepts prepayment of advisory fees of more than six months in advance and more than $500 per client must maintain at all times a positive net worth.[90] Investment advisers registered or required to be registered under state law that do not fall within one of the aforementioned categories have no net worth requirement.

87. NASAA Model Rule 411(a)-1(b) under the USA 2002.
88. NASAA Model Rule 411(a)-(1)(g) under the USA 2002.
89. NASAA Model Rule 411(c)-1 under the USA 2002.
90. NASAA Model Rule 411(a)-1 under the USA 2002.

An investment adviser that has its principal place of business in another state shall maintain such minimum net worth as required by the state in which the investment adviser maintains its principal place of business, provided that the investment adviser is registered or licensed in such state and is in compliance with the state's minimum capital requirements. This is a restatement of the Home State rules imposed on the states under Section 222(c) of the Advisers Act.

An investment adviser must notify the administrator within the close of the next business day after it is determined that the investment adviser is not maintaining the required net worth. After transmitting the notice, the investment adviser shall file with the administrator by the close of business on the next business day a report of its financial condition, including a trial balance of all ledger accounts, a statement of all client funds or securities which are not segregated, a computation of the aggregate amount of client ledger debit balances and a statement as to the number of client accounts.[91]

Brochure

The basis for requiring the preparation, use and delivery of a brochure is grounded in the specific antifraud provisions of Section 102(a) of the USA 1956. In addition to retaining the same specific antifraud provisions in the USA 1956, Section 411(g) of the USA 2002 permits the administrator to adopt a rule or order to require investment advisers to furnish and disseminate to clients or prospective clients in the state such information or other record as it deems necessary or appropriate in the public interest and for the protection of investors and advisory clients.[92]

Part 2A of Form ADV fulfills requirements under federal[93] and state law for investment advisers to deliver to clients and prospective clients a brochure disclosing certain information about the firm. Part 2A is known in the industry as the "brochure rule" because the required narrative is intended to read like an informative brochure about the firm.[94] Part 2B of Form ADV is much shorter and is intended as a brief biography of each investment adviser representative associated with or employed by the investment adviser. Parts 2A and 2B to Form ADV are filed by the investment adviser through IARD. If a

91. NASAA Model Rule 411(a)-1(d) under the USA 2002.
92. NASAA Model Rule 411(g) under the USA 2002.
93. 17 CFR 275.204-3.
94. *Supra* note 92.

firm offers several substantially different types of advisory services, it is permitted to create a separate brochure for each advisory service.

The development of the brochure is highly structured and investment advisers must follow the format set forth in Parts 2A and 2B precisely. Due to the structured nature of Parts 2A and 2B and the fact that this will be the document given to clients and prospective clients by the investment adviser, some state securities regulators will review the proposed brochure and request that the applicant amend the brochure to address any staff comments, including a failure to follow the required presentation format.

An investment adviser must deliver Part 2A and any applicable Part 2B brochure supplement to a prospective advisory client (1) within 48 hours prior to entering into an investment advisory contract or (2) at the time of entering into an investment advisory contract if the advisory contract provides the client with the right to terminate the contract without penalty within five business days after entering into the advisory contract.

Solicitor's Disclosure

Although the NASAA Model Rule under the USA 2002 relating to brochures[95] does not require a separate disclosure for cash payments to solicitors similar to SEC Rule 206(4)-3 under the Advisers Act, some states have imposed this requirement.[96] In such instances, a person who directly or indirectly solicits a client for, or refers any client to, an investment adviser who receives a cash payment from an investment adviser for solicitation activities related to the provision of impersonal advisory services must provide written disclosure containing (1) the name of the solicitor, (2) the name of the investment adviser, (3) the nature of the relationship, including any affiliation, between the solicitor and investment adviser, (4) a statement that the solicitor will be compensated for his solicitation services by the investment adviser, (5) the terms of the compensation arrangement, including a description of the compensation to be paid to the solicitor and (6) the amount, if any, for the cost of obtaining the account which the client will be charged in addition to the advisory fee.

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95. NASAA Model Rule 411(g) under the USA 2002.
96. *See* Pennsylvania Department of Banking and Securities Regulation 404.012, 10 Pa. Code §404.012.

Investment Advisory Contracts

All requirements relating to investment advisory contracts in the USA 1956 were contained in the specific anti-fraud provisions of Section 102(b). Section 502(c) of the USA 2002 authorizes the administrator to adopt rules specifying the contents of an investment advisory contract. The relevant NASAA Model Rule establishes a set of prohibitions about what cannot be in a contract and a set of disclosures which must be given to a client before entering into an investment advisory contract.[97] State securities regulators may request that an applicant for registration as an investment adviser file a form of investment advisory contract which it plans to utilize to ensure compliance with these requirements.

BASIS FOR DENIAL OF APPLICATION

Section 204 of the USA 1956 and Section 412 of the USA 2002 enumerate the statutory bases upon which an administrator may deny an application for registration as an investment adviser or an investment adviser representative. This introduction to investment adviser regulation does not permit an extensive discussion of these provisions and interested readers should refer to Chapter 35 of PLI's Treatise on Investment Adviser Regulation.

Although an investment adviser or investment adviser representative applicant may meet one of the criteria set forth in either the USA 1956 or USA 2002 upon which its application may be denied, whether or not to exercise this authority is within the total discretion of the administrator subject only to such action being in public interest. The USA 2002 recognized that an administrator may be persuaded that the relevant circumstances do not justify a denial of registration but may justify granting limited registration. Granting a conditional license is a status permitted under the USA 2002.

Sections 204 of the USA 1956 and 412 of the USA 2002 particularly may be subject to non-uniform treatment as individual states may have expanded the criteria contained therein, often in response to specific situations that occurred in their jurisdiction. Therefore, special care should be taken in reviewing the corresponding provision of a state's securities law where the registration application will be filed.

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97. NASAA Model Rule 502(c) under the USA 2002.

If an investment adviser or investment adviser representative would meet one of the criteria enumerated in the relevant provision of the state's securities law upon which the registration application could be denied, it is good practice to contact the licensing section of that state's administering office prior to filing a registration application to discuss whether or not the state likely would exercise its discretion and deny the application or whether it would entertain registration based upon certain representations (*eg* heightened supervision) or limitations imposed on the registration. Doing so could avoid issuance of a denial of registration order which not only is reportable on Form ADV and Form U-4 but also may serve as a basis for regulatory action in other jurisdictions.

ISSUES RELATING TO RENEWAL, TERMINATION, WITHDRAWAL AND TRANSFER OF REGISTRATION

Renewal of Investment Adviser and Investment Adviser Representative Registration

Under the USA 1956, each investment adviser registration was effective for one year from its effective date unless renewed. With the advent of CRD and the move toward greater uniformity, states revised their securities laws to have registrations of all licensed persons effective until 31 December of each year unless renewed.[98] Section 406(c) of the USA 2002 has codified this practice with respect to investment advisers and investment adviser representatives.

It should be noted that it is possible that, if an application was approved on December 1 of a given year, the registration would be effective for only one month before it needs to be renewed which renewal will incur all applicable renewal fees. Renewal requires the payment of fees imposed by each state's securities statute.[99] Renewals are accomplished wholly within IARD and an opportunity is given to each registrant not to renew its registration in any given jurisdiction. Under the USA 2002, a registration automatically is renewed and effective upon filing such records as may be required for renewal with IARD and paying any applicable fees.[100]

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98. However, a registration of an investment adviser representative only can be effective while such individual is employed by, or associated with, a registered investment adviser or federal covered investment adviser.
99. Section 406(a) of the USA 2002.
100. Section 406(d) of the USA 2002.

Termination of Registration

The USA 1956 permits the administrator to cancel the registration of a registrant or application of an applicant if the administrator finds that the registrant or applicant (1) is no longer in existence, (2) has ceased to act as an investment adviser, (3) is subject to an adjudication of incapacity or is subject to the control of a committee, conservator, or guardian or (4) cannot be reasonably located.

The USA 2002 has a provision similar to the USA 1956 but extends it to investment adviser representatives and requires the administrator to adopt a rule with respect to taking such actions. It further provides that any administrator may reinstate a terminated registration, with or without hearing, and make the registration retroactive.

Withdrawal of Registration

Whereas termination may reflect an affirmative action by the administrator, a withdrawal generally is a voluntary request filed with the administrator by the registrant. An application for withdrawal from registration is accomplished by means of filing Form ADV-W for investment advisers and Form U-5 for investment adviser representatives, both of which are filed through IARD.

Under the USA 1956, withdrawal from registration as an investment adviser becomes effective 30 days after receipt of an application to withdraw or within such shorter period of time as the administrator may determine unless a revocation or suspension proceeding is pending when the application is filed or a proceeding to revoke or suspend or to impose conditions upon the withdrawal is instituted within 30 days after the withdrawal application is filed. If a proceeding is pending or instituted, withdrawal becomes effective at such time and upon such conditions as the administrator by order may determine. The provisions in the USA 2002 mirror those in the USA 1956 except that the USA 2002 extends the provision to investment adviser representatives and the period prior to effectiveness of the withdrawal from 30 to 60 days.

Even if an application to withdraw becomes effective, both the USA 1956 (with respect to investment advisers) and USA 2002 permit the administrator to institute a revocation or suspension proceeding within one year after the automatic effectiveness of the withdrawal and issue a revocation or suspension order as of the last date on which the registration was effective if a proceeding is not pending. Official Comment No. 1 to Section 409 of the USA 2002 states that

this provision is designed to prevent withdrawal of an effective registration "under fire" and preserves the regulator's ability to initiate a suspension or revocation proceeding under circumstances where the administrator did not know the reasons which formed the basis of the proceeding until after the withdrawal application became effective by operation of law.

In such circumstances, the administrator is authorized to issue a revocation or suspension order as of the last day on which the registration was effective and no proceeding was pending. This has the effect of ensuring that such regulatory order is reportable to, and captured by, IARD and thereby could form the basis for denial of an application for registration in another state. In other words, if a registrant believes he might be the subject of a state investigation and files an application to withdraw which automatically becomes effective and the administrator, within one year of the effective date of the withdrawal, institutes a proceeding which results in a revocation or suspension order, such order will be deemed issued and entered while the person was a registrant and will become part of that person's permanent IARD record.

Transfer of Investment Adviser Representative Registration

A transfer of registration of an investment adviser representative from one investment adviser or federal covered adviser to another is effected on Form U-4 and filed through IARD. Since many agents of broker-dealers simultaneously are registered as investment adviser representatives and use Form U-4 as the principal agent registration application, it made eminent sense to use Form U-4 as the principal registration application for investment adviser representatives.

Due to antecedent history relating to the registration of agents under the USA 1956[101] and the use of Form U-4 to effect transfers, states treat a transfer as a *de novo* application for registration. If an individual has been registered in a jurisdiction 30 days prior to the date the application for registration (transfer) is filed with IARD, such person is eligible, by signing the acknowledgement in Item 15C of Form U-4 for a temporary registration while the transfer application is under review by the relevant state securities regulator.

The "temporary registration" status is a recognition that, on the one hand, the investment adviser representative has been in the

101. *See* Regulation of Broker-Dealers (Practising Law Institute), Chapter 5A.

investment advisory business in a registered status and business considerations favor a seamless transfer from one employer to another but, on the other hand, the state's insistence that the transfer, in effect, is a new registration application for association with a different investment adviser or federal covered investment adviser and subject to state regulatory review. This "temporary registration" status has been recognized by Section 408(b) of the USA 2002, is administered through IARD and is the subject of Item 15C to Form U-4.

Under Section 408(b) of the USA 2002, if an investment adviser representative registered under the state securities act terminates employment or association with an investment adviser registered under such act or a federal covered investment adviser that has filed a notice under such act and applies for registration within 30 days after termination which complies with Section 406(a)(initial application for registration), the registration becomes (1) immediately effective upon filing and payment of any filing fee if the investment adviser representative's IARD record does not contain new or amended disciplinary disclosure within the previous 12 months; or (2) is temporarily effective if the investment adviser representative's IARD record contains new or amended disciplinary disclosure within the preceding 12 months. Even where an investment adviser representative meets these requirements, the USA 2002 authorizes the administrator to prevent the effectiveness of the new or temporary registration based on the public interest and the protection of investors.[102]

The administrator may withdraw a temporary registration if there are grounds for discipline under Section 412 of the USA 2002 and the administrator effects the withdrawal within 30 days after filing of the transfer registration application. If the administrator fails to withdraw the temporary registration within the 30 day period, the temporary registration automatically becomes permanent on the 31st day after filing.

102. Official Comment No. 2 to Section 408 of the USA 2002 states that this authorization is intended to ensure that the administrator has the authority to prevent immediate effectiveness in appropriate cases.

Form U-5 and Defamation Actions

Form U-5 is used for withdrawal of investment adviser representative registration and requires the investment adviser to provide a reason for the withdrawal. This requirement has proved somewhat problematic for investment advisers where an investment adviser representative has been terminated for cause. In such circumstances, the investment adviser is concerned that the reasons for termination stated on Form U-5 would become the basis of a complaint for defamation filed against the investment adviser and its principals by the terminated investment adviser representative.[103]

Libel and defamation actions generally are governed by the applicable law of each particular state. In 2007, the New York Court of Appeals, in answering a question certified to it by the United States Court of Appeals for the Second Circuit, opined that statements made by a broker-dealer on Form U-5 are protected by absolute privilege.[104] It would seem that the same would apply in context of an investment adviser and investment adviser representative. It should be noted that an investment adviser representative who has been the subject of a Form U-5 filing may respond to specific adverse disclosures and have those responses included in publicly available IARD information.

In recognition of this defamation issue, the USA 2002 provides that an investment adviser, federal covered investment adviser or investment adviser representative is not liable to another broker-dealer, agent, investment adviser, federal covered investment adviser or investment adviser representative for defamation relating to a statement contained in a record required by the administrator or designee of the administrator (*ie* IARD), the SEC or a self-regulatory organization unless the person knew or should have known at the time that the statement was made, that the statement was false in any material respect or that the person acted in reckless disregard of the truth or falsity of the statement.[105]

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103. Note waiver of liability provisions in Form U-4.
104. *Rosenberg v. Metlife, Inc.,* 8 N.Y.3d 389, 866 N.E.2d 439 (Ny.App. 2007); *Rosenberg v. Metlife, Inc., Metropolitan Life Insurance Company and Metlife Securities, Inc.*, 453 F.3d 122 (2nd Cir. 2006).
105. Section 507 of the USA 2002. Official Comment No. 7 to this section advises that several states have adopted qualified immunity by judicial decision.

POST-REGISTRATION REQUIREMENTS

Recordkeeping

With respect to broker-dealers, states cannot impose recordkeeping requirements that are in excess of, or different from, those imposed by the SEC. However, with respect to state-registered investment advisers, states may impose their own recordkeeping rules. In this regard, NASAA has adopted a model rule with two alternatives.[106] The first alternative provides detailed rules on recordkeeping requirements to be imposed directly under state regulatory authority. The second alternative is incorporation by reference into state law of the books and records requirements for federal covered investment advisers adopted by the SEC in Rule 204-2 under the Advisers Act.[107]

Annual Updating Amendments

Investment advisers are required to file an annual updating amendment through IARD to Form ADV within 90 days after the end of the registrant's fiscal year. This includes updating responses to all items on Form ADV as well as updating corresponding sections of Schedules A, B, C and D. Registrants also must submit a summary of material changes required by Item 2 of Part 2A either in the brochure (on the cover page or the page immediately thereafter) or as an exhibit to the brochure.

Material Amendments to Form ADV and Form U-4

Investment advisers are required to amend Form ADV promptly if any information (1) provided in response to Items 1, 3, 9 (except 9.A.(2), 9.B.(2), 9.E. and 9.F.) or 11 of Part 1A or Items 1, 2.A. through 2.F., or 2I of Part 1B becomes inaccurate in any way;[108] (2) provided in response to Items 4, 8 or 10 of Part 1A or Item 2.G. of Part 1B becomes materially inaccurate;[109] or (3) provided in the

106. NASAA Model Rule 411(c)-1 under the USA 2002.
107. 17 CFR 275.204-2.
108. This includes Identifying Information, Form of Organization, Custody, and Disclosure Information with respect to Part 2A and State Registration, Person Responsible for Supervision and Compliance, Net Capital, Disclosures relating to denial or revocation of bonds, unsatisfied judgments or liens, arbitrations, and other civil administrative actions, and Custody under Part 1B.
109. This includes Successions, Participation or Interest in Client Transactions, and Control Persons under Part 1A and Other Business Activities under Part 1B.

firm's brochure or a brochure supplement for an investment adviser representative becomes materially inaccurate.

Annual Financial Reporting

Investment advisers that have custody of client funds or securities and investment advisers who have discretion over client funds and securities must file an annual financial report with the administrator.[110] Unlike most other filings with state securities regulators, financial reports generally are filed directly with the administrator and not through IARD. An investment adviser that has custody of client funds or securities or requires payment of advisory fees six months or more in advance and in excess of $500 per client must file an audited balance sheet as of the end of the investment adviser's most recent fiscal year which must be:

- Examined in accordance with GAAP;
- Audited by an independent certified public accountant; and
- Accompanied by an unqualified opinion of the accountant as to the report of the financial position and a note stating the principles used to prepare it, the basis of included securities and any other explanations required for clarity.[111]

An investment adviser that has discretionary authority over client funds or securities, but not custody, must file a balance sheet which need not be audited but must be prepared in accordance with GAAP or such other basis of accounting acceptable to the administrator and represented by the investment adviser or the person who prepared the statement to be true and accurate, as of the end of the investment adviser's most recent fiscal year.[112]

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110. NASAA Model Rule 411(b)-1. Generally, a financial report in the form required annually must be submitted with an application for registration by an investment adviser that will have custody of, or discretionary authority over, client funds and securities.
111. Some states require that, in addition to the audited balance sheet, a supplementary opinion must be submitted by the accountant with respect to any material inadequacies found to exist in the accounting system, the internal accounting controls and procedures for safeguarding securities and funds and indicate any corrective action taken or proposed. *See* 10 Pa. Code §304.022(a)(1).
112. NASAA Model Rule 411(b)-1 under the USA 2002.

Annual Custody Audits

Investment advisers that have custody of client funds or securities will need to arrange for an annual custody audit by an independent certified public accountant to verify, by actual examination, the client funds and securities over which the investment adviser has custody. The audit must be unannounced and the accountant is responsible for filing the custody report with the state securities regulator by filing Form ADV-E through the IARD.[113]

Annual Offer to Deliver a Brochure

Part of the rule governing the obligation of the investment adviser to create a brochure is the requirement of annual delivery.[114] Annually, an investment adviser must, within 120 days of the end of its fiscal year, deliver (1) a free, updated brochure and related brochure supplements which include or are accompanied by a summary of material changes or (2) a summary of material changes[115] that includes an offer to provide a copy of the updated brochure and supplements and information on how the client may obtain a copy of the brochure and supplements but no summary of material changes or brochure need be delivered to clients if no material changes have taken place since the last summary and brochure delivery. Delivery of the brochure and related brochure supplements need not be made to (1) clients who have received only impersonal advice and who pay less than $500 annually in fees and (2) an investment company registered under the 1940 Act or a business development company as defined in the 1940 Act and whose advisory contract meets the requirements of Section 15c of the 1940 Act.

Advertising

Advertising is addressed under the specific investment adviser anti-fraud provisions of Section 502(b) of the USA 2002. The relevant NASAA Model Rule provides for two alternatives. The first alternative is incorporation by reference into state law of the advertising

113. NASAA Model Rule 411(f-(1) under the USA 2002 contains detailed rules relating to custody and the annual custody audit as well as exemptions from application of the custody rule.
114. NASAA Model Rule 411(g)(b) under the USA 2002.
115. Some states only require delivery of a written offer to provide a free copy of the brochure and brochure supplement. *See* 10 Pa. Code §404(e).

rules adopted by the SEC in Rule 206(4)-1 under the Advisers Act applicable to federal covered investment advisers. The second alternative is a rule which prohibits the use of certain types of advertising and use of certain representations.[116]

Continuing Education

Section 411(h) of the USA 2002 authorizes the administrator to adopt a rule or order requiring continued education for a registered investment adviser representative. Often, a registered investment adviser representative also is a registered representative of a registered broker-dealer and, as such, is subject to FINRA rules on continuing education.[117] Where this is the case, Section 411(h) of the USA 2002 permits the administrator to require such individual to participate in a continuing education program approved by the SEC and administered by FINRA.

By its terms, Section 411(h) of the USA 2002 authorizes an administrator to establish a state law continuing education requirement for investment adviser representatives and failure to comply with such requirement could constitute a violation of state law (as opposed to a FINRA requirement with respect to individuals dually registered as agents and investment adviser representatives) which failure could be the subject of administrative enforcement as provided in Section 604 of the USA 2002, including imposition of a civil penalty.

REGULATORY AUDITS AND INSPECTIONS

The USA 1956 authorizes the administrator to conduct at any time and from time to time reasonable periodic, special or other audits or inspections within or without the state as the administrator deems necessary or appropriate in the public interest or for the protection of investors.

The USA 2002 mirrors the language of the USA 1956 but adds that the inspection may be made without prior notice. Further, the administrator is authorized to copy, and remove for audit or inspection, copies of all records the administrator reasonably considers necessary or appropriate to conduct the audit or inspection. The USA 2002 also permits the administrator to assess the registrant a reasonable charge for conducting an audit or inspection.

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116. NASAA Model Rule 502(b)(o) under the USA 2002.
117. FINRA Rule 1250.

Official Comment No. 6 to Section 411 of the USA 2002 observes that, although the administrator's power to copy and examine records is subject to all applicable privileges, no subpoena is required as the powers granted by this section for inspection are separate and distinct from the administrator's enforcement powers in Section 602. The Official Comment further states that failure to allow or engaging in actions which impede the administrator from conducting an audit or inspection or refusal of access to a registrant's office to conduct an audit or inspection may result in an action against the registrant's license, a criminal prosecution or an injunction.[118]

Under Section 203A(c) of the Advisers Act, states retain authority to bring enforcement actions with respect to fraud or deceit against any federal covered investment adviser or any person associated with a federal covered investment adviser. Use of the terms "fraud and deceit" suggest that states would have to utilize their investigatory and subpoena powers vested in Section 407 of the USA 1956 and Section 602 of the USA 2002 with respect to federal covered investment advisers and not their regulatory audit and inspection authority.

INVESTMENT ADVISOR PUBLIC DISCLOSURE

The Investment Adviser Public Disclosure ("IAPD") is a web page on the SEC web site that provides public access to information appearing on Form ADV filed by SEC-registered investment advisers and state-registered investment advisers.[119] The web site also will search FINRA's BrokerCheck® system and indicate whether an investment adviser is affiliated with a brokerage firm. Since the IAPD captures all Form ADV filings with IARD, it also will contain information on "exempt reporting advisers" with the SEC even if such entities have an exemption from registration at the state level. IAPD will disclose any customer complaints, arbitrations, bankruptcies, regulatory actions, civil suits and criminal prosecutions that are subject to disclosure on Form ADV.

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118. *See* Section 412(d)(8) of the USA 2002 which provides a basis for action by the administrator against a registrant's license for refusing or otherwise impeding the administrator from conducting an audit or inspection or refusing access to a registrant's office to conduct an audit or inspection. However, Official Comment No. 11 to Section 412 of the USA 2002 notes that a request by a person subject to an audit or inspection for a reasonable delay to obtain the assistance of counsel does not constitute conduct justifying the administrator taking disciplinary action under this provision.
119. *See* http://www.adviserinfo.sec.gov/IAPD/Content/IapdMain/iapd_SiteMap.aspx.

IAPD also is available to search for information concerning individual investment adviser representatives. IAPD will provide information concerning the individual's professional background and conduct, including current registrations, employment history, and any disciplinary events. Information about investment adviser representatives who are or were associated persons of broker-dealers also will be made available through an interface with FINRA's BrokerCheck® system.

STATE ACTIONS PROVIDING A BASIS FOR FEDERAL REGULATORY ACTION

Section 203(e)(9) of the Advisers Act permits the SEC to censure, deny or suspend the registration of an investment adviser subject to SEC registration if the investment adviser or any person associated with such investment adviser (whether prior to or subsequent to becoming so associated) is subject to any final order of a state securities commission that (1) bars such person from association with any entity regulated by such commission or from engaging in the business of securities, or (2) constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative or deceptive conduct.

Unless there is a stay in effect, a final order of an administrator meeting the criteria of Section 203(e)(9) of the Advisers Act will be sufficient to provide a basis for regulatory action by the SEC even where the respondent has petitioned for judicial review of the final order.

Therefore, when an investment adviser or investment adviser representative is negotiating a regulatory consent order with a state securities administrator, it is important to consider whether or not the proposed language of the order would provide a basis for disciplinary action under Section 203(e)(9) of the Advisers Act.

USA 2002 CONCEPT OF CONTROL PERSON DISCIPLINE

The USA 2002 introduced a new concept of control person liability with respect to discipline (*ie* suspension or revocation) that could be imposed on a registrant under Section 412. Under Section 412(h) of the USA 2002, a person that controls, directly or indirectly, a person not in compliance with Section 412 may be disciplined by order of the administrator under this section to the same extent as the non-complying person, unless the controlling person did not know, and in the exercise of reasonable care could not have known, of the existence of conduct that is grounds for discipline under this section.

Although this provision is new to the USA 2002 and did not exist in the USA 1956, there is no official comment in the USA 2002 as to the basis for inclusion. However, there does appear to have been a compromise perhaps related to its inclusion in that the USA 2002 contains a statute of limitations with respect to each basis under Section 412 (except a felony conviction) upon which a registration may be suspended, revoked or conditioned whereas the USA 1956 generally did not. In particular, the USA 2002 imposes a ten year statute of limitations with respect to willful violations of the state's securities law, failing to supervise an agent, investment adviser representative or other individual or engaging in dishonest or unethical practices in the securities, commodities, investment, franchise, banking, finance or insurance business.

Under Section 412(h) of the USA 2002, an investment adviser could face the possibility of a suspension of its license solely because an investment adviser representative entered into a consent order with the administrator in which he agreed to have his license suspended for thirty days. Even though the investment adviser did not participate in negotiation of the consent order, it may be required to invest time and money in establishing an affirmative defense if the administrator seeks to impose similar discipline on the investment adviser or a control person of the investment adviser similar to that imposed on the investment adviser representative.

Except for Pennsylvania and Washington State, only jurisdictions that have adopted the USA 2002 in its entirety have enacted this provision. A recent amendment to Pennsylvania's securities law added this section,[120] and Washington State adopted a modified version of Section 412(h) of the USA 2002 that substitutes a "good faith" standard[121] in lieu of the affirmative defense contained in Section 412(h). It provides that a person who, directly or indirectly, controls a person not in compliance with any part of this section may also be sanctioned to the same extent as the non-complying person, unless the controlling person acted in good faith and did not directly or indirectly induce the conduct constituting the violation or cause of the sanction[122]

120. 70 P.S. §1-305(h).
121. This is the same standard used in both the civil and administrative context for control person liability under Section 20(a) of the 1934 Act.
122. Revised Washington Code 21.26.110(6).

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