



STATE REGULATION OF INVESTMENT ADVISERS

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Fundamentals of Investment Adviser Regulation

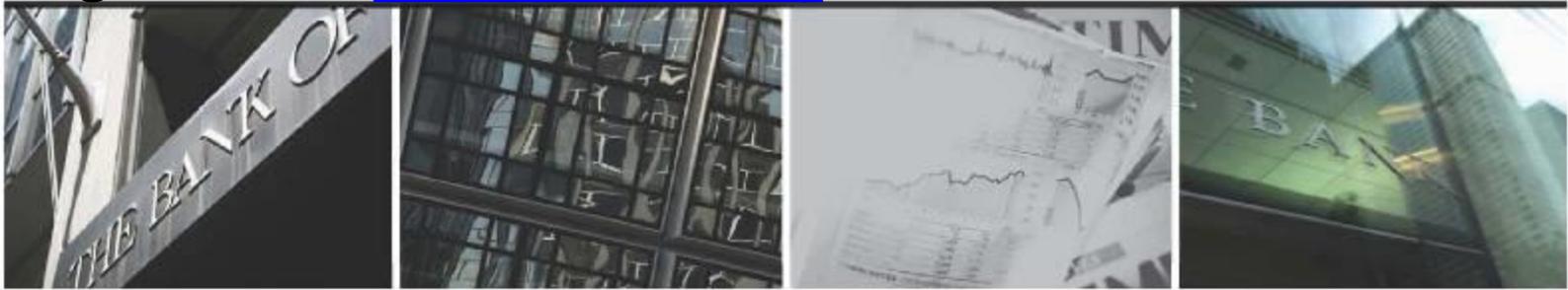
PRACTISING LAW INSTITUTE

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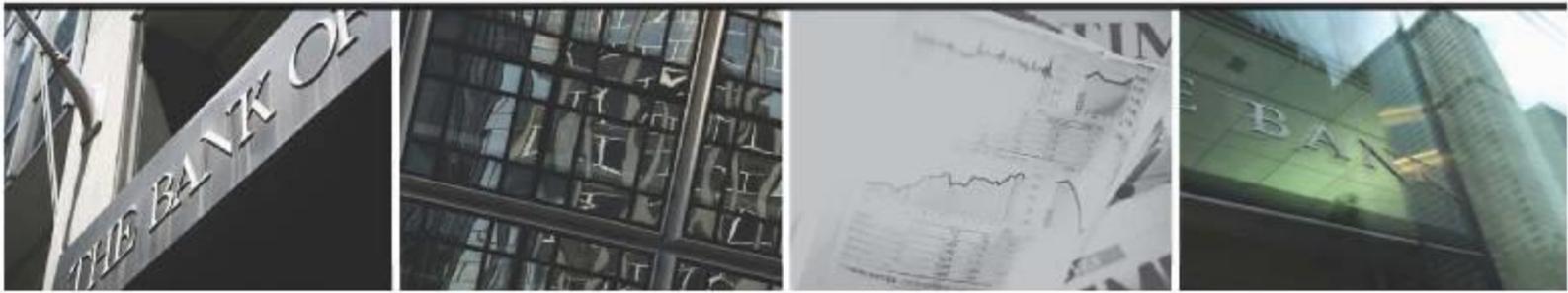
BLUE SKY IS EVERYWHERE

- Uniform Securities Act
 - 1956 Act is the basis of regulation in many states
 - 2002 Act is entirely new act adopted in GA, HI, IA, ID, IN, KS, ME, MI, MN, MS, NH, NM, OK, SC, SD, VT, VI, WI and WY (eff. 7/1/2017)
- Each state has agency which administers securities laws
- North American Securities Administrators Association (NASAA) maintains a link to each state securities regulator at www.nasaa.org



THE REGISTRATION DIVIDE

- Unlike broker-dealer registration where both SEC and states have registration jurisdiction, registration of investment advisers is exclusive to one or the other
- States, however, can require SEC-registered advisers operating in their jurisdiction to file a notice on Form ADV and pay a filing fee



FRAUD AND DECEIT

- However, SEC and states both have jurisdiction over all investment advisers with respect to activities constituting fraud or deceit
 - Query: do SEC anti-fraud rules (eg pay-to-play, code of ethics) apply to state-registered advisers even in the absence of analogous state rules?



EXCLUSIVE SEC REGISTRATION

- Investment advisers with more than \$100 million of assets under management (“AUM”)
- Advisers to registered investment companies
- Required to register in 15 or more states
- Provides advice exclusively through the internet
- Pension consultant to plan with \$200 million in value
- Advisers in states with no IA regulation (Wyoming)



EXCLUSIVE STATE REGISTRATION

- Advisers with AUM of \$100 million or less (except NY where it is AUM of less than \$25 million) unless:
 - An exclusion or exemption is available under state law; or
 - Adviser can rely on National De Minimis provision of federal Investment Advisers Act of 1940 (“Advisers Act”)
- Advisers exempt from registration with SEC under Sections 203(l) or (m) of Advisers Act



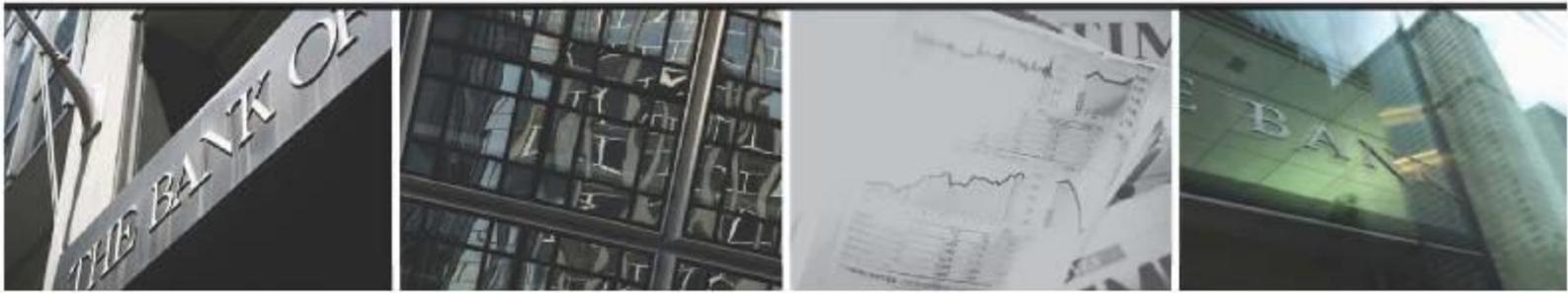
SEC EXEMPT REPORTING ADVISERS

- Unless exemption or exclusion available, advisers exempt from SEC registration under Sections 203(l) (venture capital advisers) and (m) (private fund advisers) of Advisers Act may be required to register under state law because, although they “report” to the SEC on Form ADV, they are not “registered” with SEC



STATE EXEMPTION FOR PRIVATE FUND ADVISERS

- NASAA has adopted a state exemption for SEC-exempt private fund advisers (§203(m))
 - Imposes certain disclosure and annual audited financial statement delivery requirements on 3(c)(1) funds advised by the exempt adviser
 - Exemption not yet widely adopted although MD, WA and VA have adopted this exemption



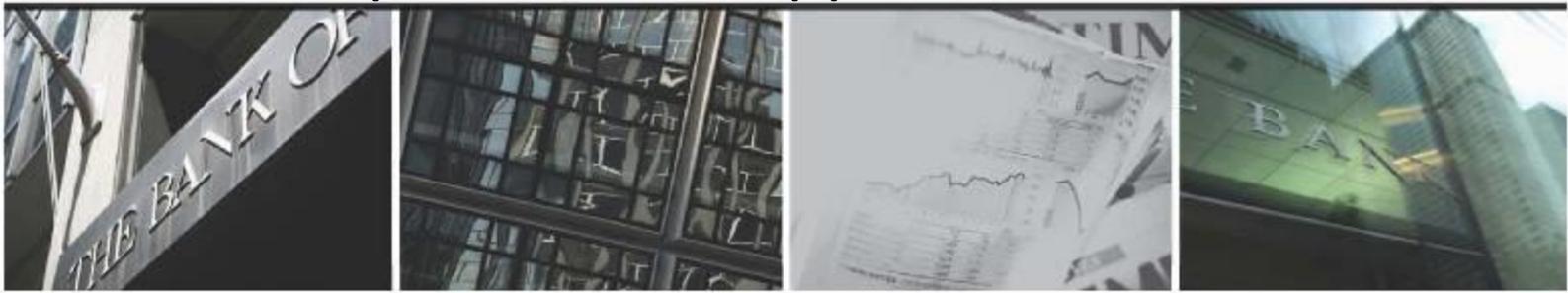
NATIONAL DE MINIMIS STATE PREEMPTION

- Federal law preempts state registration laws otherwise applicable to an investment adviser where:
 - Adviser does not have a place of business in the state; and
 - In preceding 12 month period, adviser had fewer than 6 clients who are residents of that state



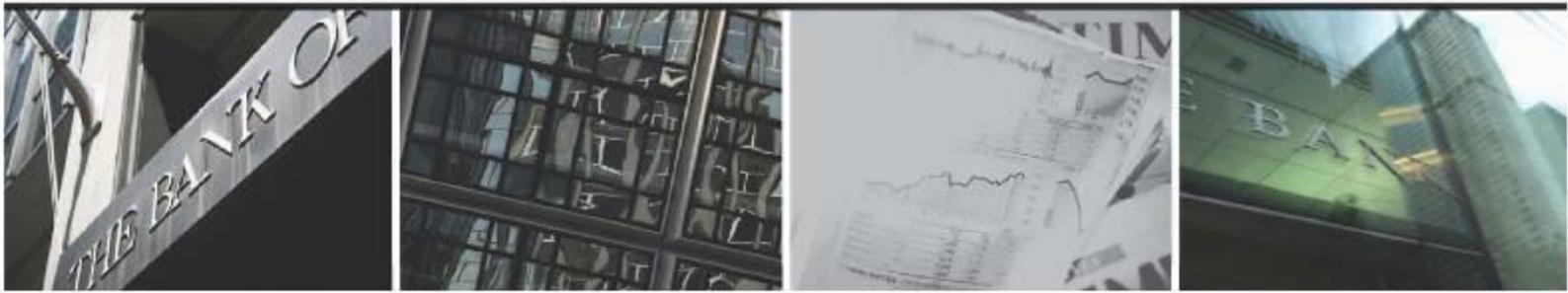
HOME STATE RULES

- Advisers Act also requires states to accept the rules of the state where state-registered investment adviser maintains its principal office and place of business with respect to net worth, bonding and books and records if:
 - Adviser is registered in such state; and
 - Is in compliance with applicable rules



DEFINITION OF INVESTMENT ADVISER UNDER USA 1956

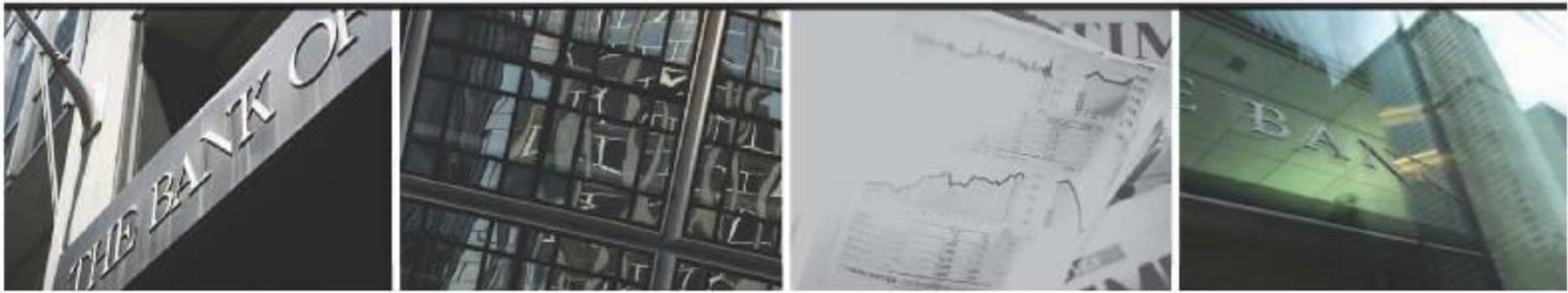
- Any person who, for compensation, engages in the business of advising others, either directly or indirectly or through publications or writings as to the value of securities or as to the advisability of investing in, purchasing or selling securities
- Same definition as in Advisers Act



DEFINITION OF INVESTMENT

ADVISER UNDER USA 2002

- Same as USA 1956 but includes financial planner and person holding themselves out as providing investment advice to others for compensation
- Based upon SEC/NASAA Investment Adviser Release 1092 issued in 1987



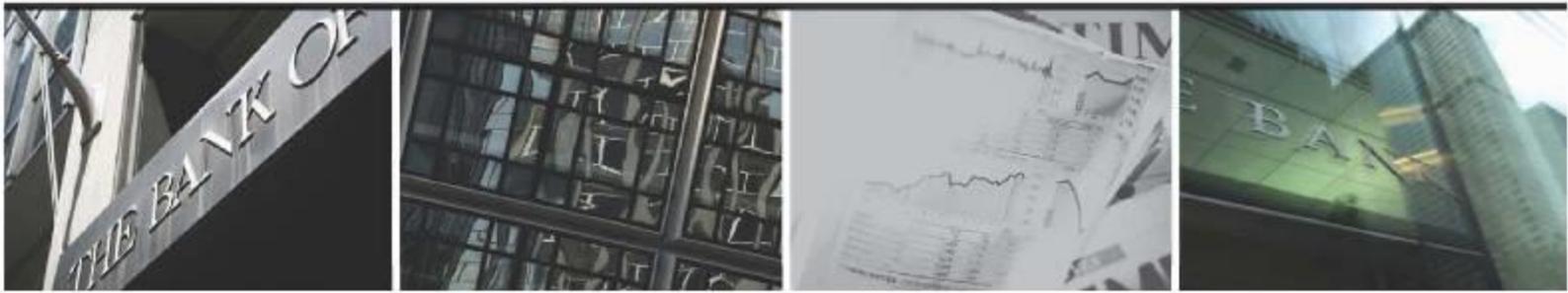
INVESTMENT ADVISER RELEASE 1092 (1987)

- Joint federal/state release on when federal and state laws on investment advisers apply
- Directed mainly at activities of “financial planners” which may require financial planners to register as an investment adviser under federal or state laws



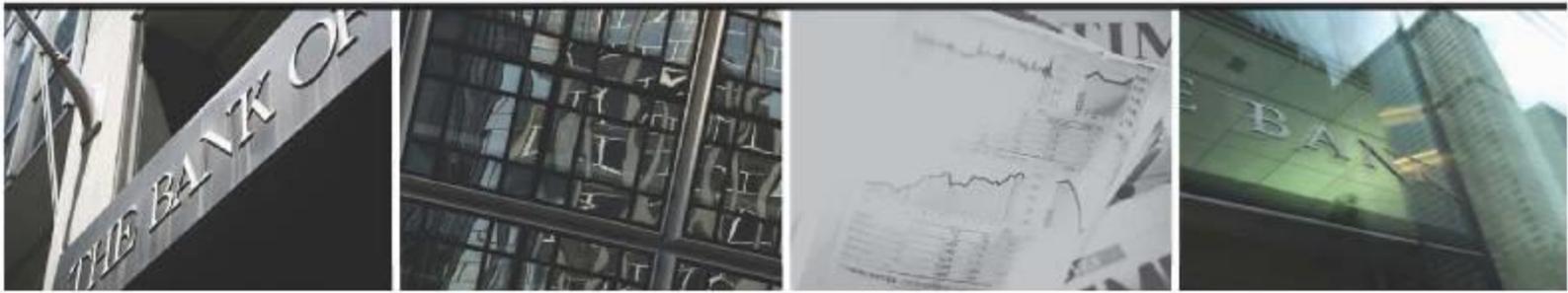
IA 1092 VIEW OF “IN THE BUSINESS”

- May apply even if giving investment advice is not the person’s principal business activity
- Holding out to the public as giving investment advice for compensation
- Receives separate or additional compensation for providing investment advice



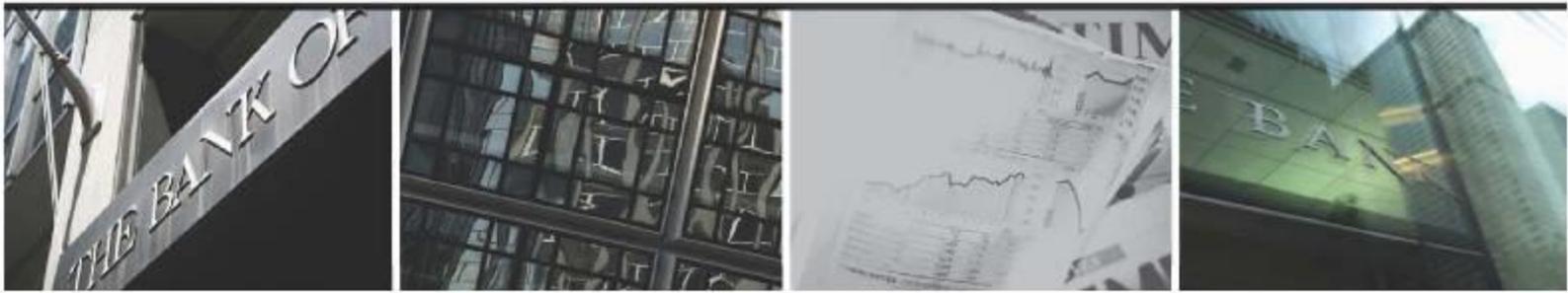
IA 1092 VIEW OF “SPECIFIC INVESTMENT ADVICE”

- Advising on advantages/disadvantages of investing in securities over other assets
- Recommendation of a specific security or a category of securities
- Advising on asset allocation even where some of the assets being allocated are not securities



IA 1092 VIEW OF “COMPENSATION”

- Receipt of any economic benefit
- May be single fee or bundled with other fees, including transaction-based compensation
- Not necessary that the client pay the fee
- Relevant issue is that the adviser is being compensated for giving investment advice



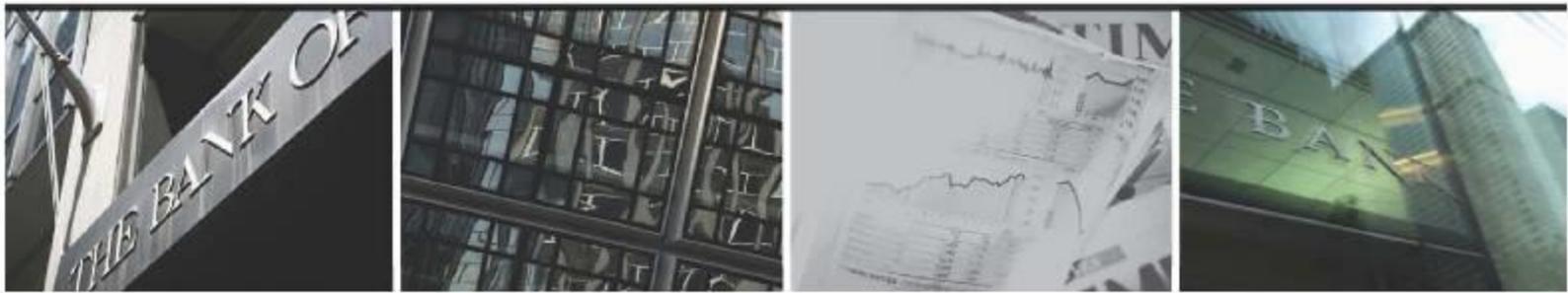
STATE FOCUS ON FINANCIAL PLANNERS

- USA 2002 definition adopted by 20 states and included in statutes of some non-USA 2002 states like California and Maryland
- Financial planners that come within the definition of investment adviser are more likely to be required to register at the state level than with the SEC



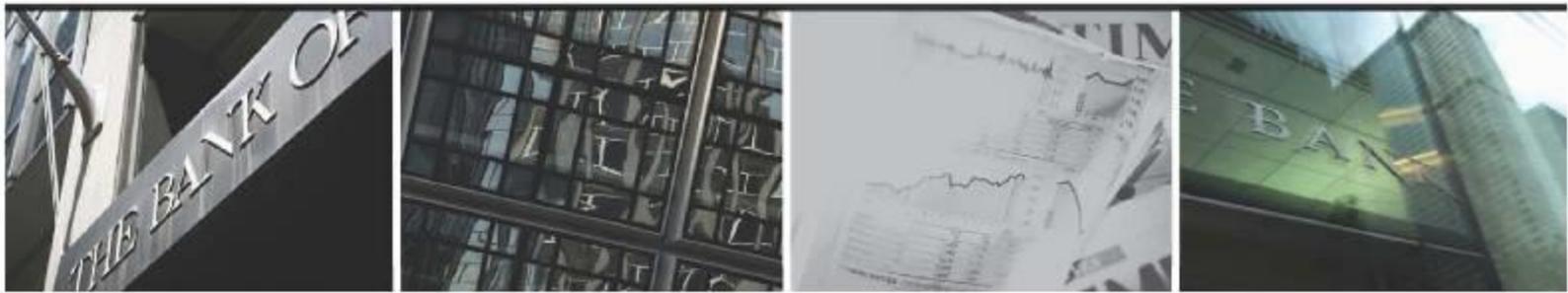
EXCLUSIONS FROM DEFINITION OF INVESTMENT ADVISER

- Banks, savings and loans, trust companies
- Lawyer, accountant and teacher if incidental to the practice of their profession
- Broker-dealer whose performance of investment advisory services is incidental to brokerage function and receives no special compensation
- Certain publishers



EXCLUSIONS FROM DEFINITION OF INVESTMENT ADVISER

- Person whose advice relates only to gov't securities
- Person with no place of business in the state if
 - Only clients are broker-dealers, investment advisers, banks, insurance companies, pension and profit-sharing plans, investment companies and institutional investors
 - No more than 5 clients in 12 consecutive month period exclusive of the above-referenced clients
 - An exclusion under USA 1956 but an exemption under USA 2002



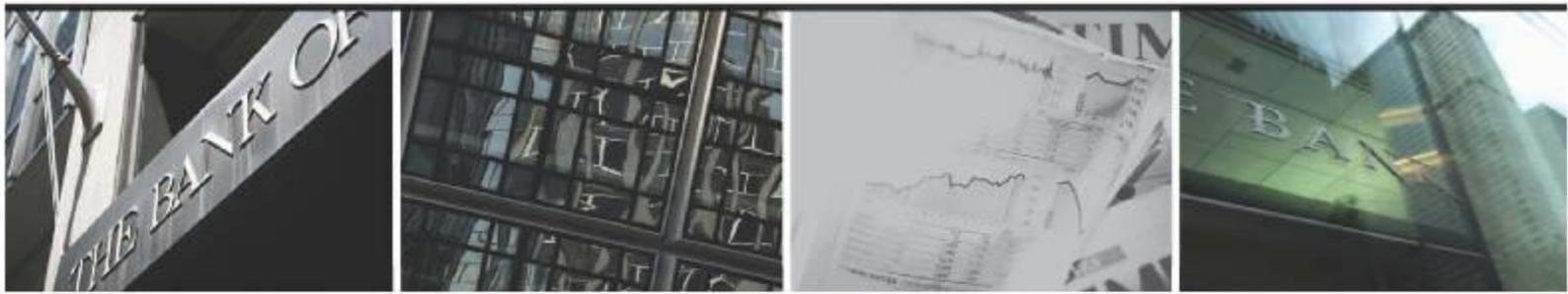
INVESTMENT ADVISER REPRESENTATIVE

- States have jurisdiction over investment adviser representatives (“IARs”) of
 - SEC-registered advisers whose supervised persons:
 - Meet the SEC definition of IAR; and
 - Have a place of business located in the state
 - State-registered investment advisers whose IARs conduct business in the state as to which state definitions of IAR apply unless state registration is preempted under the National De Minimis provision



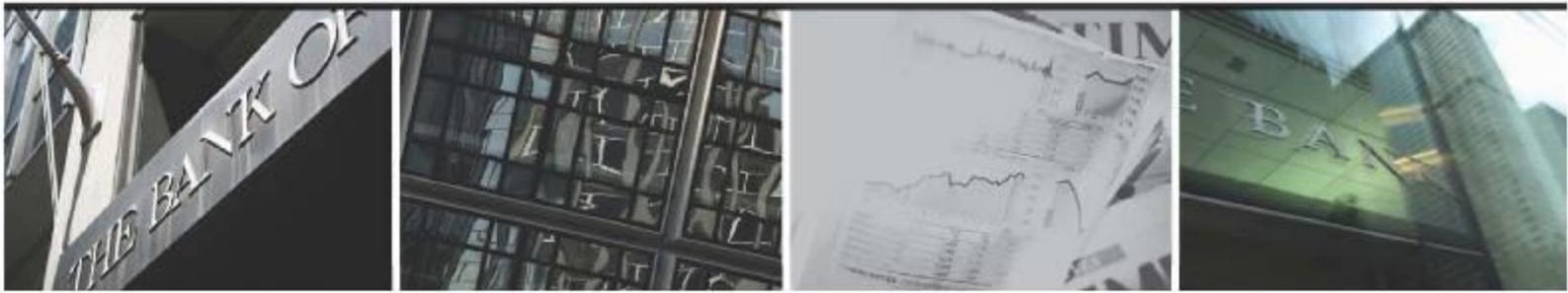
SEC DEFINITION OF INVESTMENT ADVISER REPRESENTATIVE

- Supervised person of an investment adviser:
 - Who has more than 5 clients who are natural persons; and
 - More than 10% of whose clients are natural persons, other than excepted clients (*ie* \$1 million AUM or net worth of \$2 million exclusive of principal residence)



SEC DEFINITION OF “PLACE OF BUSINESS”

- Office at which the IAR regularly provides investment advisory services or solicits, meets with or otherwise communicates with clients
- Other location that is held out to the general public as a location where the IAR provides these services



DEFINITION OF IAR UNDER STATE LAW

- Individual employed by or associated with an investment adviser or SEC-registered adviser
 - Gives investment advice regarding securities
 - Manages accounts or portfolios of clients
 - Determines investment advice to be given
 - Provides investment advice
 - Solicits or negotiates the sale of investment advice



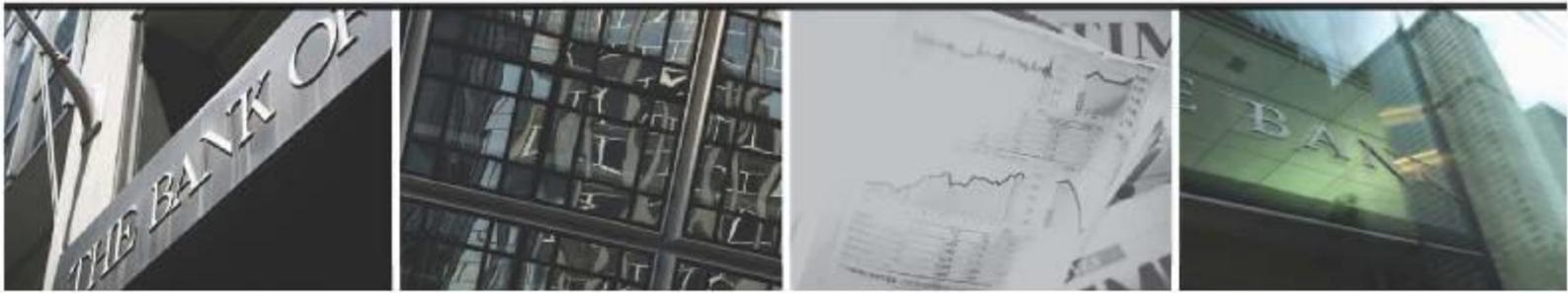
EXCLUSION FROM THE DEFINITION OF IAR UNDER STATE LAW

- Performs only clerical functions
- Agent of a broker-dealer whose performance of investment advice is incidental to acting as agent for which no special compensation is received
- IAR of a SEC-registered investment adviser unless principal place of business is in the state and meets the federal definition of IAR and is not a supervised person under federal law



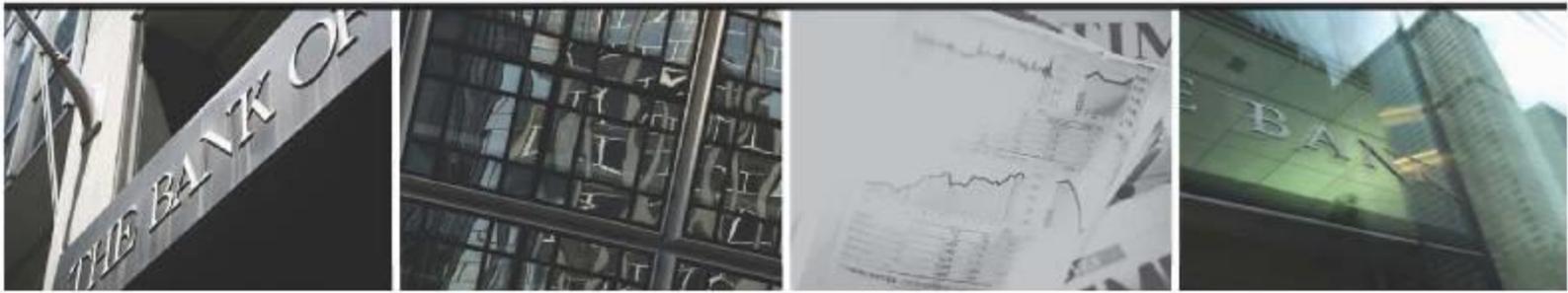
STATE APPLICATION PROCESS

- Form ADV for investment advisers
- Form U-4 for investment adviser representatives
- All forms filed electronically through Investment Adviser Registration Depository (“IARD”)
- Consent to service of process (included in Form ADV and Form U-4)



EXAMINATION REQUIREMENTS

- Investment adviser (if sole proprietor) and IARs subject to state registration must take and pass the Uniform Investment Adviser Exam (Series 65) but automatic waivers available for:
 - Certified Financial Planners
 - Chartered Financial Consultants
 - Chartered Financial Analysts
 - Personal Financial Specialists
 - Chartered Investment Counselors



DUAL REGISTRATION

- IARs may be associated with more than one investment adviser at the same time
- Registered agent of a broker-dealer also may:
 - Be registered as an IAR of an affiliated or unaffiliated investment adviser
 - Be registered as an independent investment adviser (usually state-registered)



NET WORTH REQUIREMENTS FOR STATE INVESTMENT ADVISERS

- Unlike SEC, state-registered advisers must meet certain net worth requirements:
 - \$35,000 if have custody of client funds or securities
 - \$10,000 if have discretion over client funds or securities
 - Positive net worth if adviser accepts prepayment of advisory fees more than 6 months in advance and more than \$500 per client
- Posting of bond in lieu of net worth is permitted



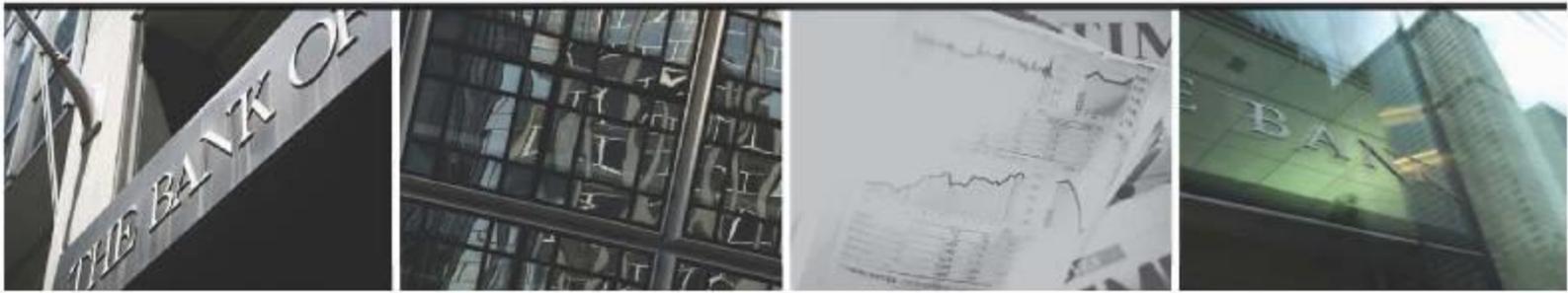
BROCHURE DISCLOSURE

- Under Part 2A of Form ADV, adviser must create a narrative about the adviser, its fees, investment policies and business background known as the “brochure”
- Part 2B is a “supplemental brochure” which contains certain information about each IAR
- Part 2A must be delivered to a prospective client within 48 hours prior to entering into an advisory contract or, if the contract permits a 5 business day cancellation without liability, at the time of entering into the advisory contract



POST-REGISTRATION REQUIREMENTS

- Recordkeeping subject to Home State Rule provision
- Annual updating of Form ADV within 90 days after the end of registrant's fiscal year
- Annual filing of financial reports (audit for custody and internally prepared balance sheet for discretion)
- Annual custody audit if have custody
- Annual delivery of material changes to Part 2A



STATE REVIEW OF INVESTMENT ADVISER APPLICATION

- States may review and comment on:
 - Any applicable net worth requirement
 - Brochure (Part 2A) and Brochure Supplement (Part 2B)
 - Form of investment advisory contract
 - Prior unregistered activity of adviser or its IARs
 - Customer complaints and arbitrations
 - How broker-dealer will supervise its agent who is registered as an independent investment adviser (*see* FINRA Notice to Members 96-33 and 94-44)
 - Existence of any statutory basis for denial



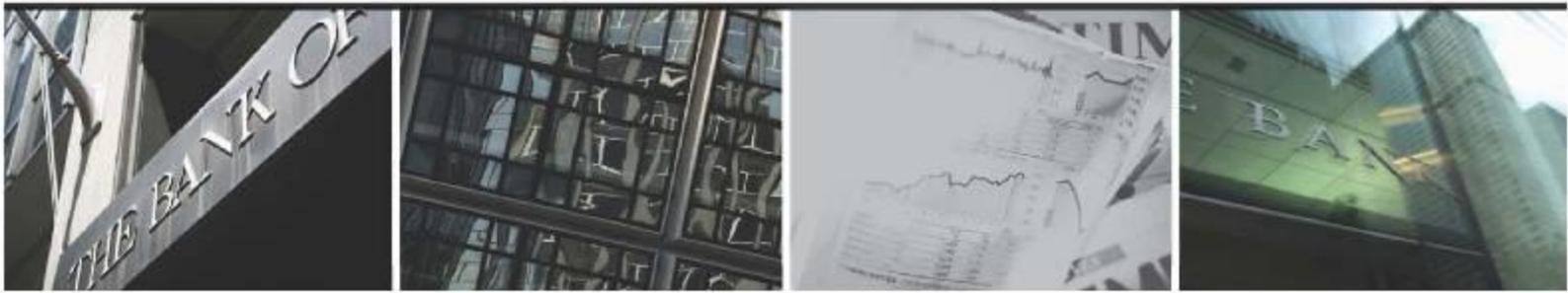
SENIOR SPECIFIC DESIGNATIONS

- Many states (eg MD, FL, NJ) have adopted a NASAA Model Rule prohibiting use of designations by investment advisers that are:
 - Non-existent, unearned or person is ineligible
 - Obtained from an entity that:
 - Is primarily engaged in sales or marketing activities
 - Does not have reasonable standards relating to competency, discipline or continuing education



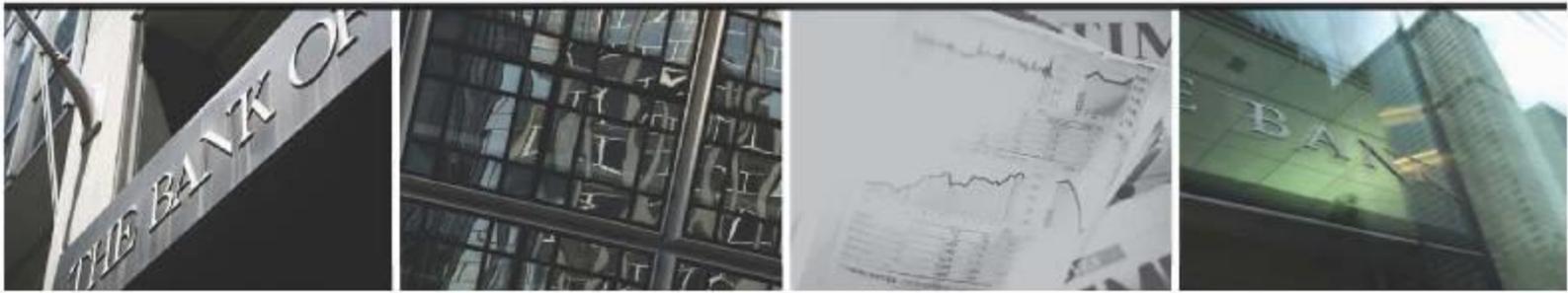
NASAA MODEL LEGISLATION TO PROTECT VULNERABLE ADULTS

- Adopted by NASAA in January 2016 to combat financial exploitation of vulnerable individuals
- Applies to
 - Adults age 65 and over
 - Persons under the care of Adult Protective Services



MODEL STATE LEGISLATION TO PROTECT VULNERABLE ADULTS

- Allows broker-dealers and their agents and investment advisers and their IARs to
 - Alert state securities regulators and adult protective services as to certain transactions requested by these individuals which are out of the ordinary
 - Delay disbursements requested from their accounts
- Without incurring any civil or administrative liability under state securities laws



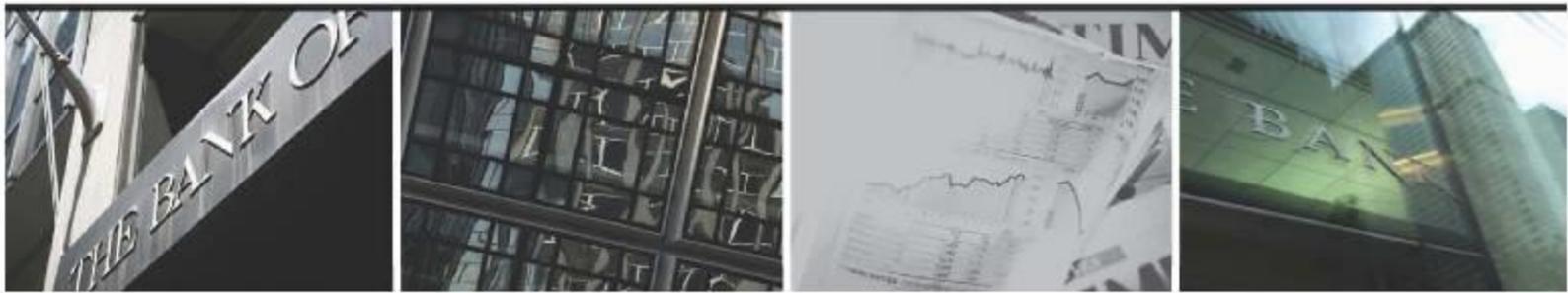
RENEWALS AND TRANSFERS

- Registrations are effective for 1 year, unless renewed
- IAR transfers are *de novo* applications but treated as temporary registration under Item 15C of Form U-4
- USA 2002 gives immediate effectiveness to transfers unless disciplinary history incurred within previous 12 months



TERMINATION AND WITHDRAWAL

- Termination requires act of administrator
- Withdrawal is a voluntary act by adviser or IAR
 - Effective with passage of time (30 or 60 days)
 - Administrator may institute a proceeding within one year of effective date of withdrawal and disposition thereof will relate back to last day of registration and be captured in CRD/IARD
 - Form ADV-W for advisers; Form U-5 for IARs



ADMINISTRATIVE ENFORCEMENT

- Proceeding before administrator to revoke, suspend or condition a license or bar a person from licensure based on specific statutory criteria
- States may impose civil monetary penalties
- State enforcement actions are in addition to, and may run concurrent with, any FINRA or SEC action



USA 2002 ADMINISTRATIVE CONTROL

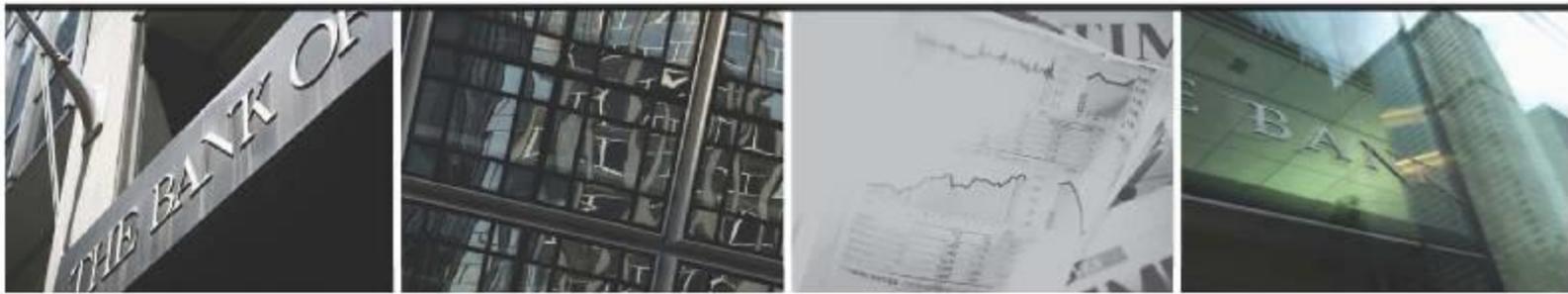
PERSON LIABILITY

- USA 2002 permits administrator to impose same discipline (suspension, revocation) on a control person of a person who is the subject of such discipline unless control person can show that he did not know and, in exercise of reasonable care, could not have known of the underlying misconduct
 - Shifts burden of proof to control person of a disciplined individual that he should not be likewise disciplined



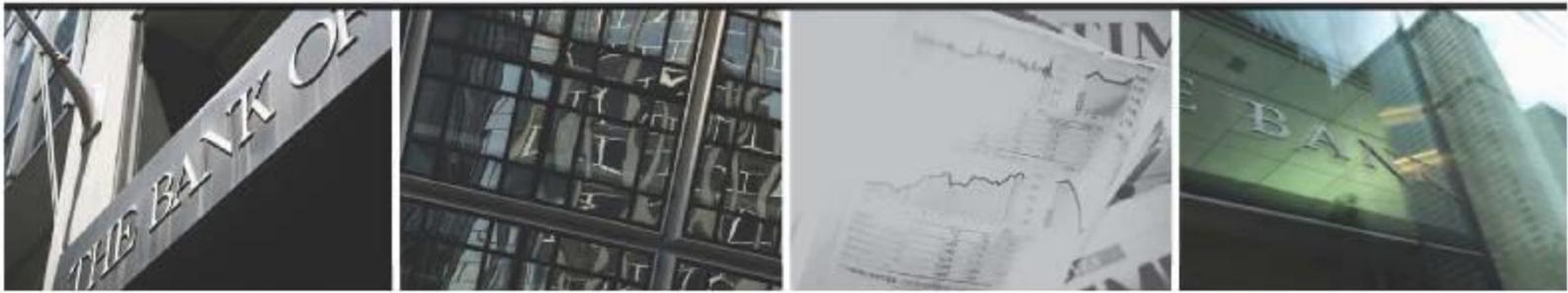
STATE ADMINISTRATIVE ORDERS AND STATUTORY DISQUALIFICATION

- The following state orders will create a statutory disqualification under Sec. 203(e)(9) of Advisers Act
 - Final order that bars a person from association with any entity regulated by the securities commission or from engaging in the business of securities
 - Final order based upon a violation of any law prohibiting fraudulent, manipulative or deceptive conduct
- Similar orders will constitute a disqualification for purposes of Rule 506 and Regulation A offerings



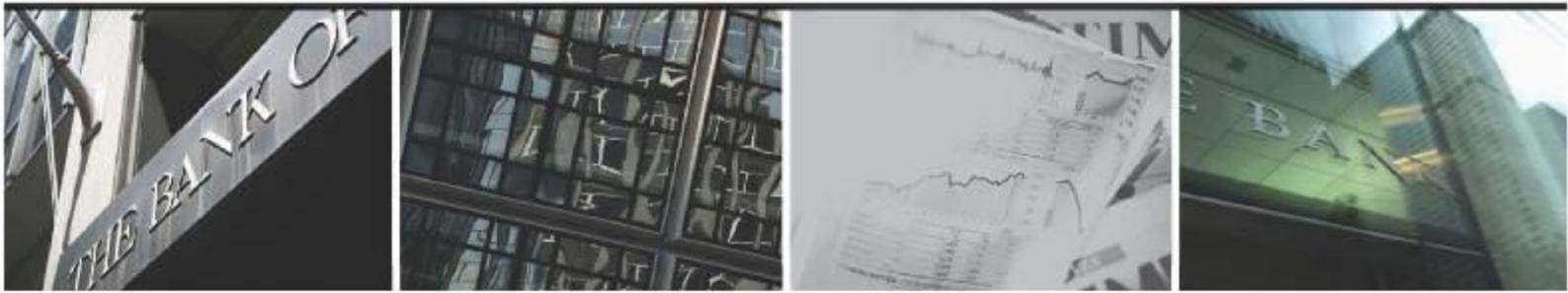
CIVIL LIABILITY UNDER USA 2002

- Unlawful for a person to advise others for compensation without registration or to
 - Employ a device, scheme or artifice to defraud another person; or
 - Engage in any act, practice or course of conduct that operates or would operate as a fraud or deceit upon another person



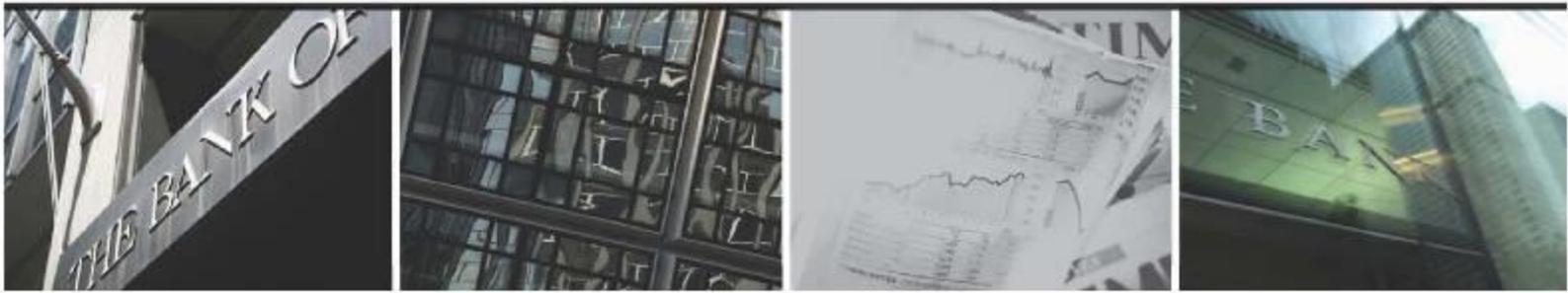
CIVIL LIABILITY FOR UNREGISTERED ACTIVITY

- Consideration paid for the advice, including:
 - Interest at the legal rate from the date of payment
 - Costs and reasonable attorneys' fees determined by a court



CIVIL LIABILITY FOR FRAUD

- Consideration paid for the advice
- Amount of actual damages caused by the fraudulent conduct
- Interest at the legal rate from the date of the fraudulent conduct
- Costs and reasonable attorneys' fees as determined by a court less income received



TAKE AWAYS

- Registration jurisdiction over investment advisers and IARs as between SEC and states is complicated and includes two federal preemptive features
 - National De Minimis
 - Home Rule Provision
- IARs of SEC-registered advisers with non-institutional clients likely will have to register in at least the state where they maintain their principal place of business



TAKE AWAYS

- SEC Exempt Reporting Advisers may be subject to state registration
- Advisers going from SEC to state registration must give sufficient lead time for state review of Form ADV before withdrawal from SEC becomes effective
- States are attuned to “financial planners” who may use such designation to avoid adviser registration
- States retain jurisdiction over all investment advisers as to enforcement actions for fraud or deceit



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