

# Regulation of Investment Advisers

## Definition of an Investment Adviser

An investment adviser is a 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 part of a regular business, issues or promulgates analyses or reports concerning securities.

Financial planners, pension consultants, and sports or entertainment representatives are included within the definition of investment adviser at both the state and federal levels.

The term investment adviser is describing the firm level. The individual who gives investment advice is the investment adviser representative.

There are three essential elements that characterize an investment adviser:

- Provides advice or analysis about securities either by making direct or indirect recommendations to clients or by providing research or opinions on securities or securities markets, and
- Receives compensation in any form for the advice provided, and
- Engages in a regular business of providing advice about securities

The giving of advice need not constitute the principal business activity or any particular portion of the business activity of a person for that person to meet the business standard. Such advice need only be given on such a basis that it constitutes a business activity occurring with some regularity.

The giving of specific investment advice or simply advertising as an investment adviser means that the person must be registered as an investment adviser. Persons selling advice on non-securities products are not required to register as investment advisers unless they are comparing those products to securities products.

## Exclusions from the Definition of Investment Adviser

The following are excluded from the definition of investment adviser under the Investment Advisers Act of 1940:

- Banks
- Broker-dealers
- Publishers of financial publications of general, regular, and paid circulation
- Certain professionals whose advice is solely incidental to their jobs
  - Lawyers, accountants, teachers, and engineers (LATE)
- Persons whose advice is related solely to U.S. government securities
- Investment adviser representatives

Lawyers, accountants, teachers, and engineers (LATE) are excluded from the definition of investment adviser if the advice they give is solely incidental to their profession. If any of these four professions provide investment advice that is not incidental to their profession, they must register as an investment adviser. If a lawyer, accountant, teacher, or engineer charges a separate fee for investment advice that means that the advice given is not incidental to their profession and they must register as an investment adviser. If a teacher meets with students outside of class hours, giving specific advice related to securities, this would be cause for the teacher to need to register as an investment adviser.

Most of the time, when a person is excluded from the definition of investment adviser federally, they are also excluded from the definition under state law (Uniform Securities Act).

There are two differences between federal and state law. A person whose advice only relates to U.S. government securities is not required to register as an investment adviser at the federal level under the Investment Advisers Act of 1940, but they would be required to register at the state level. Federally covered advisers are exempt from registration at the state level but required to register federally.

#### Fiduciary Standard

Under the Investment Advisers Act of 1940, an investment adviser is held to a fiduciary standard. This fiduciary standard requires the adviser to be loyal to the client, to have a sound and objective basis for investment recommendations, and to make sure that investment recommendations given are appropriate based upon the client's objectives and financial circumstances.

**Notice Filing Requirements**

Federally covered investment advisers are registered with the SEC and not the state. They are required to do a notice filing in every state in which they have more than five public clients or maintain an office. There is a filing fee due with the notice filing at the state level that is in addition to the federal filing fee. Consent to service of process is required to be filed in every state in which the investment adviser registers, or does a notice filing.

Multi-state advisers that are required to register in 15 states or more are required to register federally with the SEC and do a notice filing in each state in which they conduct business.

Federally covered advisers are not required to file advertising at the state level.

## **Registration/Post-Registration**

Registration of an investment adviser automatically registers a firm's partners, officers, and directors as investment adviser representatives, if they act in such a capacity.

### **Federally Covered Advisers**

A federally covered adviser is one that is required to register at the federal level. The following advisers would all register federally with the SEC:

- Investment advisers that manage mutual funds
- An investment adviser with \$100 million or more in assets under management
  - A new investment advisor who reasonably expects to have \$100 million or more in assets under management during the first 120 days is allowed to register with the SEC instead of the state
- Private fund advisers with \$150 million or more in assets under management
  - This includes private equity funds advisers and hedge fund advisers
- Investment advisers doing business in 15 or more states (regardless of the size of assets under management)

Federal registration as an investment adviser will be either granted or proceedings will begin to determine whether registration should be denied within 45 days of filing an application (or within such a longer period as the applicant consents).

### **State Registered Investment Advisers**

It is unlawful for any person to transact business in a state without registration in that state. The following advisers would all register at the state level:

- An investment adviser with less than \$100 million in assets under management
- An investment adviser whose only advice is related to U.S. government securities
  - Regardless of the size of assets under management
- An investment adviser to insurance companies
  - Regardless of the size of assets under management
- An investment adviser who only advises clients in their own state and whose advice is only related to securities sold within the state
  - Regardless of the size of assets under management

State registration as an investment adviser will be either granted or proceedings will begin to determine whether registration should be denied within 30 days of filing an application, or sooner at the state securities Administrator's discretion. State registration for broker/dealers, investment advisers, agents, and investment adviser representatives expire every December 31<sup>st</sup> unless renewed.

A federally registered investment adviser can do business in a state, without registration, so long as they do not have an office in the state and the business is with the following:

- Institutional clients
- Broker-dealers
- Existing clients visiting the state
- Up to five public clients in that state during a twelve-month period

A federally covered adviser is exempt from state registration but will be required to do a notice filing in every state in which they do business.

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Investment advisory firms can do business outside of their home state, without registration, so long as they limit their business to institutional clients or no more than five public clients in twelve months.

#### Form ADV

FINRA owns and operates the IARD (Investment Adviser Registration Depository). It is through the IARD website that clients can find a firm's Form ADV and public disclosure documents. Form ADV is filed by investment advisers, regardless of if they are registering at the federal or state level.

Form ADV has three parts:

- Part 1, the application
- Part 2A, the firm brochure
  - Part 2B, brochure supplements
- Part 3, the relationship summary
  - Prepared by SEC-registered investment advisers that offer services to retail investors

Investment advisers are required to file an updating amendment to their Form ADV annually, within 90 days of the end of their fiscal year. Since the value of a firm's assets under management fluctuates daily, there is a 20% cushion allowed before a firm must change registration from state to federal or vice versa. If a firm was registered at the state level and at the time of the annual updating amendment has assets under management of greater than \$110 million, they must switch to federal registration. If a firm that was registered at the federal level has assets under management of less than \$90 million at the time of the annual updating amendment, it must switch to state registration. When a firm's assets under management are between \$90 million and \$110 million, it may choose to stay registered at the same level as the prior year. It is only when the AUM exceeds \$110 million or falls below \$90 million that the registration level must be switched.

The firm may state that it is registered with the state or SEC, as the case may be, but cannot imply that the state or SEC has verified the accuracy of any of the information that was provided as part of the registration process. To imply that the firm has been approved by the state or SEC is a violation of state and federal laws.

When a state-registered investment adviser requires or solicits pre-payment of fees more than \$500 per client six months or more in advance the firm's balance sheet must be included with Form ADV. When a federally registered investment adviser requires or solicits pre-payment of more than \$1,200 in fees six months or more in advance the firm's balance sheet must be included with Form ADV.

Successor Firm

When an investment advisory firm reorganizes the successor firm must file a new Form ADV but can use the unexpired portion of the original firm's filing fee.

Form ADV-W

An investment adviser files Form ADV-W to withdraw its registration. The withdrawal at the state level will be effective within 30 days or sooner, at the Administrator's discretion. The withdrawal may be delayed if administrative action is pending against a person in the firm. The firm must keep books and records after they go out of business for the period of retention, which is five years.

Books and Records

An investment adviser can keep records on paper, tape, computer disk, or microfilm. Hard copy backups of electronic records are not required. Books and records must be maintained by an investment adviser for five years from the date of record, two years readily accessible in the adviser's office.

Surety Bond/Net Capital

A surety bond (fidelity bond) protects clients against losses due to check forgery, lost securities, or fraudulent trading. Surety bonds may be required of agents, broker/dealers, and investment advisers, at the discretion of the state securities Administrator. The minimum coverage must be not less than \$35,000. Broker-dealers and investment advisers whose net capital is \$35,000 or more may be exempt from this requirement. The Administrator will accept appropriate deposits of cash or securities in lieu of a bond.

Net capital is liquid capital, cash, or readily convertible into cash, as required by law for customer protection. A state-registered investment adviser that has custody of client funds or securities must maintain a minimum net capital of \$35,000. If an investment adviser has discretionary authority over a client's funds and/or securities but does not have custody, the minimum net worth requirement is \$10,000. When an investment adviser does not have discretionary authority over a client's funds and/or securities or custody but does accept prepayment of fees of more than \$500 per client six months or more in advance, they must have, at minimum, a positive net worth.

An investment adviser that is registered in multiple states will always have a home state. That home state is the state where the investment adviser's principal place of business is located (home office). The strictest requirement that can be imposed on an investment adviser regarding the amount of the surety bond and/or net capital requirement is that of the firm's home state.

If a state-registered investment adviser's net capital should fall below the minimum requirement, the firm is required to notify the Administrator no later than the close of the following business day. Then by the close of business of the next day, the investment adviser must file a financial report with the Administrator that must include the following:

- A trial balance of all ledger accounts
- A statement of all clients' funds or securities that are not segregated
- A computation of the aggregate amount of client ledger debit balances, and
- A statement as to the number of client accounts

### **Exemptions for Exempt Reporting Advisers and Private Fund Advisers**

An exempt reporting adviser (ERA) is an investment adviser that is not required to register as an adviser with the SEC or with the state, but that is still required to pay fees and report public information via the IARD system. There are two exemptions that advisers can use to claim ERA status:

- The private fund adviser exemption, or
- The venture capital fund adviser exemption

The term private fund adviser includes investment advisers that manage private equity funds and hedge funds.

To claim the private fund adviser exemption, the investment adviser must be U.S. based and have less than \$150 million in regulatory assets under management (AUM).

An adviser advising solely venture capital funds can qualify for the exemption, regardless of the size of AUM. An investment adviser to a venture capital fund would be exempt from federal registration but is required to keep books and records related to the advice given and provide the SEC with reports as required under federal law.

Large advisers (firms with AUM of \$100 million or more) will register with the SEC unless an exemption is available. This means that advisers with between \$100 million and \$150 million AUM solely attributable to private funds are exempt under the private fund adviser exemption, while advisers with over \$150 million AUM must register with the SEC. Generally, mid-sized advisers (those with AUM between \$25 million and \$100 million) register with the state.

Exempt reporting advisers file an abbreviated Form ADV with the SEC but are not required to prepare or deliver a brochure to their clients. They are required to keep books and records, follow a code of ethics, ensure they have policies in place to prevent the misuse of material nonpublic information, and they must properly allocate fees and expenses between the adviser and the clients. Exempt reporting advisers (ERAs) are required to file annual updating amendments to Form ADV, within 90 days of the end of the firm's fiscal year, and more frequently in certain situations.

Private fund advisers that manage \$150 million or more in assets are required to register federally with the SEC as an investment adviser. In addition to filing Form ADV, these advisers are required to file Form PF (Private Fund), either annually or quarterly depending upon the size of assets under management. Since these advisers do not deal with the general public, this form is not available to the public through the IARD (investment adviser registration depository), instead, it is filed through the private fund reporting depository (PFRD).

SEC-registered investment advisers with less than \$150 million in private fund AUM, exempt reporting advisers, and state-registered investment advisers are generally not required to file Form PF.

**Investment Adviser Representative Supervision**

Investment advisers are responsible for the supervision of all of their supervised persons, including investment adviser representatives. The term supervised person includes the following:

- Officers, directors, and partners of the firm
- Employees of the firm, and
- Any person who provides investment advice on behalf of the adviser (investment adviser representatives)

Clerical staff and customers are not considered supervised persons under federal securities law.

The investment adviser's Chief Compliance Officer is responsible for the adequacy and effectiveness of the firm's written policies and procedures that are designed to prevent violation of state and federal securities laws. The Chief Compliance Officer must review the investment advisory firm's policies and procedures no less frequently than annually.