INVESTMENT ADVISER REGULATION—A NEW DUAL SYSTEM

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The National Securities Markets Improvement Act of 1996 (the "Act")[1] has altered in some significant respects the nation's securities regulatory structure. A major change is the elimination by the Act of certain portions of the regulatory overlap between the states and the federal government. This change is evident in Title III of the Act, which amends the Investment Advisers Act of 1940 (the "Investment Advisers Act")[2].

Title III of the Act made several amendments to the Investment Advisers Act, the most significant of which was the addition of new Section 203A[3]. With few exceptions, before July 8, 1997,[4] investment advisors had to register with the Securities and Exchange Commission (the "SEC").[5] Section 203A reallocated federal and state regulatory responsibility over the more than 23,000 investment advisers registered with the SEC. Congress accomplished this by making the states primarily responsible for smaller advisory firms and the SEC primarily responsible for larger firms.[6]

Congress had two reasons for reallocating authority. First, Congress was concerned that the SEC had inadequate resources to properly supervise the increasing numbers of investment advisers, many of which are small, locally operated, financial planning firms.[7] For example, by 1995, the rate at which the SEC was able to examine smaller investment advisers on a routine basis had fallen to an average of only once every 44 years.[8] Congress concluded that supervision of smaller investment advisers would be improved and regulation itself would be more efficient if it instituted a new system of divided responsibility to replace the overlapping scheme of state and federal authority over investment advisers.

The second reason for the reallocation was Congress' concern over the costs which overlapping, sometimes duplicative regulation imposed on investment advisers and their clients.[9] In addition to the SEC, 46 states, the District of Columbia, Puerto Rico and Guam regulate investment advisers. Consequently, large advisers, particularly those advisers operating nationally, had been required to comply with a variety of regulations in numerous jurisdictions. Therefore, dividing responsibility reduces the regulatory burdens on large advisers.[10]

On May 22, 1997, the SEC promulgated final rules which implement the provisions of Title III.[11] In this article, we will discuss aspects of Title III and these rules which effect the new dual system of regulation of investment advisers under the Investment Advisers Act.

THRESHOLDS FOR FEDERAL OR STATE REGULATION

Under Section 203A and the rules, a $25 to $30 million threshold of assets under management divides investment advisers for purposes of state or federal regulation. Section 203A prohibits states from registering, licensing or qualifying (a) investment advisers that meet the federal threshold of assets under management or (b) the supervised persons[12] of such advisers. These advisers and supervised persons must continue to register with and will be regulated by the SEC.[13]

Although Congress set this threshold at $25 million in the Act, it also authorized the SEC to increase the threshold should the SEC deem such an increase appropriate.[14] In its May rulemaking, the SEC boosted the threshold to $30 million.[15] However, registration with the SEC is optional for those investment advisers with more than $25 million but less than $30 million in assets under management. The SEC created this $5 million gap to ease the burden of registering and deregistering faced by investment advisers whose assets under management fluctuate near the threshold amount.[16]

An investment adviser with less than $25 million of assets under management may only be registered or licensed with, or qualified by, the state in which it maintains its principal office and place of business. Although such an adviser is permitted to register with the SEC once its level of assets under management exceed $25 million, it must do so once its assets under management reach $30 million.[17]

Congress defined the term "assets under management" to mean "the securities portfolios with respect to which an investment adviser provides continuous and regular supervisory or management services."[18] "Securities portfolios" are further defined in new Schedule I to Form ADV[19] as accounts in which securities comprise at least 50% of the total account value. For purposes of the 50% test, cash and cash equivalents (*i.e.,* bank deposits, certificates of deposit, bankers acceptances and similar bank instruments) are permitted, but are not required, to be considered to be "securities."[20]

Schedule I provides general criteria for determining whether an adviser provides an account with "continuous and regular supervisory or management services."[21] Investment advisers who have discretionary authority over accounts to which they provide ongoing supervisory or management services would satisfy the criteria. Investment advisers who do not have such discretionary authority nevertheless may meet the standard of providing continuous and regular supervisory or management services if (a) they have an ongoing responsibility to select or make recommendations as to specific securities or other investments the account may purchase or sell, based upon the needs of the client, and (b) if such recommendations are accepted by the client, they are responsible for arranging or effecting the purchase or sale. Additionally, in applying these general principles, applicants are asked to consider the terms of the advisory contract, the form of compensation and the management practice of the adviser. The SEC has provided some examples in Schedule I of accounts that may receive continuous and regular supervisory or management services.[22]

The SEC has stated that no bright line test exists regarding whether a particular arrangement involves providing continuous and regular supervisory or management services. Therefore, it provided a safe harbor from SEC registration for an adviser who is registered with state securities authorities (rather than with the SEC) in the state in which it has its principal office and place of business. The adviser registered with a state must harbor a reasonable belief that it need not register federally because it does not have assets under management of at least $30 million.[23] An investment adviser's "principal office and place of business" means the executive office from which the officers, partners or managers of the investment adviser direct, control and coordinate the investment adviser's activities.[24]

EXEMPTIONS

The effect of Title III is to require or permit some investment advisors to register with the SEC while prohibiting others from doing so. Congress, however, granted the SEC the power to exempt certain investment advisers who would not otherwise qualify for federal registration from the prohibition on registering with the SEC. In other words, exempted investment advisers must register and be regulated by the SEC instead of by the states with certain exceptions, even though they may not have $25 million of assets under management. The statutory test for an exemption is that state registration "would be unfair, a burden on interstate commerce, or otherwise inconsistent with the purposes of [Section 203A]."[25] New Rule 203A-2 lists four categories of advisers that meet this test:[26]

- *Nationally Recognized Statistical Rating Organizations ("NRSRO").* An NRSRO must register with the SEC. NRSROs, often referred to as "rating agencies," provide ratings of securities, on the basis of which the securities receive special treatment under SEC rules. NRSROs do not have assets under management, but their activities significantly affect the national securities markets and the operation of federal securities laws.

- *Pension Consultants.* A pension consultant must register with the SEC if it provides investment advisory services to certain employee benefit, governmental or church pension plans which in the aggregate have at least $50 million of assets. Pension consultants themselves may not have assets under management, but their activities directly influence the management of billions of dollars of plan assets and affect national markets.[27] In determining the aggregate value of plan assets, a consultant may include only that portion of a plan's assets for which it provided investment advice.

- *Certain Affiliated Investment Advisers.* An investment adviser must register with the SEC if (a) it controls, is controlled by or is under common control with an investment adviser registered with the SEC and (b) its principal office and place of business is the same as the adviser referred to in clause (a). The SEC reasoned that subjecting the activities of centrally-managed affiliated advisers to separate schemes of regulation would be burdensome and inefficient.

- *Investment Advisers With Reasonable Expectation of Eligibility.* A newly-formed investment adviser must register with the SEC if it has a reasonable expectation that it would be eligible for federal registration within 120 days after its registration becomes effective. If the adviser doesn't have at least $25 million of assets under management at the end of the 120-day period, it must withdraw from federal registration and register with the appropriate state or states. The basis for this provision is to avoid burdensome registration and deregistration.

STATE REGULATION OF FEDERALLY-REGISTERED ADVISERS

Although the amendments to the Investment Advisers Act eliminate substantially all of the overlapping regulatory scheme governing the nation's investment advisers, states retain jurisdiction over federally-registered investment advisers in three areas:

- *Preservation Of Filing Requirements and Fees.* A state may require a federally-registered investment adviser to file, solely for notice purposes, documents filed with the SEC and a consent to service of process, and to pay filing, registration and licensing fees, to the extent that those fees would have been payable pursuant to state law in effect on October 10, 1996. Furthermore, a state may enforce fee collection until October 11, 1999 by requiring the registration of any investment adviser which does not pay those fees.[28]

- *Enforcement Actions For Fraud and Deceit.* A state may investigate and bring enforcement actions for fraud and deceit against investment advisers or persons associated with such advisers.[29]

- *Investment Adviser Representatives.* A state may license, register or otherwise qualify an "investment adviser representative" who has a "place of business"[30] within the state, even if the investment adviser for whom the representative works is registered with and regulated by the SEC.[31]

An "investment adviser representative" is a supervised person[32] more than ten percent of whose clients are natural persons.[33] However, a number of exclusions limit this definition. The SEC excludes from the ten percent test any natural person who, immediately after entering into the advisory contract, has at least $500,000 under management with the investment adviser or whom the investment adviser reasonably believes, immediately prior to entering into the advisory contract, has a net worth (including assets held jointly with the person's spouse) of more than $1 million.[34]

The SEC also excludes from the definition of "investment adviser representative" a supervised person who does not regularly solicit, meet with, or otherwise communicate with clients of the investment adviser or who provides only impersonal investment advice.[35] "Impersonal investment advice" means investment advisory services provided by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts.[36]

STATE REGULATION OF STATE-REGISTERED ADVISERS

Title III includes a number of other provisions that affect only investment advisers subject to state regulation. In practice, these provisions further limit state regulation of investment advisers.

- *Dual Compliance.* States may not require an investment adviser to maintain any books or records in addition to those required under the laws of the state in which it maintains its principal place of business, if the adviser is registered in the latter state and in compliance with its books and records requirements.[37]

- *Limitation On Capital and Bond Requirements.* States may not require an investment adviser to maintain a higher minimum net capital or to post any bond in addition to that required in the state in which it maintains its principal place of business, if the adviser is registered in, and in compliance with requirements of, the latter state.[38]

- *National De Minimis Standard.* Under a new "national de minimis standard," state investment adviser statutes will not apply to an adviser that has had fewer than six clients who are state residents during the preceding 12-month period and does not have a place of business located in the state.[39] A state may have a higher, but not a lower, de minimis threshold. Previously, the maximum number of clients an adviser could have before being subject to state regulation varied from state to state.

The SEC has created a definition of "client" of an investment adviser[40] which uniformly applies both to the new state standard and to the federal de minimis provision.[41] The definition provides a nonexclusive method for determining who may be treated as a single client under these standards.

CONCLUSION

President Clinton praised the National Securities Markets Improvement Act of 1996 as a measure that "will save hundreds of millions of dollars for American businesses."[42] The revised scheme for the registration of investment advisers should further this goal. Additionally, allowing states to retain their authority to take enforcement against fraudulent conduct in all situations should continue to maintain the investor protections furnished by our nation's securities regulatory structure. In the words of the President, Title III and the other legislation comprising the Act achieve "the difficult task of improving the efficiency of the financial markets without compromising investor protections."[43]

NOTES

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1. Pub. L. No. 104-290, 110 Stat. 3416 (Oct. 11, 1996) (codified in scattered sections of 15 U.S.C.).

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2. 15 U.S.C. §§ 80b-1 to 80b-21 (1997). Title III of the Act is known as the "Investment Advisers Supervision Coordination Act".

3. *Id.* § 80b-3a.

4. President Clinton extended the effective date of Title III, originally April 9, 1997, to July 8, 1997 by signing into law Pub. L. No. 105-8, 111 Stat. 15 (1997).

5. *See* 15 U.S.C. § 80b-3.

6. *See* S. Rep. No. 104-293, at 3-4 (1996).

7. *See id.* at 3-4.

8. *See id.* at 3 (citing *The Securities Investment Promotion Act of 1996: Hearing on S. 1815 Before the Senate Comm. on Banking, Housing, & Urban Affairs,* 104th Cong., 2d Sess. 36 (1996) (testimony of Arthur Levitt, Chairman, SEC)).

9. *Id.* at 2.

10. *Id.*

11. *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, 62 Fed. Reg. 28,111 (1997) (to be codified at 17 C.F.R. pts. 275 & 279) ("Rules"). The effective date of the rules was the same as that of Title III, July 8, 1997, except for 17 C.F.R. § 275.203A-2, which became effective on July 21, 1997.

12. "Supervised person" is newly-defined to mean "any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser." 15 U.S.C. § 80b-2(a)(25).

13. Section 203A also prohibits states from regulating any person not federally registered if that person is excepted from the definition of investment adviser under 15 U.S.C. § 80b-2(a)(11). *See id.* § 80b-3a(b)(1)(B). Additionally, the SEC retains regulatory responsibility, regardless of the amount of assets under management, for advisers with a principal office and place of business in a state (including a U.S. possession) that has not enacted an investment adviser statute and for foreign advisers doing business in the United States. *See id.* § 80b-3a(a)(1); *see also id.* § 80b-3 (regarding registration of investment advisers). Finally, advisers to registered investments companies (*e.g.,* mutual funds) also are subject to federal regulation. *See id.* § 80b-3a(a)(1)(B).

14. *See id.* § 80b-3a(a)(1)(A).

15. *See* 17 C.F.R. § 275.203A-1 (1997).

16. *See* Rules, *supra* note 11, at 28,116.

17. Rule 203A-1(d) provides that advisers whose assets under management grow to $30 million may postpone registration with the SEC until 90 days after the date the adviser is required to report $30 million or more of assets under management to its state securities authorities. This rule is available only to advisers registered in a state that requires such adviser to report annually the amount of assets under management pursuant to a form or rule substantially similar to Schedule I to Form ADV (17 C.F.R. § 279.1). An adviser not registered in such a state must register promptly with the SEC upon meeting the $30 million threshold.

18. 15 U.S.C. § 80b-3a(a)(2).

19. *See* Instruction 7(a) to Schedule I to Form ADV. Schedule I contains instructions designed to assist an adviser in determining whether it meets the criteria for SEC registration set forth in Title III and the SEC rules. *See* 17 C.F.R. § 279.1 (1997). It is required to be included with all new registrations filed on or after July 8, 1997. Schedule I must be amended annually within 90 days after the end of the adviser's fiscal year. *See id.* § 275.204-1(a)(1). In order to determine assets under management, *see generally* Instruction 7 to Schedule I to Form ADV.

20. The SEC reasoned that cash and cash equivalents typically comprise a small component of most advisory accounts and that treating such items as securities would not have a significant effect on the number of advisers eligible for SEC registration. *See* Rules, *supra* note 11, at 28,114 n.29.

21. *See* Instruction 7(c) to Schedule I to Form ADV.

22. *See id.*

23. 17 C.F.R. § 275.203A-4 (1997).

24. *Id.* § 275.203A-3(4)(c).

25. *See* 15 U.S.C. § 80b-3a(c).

26. *See* 17 C.F.R. § 275.203A-2 (1997). The SEC also may exempt any person from the prohibition by order upon application. *See* 15 U.S.C. § 80b-3a(c). 15 U.S.C. § 80b-3 lists other exemptions from federal registration. An adviser that qualifies for an exemption under Section 80b-3, even if it meets the conditions of Rule 203A-2, need not register with the SEC. The SEC has proposed an additional exemption from the prohibition on federal registration. *See* Exemption for Investment Advisers Operating in Multiple States; Revisions to Rules Implementing Amendments to the Investment Advisers Act of 1940, 62 Fed. Reg. 61,866, 61,867 (1997) (to be codified at 17 C.F.R. pts. 275 & 279) ("Proposed Rules"). Under the exemption as proposed, an investment adviser that does not have $25 million of assets under

management would be permitted to register federally if it has a national or multi-state practice and conducts advisory activities that require it to register as an investment adviser in 30 or more states. *See id.*

27. The SEC provided a higher threshold for pension consultants than for investment advisers because pension consultants have substantially less control over client assets than advisers who have assets under management. *See* Rules, *supra* note 11, at 28,117 n.60.

28. *See* Section 307(a) & (b) of the Act.

29. *See* 15 U.S.C. § 80b-3a(b)(2).

30. The "place of business" of an investment adviser representative includes both an office and any other location that is held out to the general public as one at which the investment adviser representative regularly provides investment advisory services, solicits, meets with or otherwise communicates with clients. *See* 17 C.F.R. § 275.203A-3(b) (1997).

31. *See* 15 U.S.C. § 80b-3a(b)(1)(A).

32. For a definition of "supervised person," *see supra* note 12.

33. *See generally* 17 C.F.R. §§ 275.203A-3 (1997) (defining investment adviser representative) and 275.203(b)(3)-1 (1997) (defining client). The SEC has proposed two alternative amendments to the definition of investment adviser representative. *See* Proposed Rules, *supra* note 26, at 61,866. The SEC has proposed either (a) to add a provision that would permit supervised persons to have the greater of five natural person clients or the number of natural persons clients permitted under the ten percent allowance or (b) to eliminate the ten percent allowance and permit supervised persons to have an unlimited number of accommodation clients who have certain business or familial relationships with the supervised person or the supervised person's business or institutional clients. *See id.*

34. *See* 17 C.F.R. § 275.203A-3(a)(i)(A) & (B) (1997).

35. *See id.* § 275.203A-3(a)(2).

36. *See id.* § 275.203A-3(a)(3)(ii).

37. *See* 15 U.S.C. § 80b-18a(b).

38. *See id.* § 80b-18a(c).

39. *See id.* § 80b-18a(d).

40. *See* 17 C.F.R. § 275.203(b)(3)-1 (1997). Subsection (a) of this Rule provides that for

purposes of Section 203(b)(3) of the Act (15 U.S.C. § 80b-3(b)(3)), the following natural persons and entities are deemed to be a single client: "(1) a natural person, and: (i) Any minor child of the natural person; (ii) Any relative, spouse, or relative of the spouse of the natural person who has the same principal residence; (iii) All accounts of which the natural person and/or the persons referred to in this paragraph (a)(1) are the only primary beneficiaries; and (iv) All trusts of which the natural person and/or the persons referred to in this paragraph (a)(1) are the only primary beneficiaries; (2)(i) A corporation, general partnership, limited partnership, limited liability company, trust (other than a trust referred to in paragraph (a)(1)(iv) of this section), or other legal organization (any of which are referred to hereinafter as a "legal organization") that receives investment advice based on its investment objectives rather than the individual investment objectives of its shareholders, partners, limited partners, members, or beneficiaries (any of which are referred to hereinafter as an "owner"); and (ii) Two or more legal organizations referred to in paragraph (a)(2)(i) of this section that have identical owners." Subsection (b) of Rule 203(b)(3)-1 provides special rules for determining which persons or entities may or may not be counted as clients.

41. *See* 15 U.S.C. § 80b-3(b)(3). The federal provision exempts from SEC registration "any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts an an [sic] investment adviser to any investment company registered under subchapter I of this chapter, or a company which has elected to be a business development company pursuant to section 80a-53 of this title and has not withdrawn its election."

42. Statement on Signing the National Securities Markets Improvement Act of 1996, 32 Weekly Comp. Pres. Doc. 2038 (Oct. 11, 1996).

43. *Id.*