THE ABCs OF INVESTMENT ADVISER REGULATION

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One of the most common questions I am asked by investment professionals is whether they are required to register as an investment adviser. Individuals and firms who meet this designation are subject to a myriad of costly administrative, compliance and risk management challenges. Their operations are also subject to routine audits by securities regulators.

This article discusses what factors determine whether a financial services individual or firm is required to register as an investment adviser, and what steps are required to register and operate as a registered investment adviser.

DEFINITION OF "INVESTMENT ADVISER" AND EXEMPTIONS

Section 202(a)(11) of the Investment Advisers Act of 1940 (the "IA Act") generally defines an investment adviser ("IA") as any individual or entity that (1) provides advice by making recommendations regarding securities or securities markets; (2) for compensation; and (3) who regularly engages in the business of providing advice regarding securities. The states similarly define an IA under their statutory framework under the Uniform Securities Act.

There is a common misperception that persons who assist companies in raising capital, or "finders," must register as an IA in order to be compensated based on the amount of money raised through their efforts. This is not typically the case. A true finder merely makes introductions to potential funding sources, and does not offer advice or recommendations concerning the merits of the investment opportunity. A carefully drafted consulting agreement will make explicit that the finder only will act as a matchmaker between the company and the funding source, and not give investment advice or discuss the terms of the investment with

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potential investors. As long as the finder operates within these and other limitations, by definition he or she is not an IA, although other regulations come into play. The regulatory framework governing finders is under Section 15(b) of the Securities Exchange Act of 1934, as amended, which regulates broker-dealers. Most finders are required to register as broker-dealers.

Most money managers fall within the statutory definition of an IA. Insurance-only agents who sell equity-indexed annuities ("EIAs"), but not traditional forms of securities, are subject to regulation as IAs because EIAs contain a substantial securities component. If an insurance-only agent discusses the risks of the stock market even in general terms or specifically recommends the client to liquidate his or her securities and then receives a commission from an insurance carrier for selling an EIA to the client, most state securities regulators will assert that the insurance-only licensed agent acted as an unregistered IA.

Clearly, the definition of an IA casts a wide net. Fortunately, there are broad exemptions from the registration requirements under the IA Act. The most common exemptions are the Private Adviser Exemption and the Professional Exemption.

Private Adviser Exemption. An otherwise covered IA is exempt from registration if it (1) had fewer than 15 clients during the preceding 12 months, (2) does not advise any investment companies or companies electing to be regulated as business development companies under the Investment Company Act of 1940, and (3) does not hold itself out generally to the public as an IA.

This definition provides that regardless of how many clients an IA has, if it otherwise holds itself out to the public as providing advisory services, the Private Adviser Exemption is unavailable. Regulators interpret "holding out" very broadly, including using the term "investment adviser" or similar terminology on a Web site, in marketing materials or in any communications to the public. If an IA makes others aware it is available to provide investment advice, advisory services, or that it is accepting new clients, the IA is "holding out" and cannot rely on the Private Adviser Exemption. In short, any money manager or adviser actively seeking to increase his or her client base takes a tremendous risk when relying on the Private Adviser Exemption.

Historically, many hedge fund IAs were exempted from registration by the private, almost secretive nature of their funds and by limiting the number of their "clients." Due to the rapid growth in the hedge fund industry and the increase in the number of enforcement actions against hedge fund advisers, in 2004 the SEC adopted Rule 203(b)(3)-2 under the IA Act. Under this Rule, IAs must count each beneficial owner of a private fund as a client for purposes of determining the availability of the Private Adviser Exemption. For example, a single limited partnership comprised of 25 limited partners and one general partner would be counted as 26 clients. By "looking through" all pooled investment vehicles to the individual owners of that legal entity, the SEC severely limited the use of the Private Adviser Exemption and broadened its supervision over hedge funds.

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Professional Exemption. The SEC has provided exemptions for several common professions that provide investment advisory services as long as such services are "solely incidental" to the firm's or individual's main business. This category includes broker-dealers, lawyers, accountants, engineers, teachers, banks, bona fide publishers, and IAs limited to U.S. government securities. The reasoning behind this exemption is, in part, that such persons and firms are already subject to governmental regulation of one type or another.

In 2005, the SEC adopted Rule 202(a)(11) of the IA Act, which provides that a broker-dealer providing nondiscretionary advice (i.e., the broker-dealer cannot trade without notifying the client) may rely on the Professional Exemption regardless of whether it charges an asset-based or fixed fee (rather than commissions, mark-ups, or mark-downs) for its services. If, however, a broker-dealer is exercising investment discretion over a customer's account, its advisory activities are not "solely incidental" to its business and it must register as an IA or avail itself of another exemption. The SEC treats the ability to effect a trade without first notifying or consulting with a client as qualitatively distinct from providing advice as part of brokerage services.

REGISTRATION AS AN INVESTMENT ADVISER

SEC or State Registration

Whether an IA must register with the SEC or state(s) is typically determined by the amount of assets under management. IAs with more than $30 million of assets under management must register with the SEC. To be eligible to register with the SEC, the IA must have over $25 million of assets under management at the time of registration or expect to meet the $25 million threshold within 120 days of the effective date of the registration. Many IAs prefer SEC registration because they perceive that SEC oversight provides added credibility to their services and enhances marketing efforts. This perception, of course, has suffered in light of the SEC's admitted failures in supervising and assessing Bernard Madoff's operation.

If a firm has less than $25 million of assets under management and does not anticipate reaching this threshold within 120 days of the effective date of its registration, it must register with the state(s) as an IA. If an IA registers with the SEC, but does not reach the $25 million threshold within 120 days, the IA must deregister and transfer its registration to the state level.

A state registered IA must register in the state where it maintains a place of business and also where it has more than five investment advisory clients. It should be noted that certain states, such as Texas, do not recognize this de minimus, five client exemption and require notification if the IA has only one client in the state. State registered IAs that do not meet the de minimus exception must go through full registration for each state. An SEC registered IA does not have to register with state securities regulators. However, it must "notice file" with its state of residence and each state where it does not meet the de minimus exception.

Investment Adviser Representatives

Almost all state securities regulators require a firm registering as an IA to also include at least one individual to serve as an Investment Adviser Representative. In contrast, for IAs registering with the SEC, there is no federal requirement that there be an Investment Adviser Representative affiliated with the firm. However, when the firm notice files with the firm's home state, the firm's home state securities regulator will note that there are no individuals registered as an Investment Adviser Representative and therefore require the firm to register individuals acting as an Investment Adviser Representative.

Most state securities regulators require that the designated Investment Adviser Representative pass the Series 65 examination. However, if an individual holds and maintains in good standing the Certified Financial Planner (CFP), Chartered Financial Analyst (CFA), Personal Financial Specialist (PFS) or Charter Financial Consultant (ChFC), most states will waive the Series 65 requirement. Also, if an individual maintains both a Series 7 and Series 66 with a broker-dealer, most states will not require the Series 65.

Registration as a Sole Proprietor Versus a Firm

An IA may operate as a sole proprietor or as a registered firm. Most IAs choose to form a legal entity such as a corporation or limited liability company and then serve in their individual capacity as an Investment Adviser Representative of their IA firm. The primary reason for this structure is so the individual IA may avail himself or herself of the limited liability protections afforded by the corporate entity. However, the protection offered to owners of an entity from general liability does not necessarily protect a securities principal from liability under the federal and state securities laws. Because this will be the source of most investor claims, IAs should realize from the outset that the "corporate veil" of the firm may not wholly insulate them from personal liability.

Compliance Obligations

As a registered IA, there are myriad compliance and reporting rules. All IAs are required by the IA Act to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the IA Act. IAs must review those policies and procedures at least annually for their adequacy and the effectiveness of their implementation, and under Rule 206(4)-7, designate a Chief Compliance Officer ("CCO") to be responsible for administering the written policies and procedures.

IAs are required to provide every client and prospective client with a written disclosure document. This may be done either by providing clients and prospective clients with Part II of the IAs Form ADV or with another document that contains, at a minimum, the information that is required to be disclosed in Part II. This written disclosure document must be delivered to prospective clients at least 48 hours before entering into an advisory contract or, if it is delivered at the time the client enters into the contract, the client should be given five (5) business days after entering into the advisory contract to terminate the contract

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without penalty.

Under Rule 204-2 (the "Books and Records Rule"), all IAs must make and keep accurate and current books and records relating to their investment advisory business. These books and records must include, among other things, financial and accounting records, records that pertain to providing investment advice and transactions in client accounts, records that document the IAs authority to conduct business in client accounts, advertising and performance records and records regarding the maintenance and delivery of the written disclosure document.

In addition, all contracts with advisory clients must include specific provisions mandated by Section 205 of the IA Act. The contracts must convey that the advisory services provided may not be assigned to any other person without the prior consent of the client. With limited exceptions, Section 205(a)(1) prohibits contracts for compensation based on the performance of the client's account.[1] In addition, the SEC staff has stated that an IA should not enter into contracts with clients that contain "hedge clauses," except with certain sophisticated clients. A "hedge clause" purports to absolve the IA of liability and provides for indemnification of the IA by the client except in cases of the adviser's gross negligence, reckless or willful misconduct, illegal acts, or acts outside the scope of the IA's authority.

Rule 206(4)-1 (the "Advertising Rule") prohibits certain types of advertising practices. According to the SEC, specifically prohibited advertising includes, but is not limited to: (1) client testimonials; (2) using past successes, unless the IA includes a list of all recommendations made during the past year; (3) representing that any graph or illustration should be used to determine what securities to buy or sell; and (4) claiming that any report, advice or service is free, unless it really is free. Additionally, the SEC staff has stated that IAs should not use the term "RIA" (or "registered investment adviser") after their name because using initials after a name usually indicates a degree or a licensed professional position for which there are certain qualifications.

Under Rule 206(4)-2 (the "Custody Rule"), IAs that have "custody" or "possession" of client assets must take specific measures to protect client assets from loss or theft. This includes the requirement that the IA maintain these client funds and securities at a "qualified custodian." Generally, qualified custodians include most banks and insured savings associations, SEC-registered broker-dealers, Commodity Exchange Act-registered futures commission merchants, and certain foreign financial institutions.

The foregoing rules are not exhaustive of the requirements imposed on registered IAs. To the contrary, depending on the nature of the advisory services provided, the IA's operations, its investments and the nature of its clients, there are numerous additional rules and regulations governing registered IAs.

Conclusion

Persons whose business involves providing any type of advice or analysis regarding securities should give careful consideration to whether their activities are within the broad definition of an IA and whether any exemptions from registration apply. Federal and state laws impose severe penalties for persons who conduct business as an IA without registration. These penalties include cease and desist orders, injunctions, fines and imprisonment. In addition, courts in multiple jurisdictions have refused to enforce IA advisory contracts when it is determined that the IA failed to properly register.

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[1] *These exceptions are contracts with: (1) registered investment companies and clients having more than $1 million in managed assets, if specific conditions are met; (2) private investment companies excepted from the Investment Company Act under Section 3(c)(7) of that Act; and (3) clients that are not U.S. residents. In addition Rule 205-3 permits IAs to charge performance fees to: (1) clients with at least $750,000 under management with the IA or more than $1,500,000 of net worth; (2) clients who are "qualified purchasers" under section 2(a)(51)(A) of the Investment Company Act; and (3) certain knowledgeable employees of the IA.*

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