

RUNNING THE TRAPS:

**FEDERAL VERSUS STATE REGISTRATION
OF
INVESTMENT ADVISERS
AND
INVESTMENT ADVISER REPRESENTATIVES**

By

Lorna A. Schnase, Esq.

Updated January 2005

*Lorna Schnase has been practicing corporate and securities law for 20 years.
Her practice emphasizes investment management matters,
primarily for registered mutual fund and investment adviser clients.
Her practice is based in Houston, Texas.*

Lorna A. Schnase, Esq.
713-741-8821 (phone) • 713-741-8886 (fax) • lschnase@houston.rr.com (email)

TABLE OF CONTENTS

Section	Page
INTRODUCTION	1
INVESTMENT ADVISER REGISTRATION	1
<i>Federal Registration and State Notice Filings</i>	1
<i>State Registration for Advisers Not Registered with the SEC</i>	2
FLOWCHART 1—ADVISER REGISTRATION	3
REGISTRATION OF EMPLOYEES AND SOLICITORS OF FEDERALLY-REGISTERED ADVISERS	4
<i>Supervised Persons</i>	4
<i>Non-Supervised Persons</i>	4
FLOWCHART 2—IA REPRESENTATIVE REGISTRATION	6
OTHER FEDERAL AND STATE REGULATIONS AFFECTING ADVISERS	7
<i>Federal Provisions Applicable to All Advisers</i>	7
<i>Federal Provisions Specifically Applicable Only to Federally-Registered Advisers</i>	7
<i>State Provisions Applicable to All Advisers; Retained State Jurisdiction Over Federally-Registered Advisers</i>	8
<i>State Provisions Applicable to State-Registered Advisers; Required Uniformity</i>	8

INTRODUCTION

Unfortunately, we're still running the traps. Many of us had great hopes that the National Securities Markets Improvement Act of 1996 ("NSMIA")¹ would once and for all divide the universe between federal and state regulation of investment advisers in the U.S., after years of grappling with overlapping and sometimes inconsistent regulatory regimes imposed by federal and state law. Following NSMIA, the Securities and Exchange Commission ("SEC") was to regulate primarily larger advisers and the states smaller advisers.² While things are significantly better than they were, NSMIA did not create a clean break between the world of federal and state regulation.³ Even today, advisers must still "run the traps" to determine whether they -- and those that work for them -- must register with the SEC under federal law or with the individual states under applicable state securities laws.⁴

This paper offers flowchart-style decision trees aimed at helping to analyze those basic registration questions. It also offers a perspective on the complex regime of other federal and state laws that still have to be considered by advisers as well. And, as is typical of legal writings, a lot of juice appears in the endnotes, so plan to spend a little time browsing there.

Investment Adviser Registration

The decision tree at the end of this section addresses the question of whether an investment adviser must register⁵ with the SEC or with a particular state (State X). It assumes the adviser meets the basic "investment adviser" definition⁶ and aims to analyze whether the adviser is nonetheless excepted or exempt from federal registration and, in any case, whether it must register with the states. Terms and concepts in **bold face** on the decision tree are addressed in more detail in the endnotes cited there. The text in this section provides additional information to supplement the decision tree and should be read in conjunction with it.

Federal Registration and State Notice Filings. As shown in the decision tree, an adviser that is not excepted from the definition of investment adviser,⁷ nor otherwise exempt from⁸ or ineligible for⁹ federal registration, will be required to register with the SEC under the Investment Advisers Act of 1940 (the "Advisers Act").¹⁰ If an adviser is required to register federally, it must register with the SEC. In other words, the adviser may not elect to register with a state in lieu of the SEC.¹¹ An application for SEC registration must be submitted electronically on Form ADV¹² via the Web-based Investment Adviser Registration Depository ("IARD") system, which is operated by the National Association of Securities Dealers ("NASD") and co-sponsored by the NASD, the SEC and the North American Securities Administrators Association ("NASAA").¹³ Once an application is filed, the SEC has up to 45 days within which to issue an order granting the registration or institute proceedings to determine whether the registration should be denied.¹⁴

If an adviser has registered with the SEC, it will not be required to also register at the state level.¹⁵ Thanks to provisions in NSMIA that preempt state law, federally-registered advisers cannot be required to also register with a state.¹⁶ However -- and this is a big however -- federally-registered advisers may still be required to submit a notice filing in every state in which they are doing business as an investment adviser¹⁷ before they can legally do business there. "Notice filings" serve to alert the state that the adviser is conducting business there, which facilitates the state's ability to monitor securities-related activities within its borders and to enforce its own laws, most notably its own anti-fraud laws.¹⁸ Of course, notice filings also serve as a vehicle for states to collect filing fees.¹⁹ However, the fact that state notice filings can be submitted via the IARD system by checking the relevant state's box on the adviser's Form ADV²⁰ substantially eases the administrative burden that advisers might otherwise have to bear with notice filings.²¹

What permits the states to require notice filings when NSMIA preempts state laws requiring the “registration, licensing or qualification” of federally-registered advisers? The answer is that NSMIA specifically preserved state authority to require the filing “solely for notice purposes” of any documents filed with the SEC under the securities laws,²² together with a consent to service of process and any required filing fees.²³ As a result, a state “notice filing” and a state “registration” do not look much different in form. Both involve Blue Sky research to determine if a filing is required in any particular state. Both involve submitting documents to the state if a filing is required. Both involve paying filing fees to any state where filings are required.

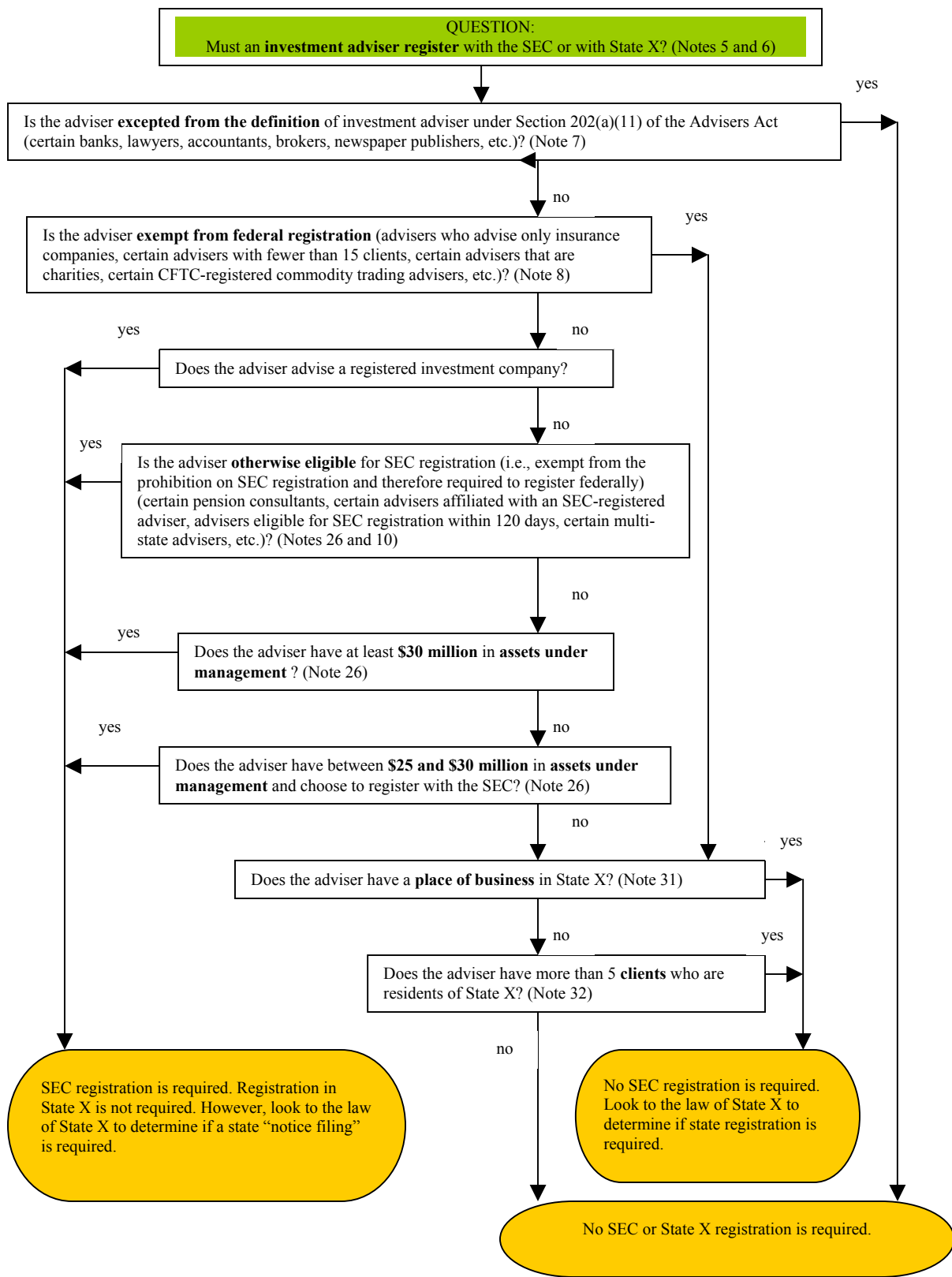
However, there is a substantive difference between a state “notice filing” and a state “registration.” Since a notice filing is made “solely for notice purposes” and cannot include anything other than documents also filed with the SEC, a state cannot impose its own separate filing requirements on a federally-registered adviser, nor “reject” its notice filing on the basis of the state’s own qualification criteria and thereby block the adviser from doing business in that state.²⁴ In contrast, a state could apply its own qualification criteria to reject the registration of any adviser that were required to register at the state level.

The bottom line for federally-registered advisers is that state law still has to be researched to determine whether notice filings are required there. Prudence dictates that the state laws be checked in every state where an adviser has a place of business, has clients or otherwise makes significant contact (whether directly or through agents) while rendering investment advisory services.²⁵ For advisers with nationwide operations, this may necessitate a dreaded 50-state Blue Sky survey, which some of us naively hoped would be dead following NSMIA, at least for advisers registered with the SEC.

State Registration for Advisers Not Registered with the SEC. If an adviser does not meet the parameters for federal registration, it is prohibited from registering with the SEC. An adviser generally may not elect to register with the SEC.²⁶ Rather, advisers that are not federally-registered (or excepted from the federal definition of investment adviser)²⁷ must analyze whether they are required to register with any state authorities instead of the SEC. It is possible that an adviser will have to register with more than one state,²⁸ if the adviser is doing business in more than one state.²⁹ It is also possible that an adviser will not have to register with any state, if under the law of each state where the adviser is doing business, it falls outside applicable definitions or regulatory parameters requiring registration.

Although there is more uniformity than before, state laws regulating investment advisers still vary from state to state. As a result, the decision tree cannot definitively address whether an adviser not registered with the SEC must register in any particular state. In that case, advisers must still look at state law in each relevant state to determine that state’s specific requirements. However, this much is clear and is uniform across the 50 states: An adviser cannot be required to register in any state where it does not meet the “National *de Minimis* Standard” established by NSMIA,³⁰ which prohibits state law from requiring an adviser to register there if it does not have a place of business³¹ located within the state and during the preceding 12 months had fewer than 6 clients³² who are residents of that state.³³ Put another way, states can require registration there only if an adviser has a place of business there or has more than 5 clients there. Although the National *de Minimis* Standard has the most direct impact on advisers that are not federally-registered and are trying to determine whether they have any state registration requirements, most states have adopted the National *de Minimis* Standard to define which federally-registered advisers are relieved from the state’s notice filing requirements as well.³⁴

The IARD system can also accommodate adviser registration in the states.³⁵ Although there is still some variation among the states in the handling of state registrations, most states now are mandating or permitting IARD registrations for state-registered advisers.³⁶



Registration of Employees and Solicitors of Federally-Registered Advisers

There is some good news and some bad news. The good news is that federal law does not require the separate SEC registration of individual employees who work for an investment adviser, even employees who provide investment advice.³⁷ Moreover, solicitors acting on behalf of an adviser will also not be required to register separately with the SEC, unless their solicitation activities themselves constitute providing investment advice (or other regulated activity) within applicable federal definitions and are not considered part of the adviser's own business covered by the adviser's federal filing.³⁸

The bad news is that under NSMIA, states retained their authority to require state registration of certain persons acting on behalf of an adviser, even if those persons are acting on behalf of a federally-registered adviser.³⁹ As a result, even after an adviser has "run the traps" to determine whether the adviser itself must register with the SEC or the states, it must also "run the traps" to determine whether those persons acting on behalf of the adviser -- such as employees or solicitors -- are required to be registered with one or more states as well.

The decision tree at the end of this section addresses the question of whether a person who acts on behalf of a federally-registered adviser must register with a state (State X). The decision tree assumes the person is acting on behalf of a federally-registered adviser⁴⁰ because that is when a state registration requirement for persons acting on behalf of the adviser is most surprising and could be most easily overlooked. Obviously, persons acting on behalf of state-registered advisers might very well have to register at the state level as well.⁴¹

Just as in the prior section, terms and concepts in **bold face** on the decision tree below are addressed in more detail in the endnotes cited there. The text in this section provides additional information to help analyze the questions addressed and should be read in conjunction with the decision tree.

Supervised Persons. The first question the decision tree asks is whether the person acting on behalf of the adviser is a "supervised person" of the adviser.⁴² If so, the decision tree then asks a series of questions to determine whether the person is an "investment adviser representative"⁴³ ("IAR") as well. This is because NSMIA preempts (and therefore prohibits) laws that require state registration of a "supervised person" unless the person is also an IAR (under the federal definition) with a place of business in that state.⁴⁴ As a result, states are still free to require registration of IARs with a place of business there,⁴⁵ even if they are acting on behalf of a federally-registered adviser.

By retaining the authority to register IARs, states have maintained the ability to identify and monitor those individuals who may pose the greatest risk to clients in their states, particularly less sophisticated, retail clients. The key lies in the definition of IAR. Under the federal definition, an IAR is a supervised person who has more than 5 clients that are natural persons and more than 10% of whose clients are natural persons.⁴⁶ People meeting certain wealth and sophistication standards are not counted as clients for this purpose.⁴⁷ In addition, supervised persons who do not solicit, meet with or otherwise communicate regularly with clients of the adviser, or who provide only "impersonal" investment advice, are specifically excluded from the IAR definition under federal law.⁴⁸

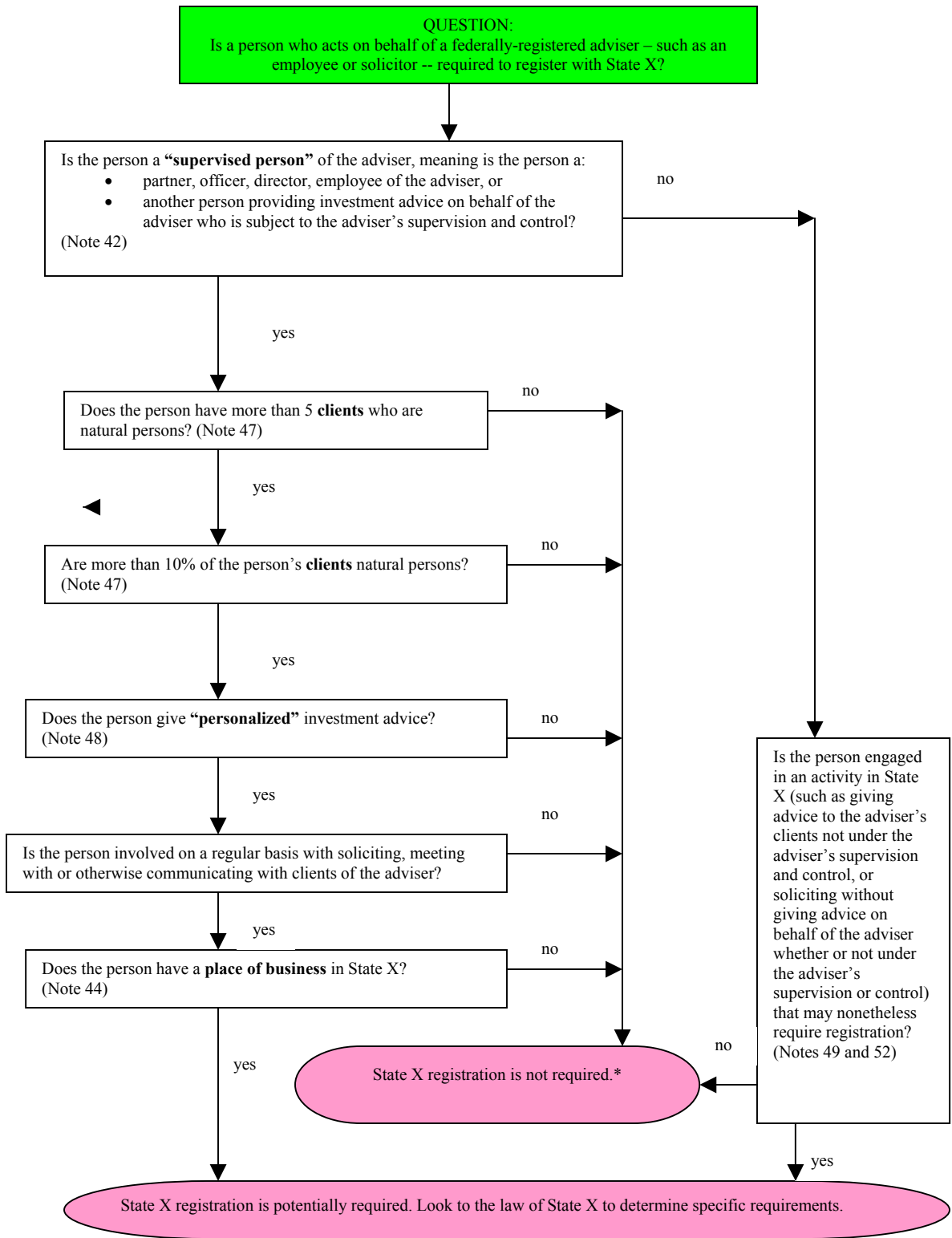
Non-Supervised Persons. If the person acting on behalf of the adviser is not a "supervised person," all bets are off. In that case, NSMIA will not preempt state registration, even if the person is acting only on behalf of federally-registered advisers and falls outside the federal definition of IAR. Rather, the person could be required to separately register in each state in which the person is doing

business⁴⁹ if the person's activities viewed separately constitute providing investment advisory services or other regulated activities under applicable state law.

One case where this could come up with some frequency is with so-called "third-party solicitors."⁵⁰ By "third-party solicitor" I mean a solicitor who is unaffiliated with the adviser and who may or may not be under the adviser's supervision and/or control, but nonetheless falls outside the "supervised person" definition.^{51 52} These solicitors may be authorized (for example, by contract) to solicit on the adviser's behalf. Whether that type of solicitor must register with a state would depend on whether the solicitor's activities themselves constitute providing "investment advisory services" or whether the state's definition of "investment adviser representative" is broad enough to include solicitors, or whether through some other state law interpretation, the solicitor falls within applicable provisions requiring state registration. Keep in mind that -- unlike the federal definitions of "investment adviser" and "investment adviser representative" -- states often expressly include in the operative provisions of their adviser laws persons who solicit on behalf of an adviser.⁵³

State IAR registrations are also accommodated on the electronic IARD system using Forms U-4 and U-5. While not accepted uniformly across-the-board, many states are now allowing IARs to register via IARD.⁵⁴ States also typically require IARs to pass certain standardized exams in order to register⁵⁵ or, alternatively, that they have one of a number of professional designations.⁵⁶

The bottom line for persons acting on behalf of investment advisers -- even federally-registered advisers -- is that state law still has to be checked to determine whether registration is required there. A conservative approach would dictate checking the laws in every state where the person has a place of business, gives advice to clients or otherwise makes significant contact (for example through solicitation) in connection with the adviser's business.⁵⁷



* However, look to the law of State X to determine if a state “notice filing” is required from the adviser on whose behalf the person is acting. (Note 45)

Other Federal and State Regulations Affecting Advisers

The focus of the first two sections of this paper was to sort out the registration requirements imposed on advisers and IARs at the federal and state levels. Unfortunately, registration is not the only area where advisers still have to “run the traps.” Advisers must still sort out myriad other federal and state laws that regulate advisers and determine whether those laws apply to them, since some apply to federally-registered advisers, some to state-registered advisers and some to both. Here are a few pieces of the puzzle:

Federal Provisions Applicable to All Advisers. These provisions of the Advisers Act apply to all advisers, including state-registered advisers:

- The general adviser anti-fraud provisions (Advisers Act Section 206);
- The prohibition on performance-based fees in most advisory contracts (Advisers Act Section 205(a)(1));
- The prohibition on assignment of an advisory contract without client consent (Advisers Act Section 205(a)(2));
- The requirement to adopt and enforce written procedures designed to prevent the misuse of material nonpublic information (meaning insider trading) (Advisers Act Section 204A).

Federal Provisions Specifically Applicable Only to Federally-Registered Advisers. In the past, these rules applied to all advisers. However, they were amended following NSMIA so that now, by their express terms, they apply only to advisers registered (or required to be registered) under the Advisers Act. Therefore, they purportedly do not apply to state-registered advisers:⁵⁸

- The books and records requirements under Rule 204-2;
- The prohibition on certain advertisements deemed fraudulent under Rule 206(4)-1;
- The adviser custody rule (Rule 206(4)-2);
- The cash solicitation rule (Rule 206(4)-3);⁵⁹
- The rule requiring certain financial and disciplinary information to be disclosed to clients (Rule 206(4)-4);
- The proxy voting rule (Rule 206(4)-6);
- The rule requiring advisers to adopt compliance policies and procedures (Rule 206(4)-7).

Of course, this does not mean that state-registered advisers are not regulated on these issues. It just means that they must look to state law to determine the applicable requirements, and many states have adopted equivalent rules. Moreover, the SEC seems to have kept its regulatory “foot in the door” to enforce the substance of these rules against state-registered advisers whenever it feels it is necessary – at least the latter four rules which were originally adopted under the anti-fraud provisions of Section 206 of the Advisers Act. This is evidenced by these SEC statements about the amendments to these rules following NSMIA:

“By excluding advisers not registered with the Commission from these rules, the Commission is not suggesting that the practices prohibited by these rules would not be prohibited by section 206 [of the Advisers Act, the general anti-fraud section still applicable to all advisers, including state-registered advisers]. Rather, the Commission recognizes that these rules contain prophylactic provisions, and that after the effective date of [NSMIA], the application of these provisions to state-registered advisers is more

appropriately a matter for state law.”⁶⁰

State Provisions Applicable to All Advisers; Retained State Jurisdiction Over Federally-Registered Advisers. States retained full jurisdiction and authority under NSMIA to investigate and enforce any violation of state laws with respect to fraud or deceit.⁶¹ This includes jurisdiction over all advisers -- including federally-registered advisers -- and their associated persons.⁶² However, at least according to the SEC, states are precluded from indirectly regulating the activities of federally-registered advisers by defining “dishonest” or “unethical” business practices, unless the prohibited practice would be fraudulent or deceptive absent the definition.⁶³ Otherwise, states could take their reserved authority to the logical extreme and, by adopting a pervasive set of anti-fraud rules, essentially reinstitute the system of overlapping and duplicative regulation that NSMIA sought to end.

The concern that under the guise of their reserved authority, states might effectively reinstitute the old system underpins the SEC’s overarching view that NSMIA preempts not only a state’s specific registration, licensing and qualification requirements, but all regulatory requirements imposed by state law on federally-registered advisers relating to their advisory activities or services, except those provisions that are specifically preserved under NSMIA.⁶⁴ If this position is upheld, states will have retained under NSMIA authority over federally-registered advisers only to (1) investigate and enforce anti-fraud laws; (2) require notice filings; and (3) require filing fees.⁶⁵

State Provisions Applicable to State-Registered Advisers; Required Uniformity. Of course, states have plenary authority to regulate the activities of advisers registered in their states, including the ability to set qualification requirements, regulate business practices, require disclosures and prevent fraud. However, in the interest of promoting uniformity for advisers subject to requirements in more than one jurisdiction, NSMIA calls for uniform state regulation in these areas:

- Maintenance of books and records;
- Bonding;
- Minimum net capital.

NSMIA achieves this goal by prohibiting states from enforcing any law that would require an adviser to maintain any books or records in addition to those required under the laws of its home state, so long as the adviser is registered in its home state and in compliance with that state’s requirements.⁶⁶ Similarly, states cannot enforce laws requiring a higher minimum net capital or any bond in addition to those required by an adviser’s home state.⁶⁷

* * *

It is an unfortunate result of our federal system that even the preemptive force of NSMIA could not cleanly divide the regulatory universe for advisers between the SEC and the states. Until there is a more complete solution, advisers will have to keep “running the traps.” Using the decision trees in this paper will help to sort it all out.

¹ The Investment Advisers Supervision Coordination Act was enacted October 11, 1996, effective July 8, 1997, as Title III of NSMIA, Public Law 104-290. NSMIA amended, among other things, the Investment Advisers Act of 1940.

² Currently, there are reported to be approximately 8,100 SEC-registered investment advisers and approximately 15,000 investment advisers registered in one or more states. See “What is IARD? Regulatory and Legal Information About IARD” at <http://www.iard.com/regulatory.asp>.

³ Of course, the entire regulatory scheme could not realistically be separated between the states and the federal government. States would not (and probably should not) give up their ability to enforce their own anti-fraud laws,

even against federally-registered advisers if they are doing business in their state. Moreover, states were not interested in giving up their ability to collecting filing fees. See the text surrounding note 23, *infra*, for more on state filing fees for federally-registered advisers.

⁴ State securities laws are sometimes referred to as “Blue Sky” laws.

⁵ In this paper, the term “register” is used for brevity. Other terms -- including the phrase “license, register or qualify” -- are sometimes used to refer in substance to the same thing.

⁶ That is, it assumes the adviser meets the operative provisions of Section 202(a)(11) of the Investment Advisers Act of 1940, which provides that an investment adviser is 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 part of a regular business, issues or promulgates analyses or reports concerning securities.

⁷ The federal definition of investment adviser contains five statutory exceptions and permits the SEC to designate others by rule. Entities excepted by statute are banks and bank holding companies to the extent not advising registered investment companies; lawyers, accountants, engineers and teachers if advice is given solely incidental to professional practice; brokers and dealers if advice is given solely incidental to their business and no special compensation is received; publishers of financial publications of regular and general circulation; and persons advising only about U.S. government and certain other exempted securities. Advisers Act, Section 202(a)(11). Many state statutes contain similar exceptions in their investment adviser definitions.

⁸ Principal exemptions from federal registration are found in Section 203(b) of the Advisers Act, which generally provides that the federal registration requirement does not apply to an adviser all of whose clients are residents of the state in which it maintains its principal office, so long as it does not advise on listed securities; an adviser whose only clients are insurance companies; an adviser meeting the Federal *de Minimis* Standard (see note 30, *infra*); an adviser that is a charity or advises only charities; an IRS section 414(e) plan; and certain commodities trading advisors registered with the Commodities Futures Trading Commission. Some state statutes contain similar exemptions from their registration provisions.

In 2004, SEC regulatory amendments to the Federal *de Minimis* Standard caused many hedge fund advisers that used to be exempt to no longer be exempt from registration as investment advisers. In substance, the amendments revised how “clients” are counted under the Federal *de Minimis* Standard so that advisers advising a fund falling within the new definition of “private fund” now have to count “through” their advised funds and count each shareholder, limited partner and beneficiary of the fund as a separate “client” in order to determine whether they can rely on the Federal *de Minimis* Standard for an exemption. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, SEC Release IA-2333 (December 2, 2004), and notes 30 and 32, *infra*, for more on the Federal *de Minimis* Standard and counting clients.

⁹ See the discussion in the text surrounding note 26, *infra*, and the decision tree questions that address SEC eligibility and thresholds of assets under management.

¹⁰ If they are not otherwise excepted from or exempt under federal law, advisers located in any state or U.S. jurisdiction that has not enacted laws regulating investment advisers must also register with the SEC. Currently, that includes only the State of Wyoming and the U.S. Virgin Islands. Since there are so few advisers in these jurisdictions that are required to register with the SEC, this issue was not addressed as a separate question on the decision tree. The SEC also maintains regulatory responsibility over foreign investment advisers doing business in the U.S., which is beyond the scope of this paper.

¹¹ However, see also note 26, *infra*, discussing the exceptions to the prohibition on SEC registration.

¹² Currently, only Part I of Form ADV can be submitted via the IARD system referred to here. However, the SEC is in the process of amending Part II of Form ADV and upgrading the IARD system to accept electronic filings of Part II as well as Part I. In the meantime, federally-registered advisers must complete Part II of Form ADV on

paper and are not required to file it with the SEC if a copy is maintained in the adviser's files (which is considered filed with the SEC). See Rule 203-1 under the Advisers Act. Part II must still be made available for SEC inspection and for use as a disclosure document under applicable SEC rules. See also note 21, *infra*, concerning paper filings of Part II still required by certain states for federally-registered notice filers.

¹³ The IARD system is a Web-based electronic filing system that facilitates investment adviser registration, regulatory review and the public disclosure information of investment adviser firms. The NASD is better known as the self-regulatory organization for broker-dealers, which originally developed its Web CRD system for the registration of broker-dealers. Even though the IARD system is operated by the NASD, investment advisers that are not also broker-dealers are neither subject to regulatory oversight by the NASD nor subject to the NASD Conduct Rules. NASAA is a voluntary organization whose members include the securities administrators from the 50 states and various other jurisdictions. It is largely due to NASAA's involvement that the IARD system has achieved widespread acceptance at the state level. The IARD system can be accessed via the Internet at <http://www.iard.com>.

¹⁴ See generally Section 203(c)(2) of the Advisers Act. Although the SEC statutorily has up to 45 days to consider an application, in practice, many adviser registrations are declared effective well within 45 days.

¹⁵ It has been noted that there may be limited circumstances where a federally-registered adviser would need or perhaps want -- for business reasons -- to also register with a state securities authority, for example, if it advises a state pension fund. If this "need" for dual state registration emanates from a state law that requires the state pension fund adviser be state-registered, is not clear why that state law would not be preempted under NSMIA. However, assuming it is not, there indeed may be unusual circumstances where a federally-registered adviser might "need" to be dual registered with a state. See the "IARD: Notice Filing & Transition Explanation" link on the NASAA website, <http://www.nasaa.org/nasaa/invadvisor/filing.asp>. (See note 21, *infra*, for more on the NASAA website). Dual federal-state registration has been specifically accommodated in some states. See, for example, the Texas Blue Sky regulations, which specifically note that a federally-registered adviser is not prohibited from registering in Texas and may elect to register there. Texas Administrative Code, Title 7, Part 7, Chapter 116, Rule §116.1(a)(12).

¹⁶ NSMIA added Section 203A(b)(1)(A) to the Advisers Act, which in substance preempts state registration requirements for federally-registered advisers by providing that no state law requiring the "registration, licensing or qualification" of any adviser shall apply to any adviser that is registered with the SEC, or that is not registered with the SEC because it is excepted from the definition of investment adviser under Section 202(a)(11) of the Advisers Act. See also note 7, *supra*, for more on the exceptions from the definition of investment adviser contained in Section 202(a)(11). This preemption is often implemented at the state level by excluding from the state definition of investment adviser any adviser registered with the SEC (sometimes referred to as a "federally covered investment adviser") or any adviser not required to register with the SEC due to an exception from the federal definition under Section 202(a)(11). Other states implement the preemption by adopting exceptions, exclusions or exemptions to their adviser laws that track the same wording as that used in the relevant federal counterparts.

¹⁷ The phrase "doing business as an investment adviser" is used generally here. State laws vary in their terminology and their thresholds as to when an adviser is viewed as transacting business in that state or the adviser's business is viewed as falling within that state's jurisdiction. Many consider an adviser to be rendering investment advisory services "in the state" or "within the state" if either the client or the adviser (or the adviser's representative) is present in the state. See, for example, the Texas Blue Sky regulations, which provide that "[a] person is an 'investment adviser' who engages 'within this state' in rendering services as an investment adviser . . . if either the person or the person's agent is present in this state or the client/customer or the client/customer's agent is present in this state at the time of the particular activity." Texas Administrative Code, Title 7, Part 7, Chapter 116, Rule §116.1(a)(10)(A). See also note 25, *infra*.

¹⁸ Several provisions in NSMIA expressly avoid preempting or limiting a state's ability to investigate and enforce its own anti-fraud laws. See, for example, Section 203A(b)(2) and Section 222(d) of the Advisers Act.

¹⁹ However, NSMIA generally prohibits states from raising the filing fees from those that were in effect on the date NSMIA was enacted (October 11, 1996). NSMIA, Section 307(b).

²⁰ See Item 2.B. of Part 1A on Form ADV.

²¹ Related notice filing fees can also be paid to the state via an adviser's IARD Financial Account. More information concerning IARD implementation at the state level can be found on the NASAA website at <http://www.nasaa.org/home/index.cfm>. This information includes the IARD Mandating Survey Table, which summarizes various IARD requirements at the state level. According to the table (updated through 10/13/2004), even though states were accepting Part 1 of Form ADV via IARD from federally-registered advisers who were required to notice file, a handful of jurisdictions (Louisiana, New Jersey, New Mexico, New York and Puerto Rico) were listed as still requiring notice filers to submit Part II of Form ADV to the state on paper until the IARD system is upgraded to accept Part II electronically. The Mandating Table can be accessed at <http://nasaa.org.nile.doceus.com/content/Files/IARDMandatingTable.pdf>.

²² It has been noted that this broad phrasing ("any documents filed with the Commission pursuant to the securities laws") may actually open the door to federally-registered advisers being required to notice file more documents with the states than they ever filed prior to NSMIA, since it technically includes everything advisers file with the SEC, such as Form 13F and Schedules 13D and 13G. See the 1999 Comments and Statements of the Investment Counsel Association of America ("ICAA Comments") on its website at <http://www.icaa.org/public/letters/compendiums/letterscompendium-1999.pdf>. While this was not likely the intent of the phrase, it would be cleaner if the Advisers Act were amended to clarify that states can only require federally-registered advisers to notice file Form ADV (or any successor federal registration/disclosure document).

²³ This preservation of state authority appears in Section 307 of NSMIA, a section which did not amend and therefore cannot be found in the Advisers Act.

²⁴ That would arguably constitute one of two things (or a combination of them): either (1) the state imposing its own "licensing, registration or qualification" requirement on a federally-registered adviser, which is preempted by NSMIA (see note 16, *supra*, and text surrounding); or (2) the state imposing on a federally-registered adviser a requirement that "conflicts with" the Advisers Act requirements and SEC rules, which would not be within the state's reserved jurisdiction under Section 222(a) (see note 64, *infra*).

²⁵ See note 17, *supra*, for more on when an adviser's activities might be considered within a state's jurisdiction. Note that the National *de Minimis* Standard and "place of business" definition discussed at notes 30 and 31, *infra*, technically only apply to state registration. This opens the door to a state applying its own *de minimis* standard for state notice filings. Even though in practice most states apply the National *de Minimis* Standard to determine which federally-registered advisers are relieved from notice filing requirements as well, some reportedly do not. See ICAA Comments, *supra* at note 22 and *infra* at note 34.

²⁶ There are a few limited exceptions to this general rule. For example, the registration status of certain advisers turns on the amount of assets they have under management, such as those that are not otherwise required to register with the SEC (e.g., because they advise a registered investment company) or are not otherwise exempt from SEC registration (e.g., because they advise only insurance companies). These advisers must register with the SEC if they have over \$30 million in assets under management. But, under Rule 203A-1, these advisers may choose to register with the SEC or alternatively with the state of their principal place of business, if they have between \$25 million and \$30 million in assets under management and are located in a state that has enacted a statute regulating investment advisers. (Currently, all states except Wyoming and the territory of the U.S. Virgin Islands have enacted investment adviser statutes.) Advisers with under \$25 million that are not otherwise eligible for SEC registration must look to state law to determine if they are required to register there. For these purposes, "assets under management" means the securities portfolios with respect to which an investment adviser provides continuous and regular supervisory or management services. Advisers Act, Section 203A(a)(2).

Although it does not technically constitute a “choice” to register with the SEC, Rule 203A-2 does provide certain advisers another route to federal registration even though they may be otherwise prohibited from registering with the SEC. Rule 203A-2 exempts certain advisers from the statutory prohibition on SEC registration. Thus, they become eligible to and therefore must register with the SEC. These advisers include nationally recognized statistical rating organizations, certain pension consultants, certain advisers affiliated with an SEC-registered adviser, advisers expecting to be eligible for SEC registration within 120 days, certain multi-state advisers and certain advisers that conduct substantially all their advisory business through an interactive website on the Internet (so-called “internet advisers”). Once federally-registered, these advisers would avoid any otherwise applicable state registration requirements.

²⁷ See note 7, *supra*, concerning exceptions from the definition.

²⁸ Advisers that would be required to register in 30 or more states under applicable state laws are permitted instead to register with the SEC. Rule 203A-2(e) of the Advisers Act.

²⁹ See note 17, *supra*, and text surrounding, concerning “doing business” in a state. See also the discussion in the text surrounding note 30, *infra*, explaining the National *de Minimis* Standard.

³⁰ Do not confuse the National *de Minimis* Standard -- which exempts advisers with no place of business and fewer than 6 clients from state registration -- with the Federal *de Minimis* Standard -- which exempts certain advisers from federal registration. As discussed in note 8, *supra*, Section 203(b)(3) of the Advisers Act lists various exemptions from federal registration, including the Federal *de Minimis* Standard, which exempts an adviser that does not advise a registered investment company nor hold itself out as an adviser if during the preceding 12 months the adviser had fewer than 15 clients. See also note 32, *infra*, on how to count “clients.”

³¹ For this purpose, “place of business” is defined to mean: (1) an office at which the adviser 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 provides investment advisory services, solicits, meets with or otherwise communicates with clients. Advisers Act Rule 222-1.

³² According to Advisers Act Rule 222-2, “clients” may be counted under the National *de Minimis* Standard the same way they are under the Federal *de Minimis* Standard. (See notes 8 and 30, *supra*, for more on the Federal *de Minimis* Standard.) This means that in certain cases, a client may be counted together with others as a “single client,” such as a natural person and certain of their relatives, certain accounts and trusts of natural persons and their relatives, and certain corporations and other entities. Moreover, clients for whom an adviser provides services without compensation need not be counted as a client. For details, see Advisers Act Rule 203(b)(3)-1.

³³ Section 222(d) of the Advisers Act.

³⁴ However, at least as of the date of the 1999 ICAA Comments, *supra* at note 22, a handful of states (Nebraska, New Hampshire, Texas and Vermont) were still not extending the National *de Minimis* Standard to notice filings made by federally-registered advisers.

³⁵ Advisers using Form ADV for registration with any state securities authorities must complete both Parts 1A and 1B of the Form, whereas federally-registered advisers complete only Part 1A.

³⁶ See the IARD Mandating Survey Table referenced in note 21, *supra*. According to the table, even among those states accepting IARD registration filings, there is still no uniformity on whether Part II of Form ADV must be filed on paper pending the upgrade of IARD to accept Part II electronically.

³⁷ Even though they will not be required to separately register with the SEC, key individuals affiliated with an adviser will of course be required to be disclosed on the adviser’s Form ADV.

³⁸ Solicitors that are providing advice to a client as to the selection or retention of an adviser could be deemed to be “advising others” within the meaning of the definition of “investment adviser” under the Advisers Act. SEC

Release IA-1092 (October 8, 1987). However, solicitors who are truly doing no more than soliciting, and not providing “advice” or making “recommendations,” would not typically fall within the federal definition of “investment adviser.” Advisers Act, Section 202(a)(11). Accordingly, they should not normally be required to register with the SEC, even if their activities are technically outside the supervision and control of the adviser for whom they solicit. That does not mean, however, that their solicitation activities are not regulated by the SEC. See Rule 206(4)-3 under the Advisers Act, which among other things imposes certain requirements on cash solicitation arrangements between solicitors and federally-registered advisers. On at least one occasion, the SEC has taken the position that a solicitor who is in compliance with the cash solicitation rule (Rule 206(4)-3) is not deemed to be an “investment adviser” solely as a result of solicitation activities. SEC Release IA-688 (July 12, 1979).

³⁹ Currently, there are only 7 states that reportedly do not register investment adviser representatives: Georgia, Louisiana, Michigan, Minnesota, New York, Tennessee and Wyoming. (Wyoming does not currently regulate investment advisers at all.) Other states provide an exemption from investment adviser representative registration for persons who are also registered representatives of a broker-dealer. See “State Participation and Exemptions of the Electronic Registration of Investment Adviser Representatives” on the IARD website at http://www.iard.com/bulletin_0302.asp#participation. Some jurisdictions that require IARs to register include solicitors in the definition of “investment adviser representative” under state law. See the NASAA “Investment Adviser Guide” at http://www.nasaa.org/industry_regulatory_resources/investment_advisers/456.cfm. As of January 1999, this included at least 34 states and jurisdictions. See AARP, Survey of State Investment Adviser Laws, A Chartbook, Public Policy Institute, 1999 (“AARP Survey”) at 6, available at http://research.aarp.org/consume/d15130_invest.pdf.

⁴⁰ Or an adviser that is going to be federally registered.

⁴¹ The SEC has noted that, in some cases, a solicitor may solicit on behalf of both a state-registered adviser and a federally-registered adviser. The SEC believes that, in that case, NSMIA would not preempt states from subjecting the solicitor to state registration requirements. “Rules Implementing Amendments to the Investment Advisers Act of 1940,” SEC Release IA-1633 (May 15, 1997), at section II.F.1.e., p.60.

⁴² Section 202(a)(25) of the Advisers Act provides that a “supervised person” is 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.”

⁴³ “Investment adviser representative” is not defined in the Advisers Act, but rather in Rule 203A-3 adopted under the Advisers Act. Under that definition, “investment adviser representatives” are a subset of “supervised persons.”

⁴⁴ Section 203A(b)(1)(A) of the Advisers Act. For this purpose, “place of business” of an investment adviser representative means (1) an office at which the 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 representative provides investment advisory services, solicits, meets with or otherwise communicates with clients. Advisers Act, Rule 203A-3(b). This parallels the “place of business” definition established for investment advisers under Rule 222-1(a). See note 31, *supra*. Although clause (1) covers the typical office scenario, clause (2) is broad enough to cover, for example, a temporary location (such as a hotel conference room) if that location is held out in ads or announcements as a place where any of the listed activities are or will be conducted.

⁴⁵ At least one state still purports to “reach” adviser representatives that are located outside of the state, apparently without regard to whether the representative falls within the federal definition of adviser representative. For example, the Texas Blue Sky regulations provide that adviser representatives that do not have a place of business in Texas but otherwise render investment advice in Texas are exempt from registration in Texas, so long as the adviser for whom they act as a representative notice files in Texas and pays fees equal to what would have been paid had both the adviser and the representative registered there. Texas Administrative Code, Title 7, Part 7, Chapter 116, Rule §116.1(b)(2)(B) and (C)(i). This appears to be a tricky way to maneuver around the preemptive

provisions of NSMIA, which prohibit states from requiring the “licensing, registration or qualification” of investment adviser representatives (meeting the federal definition) unless they have a place of business located in the state. See note 44, *supra*. In its defense, Texas would likely argue that even though the notice filing under the cited regulation is triggered by the conduct of adviser representatives with no place of business in Texas, the state’s approach is consistent with NSMIA because the state specifically exempts those representatives from registration, and only requires from the adviser a notice filing (Form ADV), a document NSMIA permits the state to require since it is already filed by the adviser with the SEC. See note 22, *supra*, and text surrounding.

⁴⁶ See Rule 203A-3(a) under the Advisers Act. Under this rule, clients are measured with respect to all of an IAR’s clients nationwide. Release IA-1633, *supra* note 41, at section II.F.1.b, p.55, n.117. Also, note that the definition of “investment adviser representative” under state law is often different and much broader than that under federal law.

⁴⁷ “Qualified clients” are excepted from the client count under both the “more than 5” and “more than 10%” tests in the investment adviser representative definition. See Rule 203A-3(a). In substance, “qualified clients” are natural persons (i) who have at least \$750,000 under management with the adviser, (ii) who have either a net worth of more than \$1.5 million or are a “qualified purchaser” under the Investment Company Act of 1940; or (iii) who are an executive officer, director, trustee or general partner of the adviser or an ‘investment function’ employee of the adviser with more than a year of experience. See Rule 205-3(d)(1). In addition, under the investment adviser representative definition, certain clients and others can be counted as a single “client” and others not counted as “clients” at all, in reliance on Rule 203(b)(3)-1 (see note 32, *supra*), and persons that are not residents of the U.S. need not be counted. See Rule 203A-3(a)(4).

⁴⁸ Rule 203A-3(a)(2). In the decision tree, the term “personalized” investment advice is used to avoid a double negative in trying to identify a representative who is not giving impersonal investment advice. For this purpose, “impersonal investment advice” means services provided by written or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts. Rule 203A-3(a)(3)(ii).

⁴⁹ See note 17, *supra*, as to when an adviser may be deemed to be transacting business within a state, concepts that could similarly under these circumstances apply to a person acting on behalf of an adviser.

⁵⁰ In general, a “solicitor” is someone who “finds” clients for an adviser or who refers clients to an adviser.

⁵¹ The SEC has taken the position that regardless of whether a solicitor is a “supervised person” for purposes of the IAR definition, it is nonetheless a “person associated with an investment adviser” under Section 202(a)(17) of the Advisers Act, and therefore has an obligation to supervise its solicitors with respect to activities performed on its behalf. Release IA-1633, *supra* note 41, citing Release IA-688, *supra* note 38. However, on the face of it, an unaffiliated third-party solicitor would not appear to fall within the “person associated with an investment adviser” definition, which generally contemplates persons in a control relationship to the adviser.

⁵² The SEC has referred to a “third-party solicitor” in a slightly different way, that is, as a solicitor who is not a “partner, officer, director or employee” of the adviser. Release IA-1633, *supra* note 41, at II.F.1.e., p.59. Such a solicitor could conceivably be a “supervised person” if it were providing advice to the adviser’s clients in addition to soliciting and were also subject to the adviser’s supervision and control. It would then be subject to state registration requirements only if it were also an IAR having the requisite number and percentage of natural persons as clients under the federal definition.

In contrast, as the term “third-party solicitor” is used in this paper, the solicitor does not fit within the “supervised person” definition at all. (See note 42, *supra*, for the full definition of “supervised person.”) This is first because the third-party solicitor is unaffiliated with the adviser and is therefore not under the “partner, officer, director or employee” portion of the “supervised person” definition. Second, the third-party solicitor would not fit within the “other person” portion of the “supervised person” definition because third-party solicitors typically do not provide investment advice on behalf of the adviser. Third, even if it were providing investment advice on behalf of the adviser and/or were in some respect under the adviser’s “supervision,” the solicitor would most likely not be deemed to be under the adviser’s “control” since it is not an affiliate of the adviser and presumably the adviser

would have no influence over the solicitor's management or policies even if it had certain contractual rights against the solicitor under the solicitation arrangement. Thus, the typical third-party solicitor would not fit within the "supervised person" definition for one or more reasons. Even though the third-party solicitor is not a "supervised person" and therefore cannot potentially become subject to state registration requirements as an IAR, it could nonetheless become subject to state registration requirements through a different pathway, which is discussed in the body of this paper -- that is, if the solicitor's activities cause it to otherwise fall within the applicable state definitions requiring registration, such as under the state definition of IAR, which is often broad enough to cover solicitors.

⁵³ See, for example, the Texas Blue Sky regulations that require every non-exempt person meeting the jurisdictional thresholds to register -- or to notice file if permitted -- (i) as an adviser if the person is acting as an adviser, including acting as a solicitor; or (ii) as an adviser OR an adviser representative if the person is employed, appointed or authorized by an adviser to render advisory services, which includes acting as a solicitor (whether or not under the adviser's supervision or control). See, Texas Administrative Code, Title 7, Part 7, Chapter 116, Rule §116.1(b)(1)(A) and (2). These Texas Blue Sky provisions would appear to require third-party solicitors for federally-registered advisers who are not giving advice on behalf of the adviser to do one of several things to comply with Texas law (assuming they meet the jurisdictional thresholds and are not otherwise exempt there): (1) register as an investment adviser with the SEC and notice file in Texas; (2) register as an investment adviser in Texas; or (3) arrange with every adviser on whose behalf they solicit in Texas to make the necessary filings to accomplish the solicitor's registration in Texas as an investment adviser representative of the adviser. However, option (1) will be unavailable if the solicitor is ineligible for SEC registration. Moreover, option (3) may be unavailable as a practical matter since it would require the cooperation and involvement of the advisers themselves to a degree that they may not be willing to participate. As a result, the solicitor may have little choice but to register separately in Texas as an investment adviser. This is consistent with the position of the Texas State Securities Board which states on its website: "A third-party solicitor for a SEC-registered investment adviser is not a supervised person and, therefore, has to register with the Texas Securities Commissioner." See "Dealer Registration Division FAQ" at <http://www.ssb.state.tx.us/Registration/DealerFAQ090103.html#THREE> (Question 3.B.)

That result would also be consistent with statements made by the State of Wisconsin on its website, which explains that it gives third-party solicitors who solicit for federally-registered advisers the option of arranging with each investment adviser for which it solicits to become licensed as an investment adviser representative in Wisconsin or becoming a separately licensed investment adviser. See "Investment Adviser Representatives – For Federal Advisers Only" (as updated 3/15/2002) at <http://www.wdfi.org/fi/securities/licensing/iarep.htm>.

⁵⁴ See "Investment Adviser Representative State Registration Filing Fee Schedule as of December 16, 2004" on the IARD website at http://www.iard.com/pdf/rep_fee_sch.pdf, which lists those states that are accepting IARD registrations for adviser representatives and those that are not, in addition to the applicable filing fees.

⁵⁵ The exams accepted most commonly for registered investment adviser representatives are the Series 65 exam (Uniform Investment Adviser Law Examination), or the Series 66 exam (Uniform Combined State Law Examination) along with the Series 7 exam (General Securities Registered Representative Examination). These exams are administered by the NASD and many were developed in conjunction with NASAA.

⁵⁶ One or more of these 5 professional designations are accepted by some states as an alternative to the exam requirement or in waiver of the exam requirement: CFP(Certified Financial Planner) awarded by the Certified Financial Planner Board of Standards, Inc.; ChFC (Chartered Financial Consultant) awarded by the American College, Bryn Mawr, Pennsylvania; PFS (Personal Financial Specialist) awarded by the American Institute of Certified Public Accountants; CFA (Chartered Financial Analyst) awarded by the Association for Investment Management Research; and CIC (Chartered Investment Counselor) awarded by the Investment Counsel Association of America, Inc. See "Professional Designations and IA Representative (RA) Registration" at http://www.iard.com/bulletin_0302.asp#professional. As of 1999, 26 states were waiving the examination requirement for IARs with a recognized professional designation. AARP Survey, *supra* note 39 at 6.

⁵⁷ This would catch the states where NSMIA allows the state to require registration for persons who meet the federal definition of IAR and have a place of business in the state. It would also catch the states that might impose a registration requirement on representatives (like solicitors) who meet the state's broader definition of "investment adviser representative" whether or not they have a place of business in the state, so long as they nonetheless make significant contact with the state. Finally, it would also catch a state like Texas (see note 53, *supra*), which imposes a notice filing requirement on advisers whose representatives give advice in the state, whether or not the representative has a place of business there.

⁵⁸ Although it was not under a mandate to do so, the SEC amended these rules following NSMIA to apply only to federally-registered advisers, believing this comported with the Congressional intent expressed in NSMIA to avoid subjecting state-registered advisers to substantive federal regulatory requirements and to leave it up to the states to impose prophylactic provisions for state-registered advisers. Release IA-1633, *supra* note 41 at sections II.I.2. and 5., pp.77, 80.

⁵⁹ The cash solicitation rule continues to apply to SEC-registered advisers, however, even if they are making payments to a state-registered solicitor. Release IA-1633, *supra*, note 41 at section II.F.1.e., p.60, n.125.

⁶⁰ Release IA-1633, *supra*, note 41 at section II.I.5, p.81. Notably, the SEC said these were "more appropriately a matter for state law," and not simply "a matter for state law" or "exclusively a matter for state law."

⁶¹ See note 18, *supra*.

⁶² Associated persons (or "persons associated with an investment adviser") would include IARs under the federal definition. See the text at note 46 and note 51, *supra*.

⁶³ Release IA-1633, *supra* note 41, at section II.H.2., p.73. Needless to say, this interpretation of NSMIA is hotly contested by NASAA and the states. See the discussion of comments received on the proposed rules in the cited release.

⁶⁴ Release IA-1633, *supra* note 41 at section II.H.1., p.69. The SEC's position and discussion on this point does not seem to grapple with the import of Section 222(a) of the Advisers Act, added by NSMIA, which says that nothing in the Advisers Act shall affect the jurisdiction of the states over any security or person insofar as it does not "conflict with" the Advisers Act or related rules. This could be interpreted to preserve the state's jurisdiction to regulate any aspect of the business of an adviser, even a federally-registered adviser, so long as it is not inconsistent with federal requirements.

⁶⁵ Notice filings and fees are discussed in the first section of this paper.

⁶⁶ Advisers Act, Section 222(b). "Home state" here means the state where the adviser maintains its principal place of business. Even though this uniformity provision of NSMIA appears on its face to apply to all advisers -- both federally-registered and state-registered -- the SEC's interpretation of NSMIA's preemptive scope (see notes 63 and 64, *supra*, and the text surrounding notes 63, 64 and 65) means the provision will apply in practice only to state-registered advisers. Otherwise, the "old" overlapping and conflicting federal/state regulatory system could in effect be restituted, with each state being allowed to impose its own books and records, net capital and bonding requirements on federally-registered advisers since federally-registered advisers are not registered in their home states. Nonetheless, the provision will be helpful to promote uniformity among the state requirements applicable to state-registered advisers registered in more than one state.

⁶⁷ Advisers Act, Section 222(c), subject to the same conditions as set out in the text surrounding note 66, *supra*.

***The information in this paper is provided only as a courtesy to readers.
It should not be construed as or used as a substitute for
individualized legal advice.***