Preparing for the SEC to State Investment Adviser Transition

The transition from SEC to State registration is fast approaching for thousands of advisers, and at Renaissance Regulatory Services ("RRS") we believe that now is the time to begin the preparation. This is the most monumental event to affect advisers in over 15 years, when the delegation of responsibilities between the Securities and Exchange Commission ("SEC") and the States first occurred. The differences in the regulatory requirements between the SEC and the state regulatory authorities are significant, and should not be taken lightly. In addition to different regulatory requirements, there are also differences in how the states review and process applications.

For example, it is not uncommon for states to review and comment on the adviser's Form ADV, and their client contracts during the registration process. States may also require firms to submit marketing materials prior to approval. This article addresses some of the key issues, and summarizes the process and deadlines for the transition from SEC to State registration.

But first, a little background is in order. Section 410 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires so-called "mid-sized" investment advisers, with assets under management (AUM) between $25 million and $100 million to transition to state registration ("the switch"), unless certain exemptions are met. Pursuant to Section 419, this provision was made effective July 21, 2011. On June 22, 2011, the SEC issued a final rule outlining the transition process. The final rule, among other things, increases the statutory threshold for registration of investment advisers with the Commission, establishes an implementation timeline, requires advisers to hedge funds and other private funds to register with the Commission, and requires reporting by certain investment advisers that are exempt from registration.

Transition Process

As of July 21, 2011, new investment advisers with AUM under $100 million are prohibited from registering with the SEC, and must register with all states in which they are required to register, unless they meet an appropriate exemption. These exemptions include: advisers located in the states that do not have an examination program; advisers meeting the exemptions found in rule 203A-2 (such as certain multi-state investment advisers, pension consultants, and advisers to investment companies); and certain advisers to private funds.

Existing advisers with AUM between $25 and $100 million that are currently registered with the SEC must remain registered with the SEC until January 1, 2012. Between January 1, 2012 and March 30, 2012, these advisers must file an amended ADV Part 1 (on the new Form ADV Part 1), reflecting their AUM, and indicating whether or not they are eligible for continued registration with the SEC. If they are not, they must register with the appropriate state regulatory authority(ies), and withdraw their registration with the SEC by filing a form ADV-W, no later than June 28, 2012.

In our conversations with regulators, they have emphasized that they will likely be very busy during the April – June time period. As a result, they are strongly recommending that firms file their application early to avoid the rush. Some have even suggested filing before the end of 2011, and asking the state(s) to postpone effectiveness until after January 1, 2012.

Comparison of State vs. SEC Requirements

With the transition on the horizon, it is important for advisers affected by the switch to understand the differences between SEC and State registration, and be prepared for the different compliance requirements that they will be subject to.

State securities regulators, working through the North American Securities Administrators Association (NASAA), have worked diligently to achieve uniformity in regulations with both the SEC, and other states. NASAA has issued various "model rules" that have been adopted by many states in order to maintain uniformity. Despite these efforts, there are differences between SEC and State regulations, as well as differences between the States themselves. In this article, we will highlight a few of these differences.

States that have adopted one of the versions of the NASAA model custody rule (there are two different versions) differ from the SEC with regards to requirements for deducting fees from clients accounts. While the SEC only requires that the adviser have client authorization to deduct fees, and ensure that clients receive an account statement from a "qualified custodian" at least quarterly, the NASAA model rules require that advisers: 1) obtain client authorization; 2) provide both the client and the custodian with an invoice detailing the fee deduction; 3) ensure that clients receive a statement from a "qualified custodian" at least quarterly; and 4) notify the State Administrator of their intention to engage in direct fee deductions by answering the appropriate questions on the Form ADV.

States that have adopted NASAA's model rules on Prohibited Conduct, have explicit prohibitions against certain activities that

sometimes differ from SEC regulations. For example, under these rules, state advisers are strictly prohibited from borrowing money or securities from clients, or loaning money to clients, unless certain limited conditions are met. While this type of activity might be prohibited under SEC regulations if it violates an adviser's fiduciary duty, or is otherwise fraudulent, it is not strictly prohibited.

The transition may also affect advisory contracts, and in some cases client contracts may need to be re-executed. NASAA has issued a model rule on investment advisory contracts that specifies what should, and should not, be included in contracts. Specifically, the model rule requires that advisory contracts contain the services to be provided, the term of the contract, the investment advisory fee, the formula for computing the fee, the amount of prepaid fee to be returned in the event of termination or non-performance of the contract, any grant of discretionary power, and a provision that if the investment adviser is a partnership they shall notify the client of any change in the membership of the partnership within a reasonable time. The contract must also contain a provision that no direct or indirect assignment or transfer of the contract may be made by the investment adviser, without the consent of the client and that the investment adviser shall not be compensated on the basis of a share of capital gains upon, or capital appreciation of, the funds or any portion of the funds of the client (this provision is waived if certain conditions are met). Finally, the contract may not contain a "hedge clause", or any provision that is contrary to the provisions of Section 205 of the Investment Advisers Act of 1940.

In comparison, the Investment Adviser's Act of 1940 (see Section 205) has a prohibition on advisers receiving compensation on the basis of a share of capital gains upon or capital appreciation of the funds(unless certain conditions are met); requires that contracts provide that no assignment of such contract shall be made by the investment adviser without the consent of the other party to the contract; and requires that contracts provide that the investment adviser, if a partnership, will notify the other party to the contract of any change in the membership of such partnership within a reasonable time after such change. While SEC rules do not specifically require (or disallow) the same items as the NASAA model rule, SEC no action letters, and the general fiduciary duty of the adviser, would dictate that similar items be included in the contract. We recommend that advisers who will be transitioning have their contracts reviewed for compliance with the appropriate state regulatory requirements.

States generally impose net capital and financial reporting requirements on advisers. Advisers must meet the requirements and also comply with annual reporting requirements (usually unaudited financials 90 days after the year-end, but the requirements do vary some from state to state). Additionally, some states have bonding requirements in addition to, or in lieu of, their net capital requirements.

SEC advisers, who are "notice filed" in states, but do not have a place of business in those state, generally do not have to register their investment adviser representatives in those states (see section 203A of the Advisers Act). However, this exemption is no longer available to firms who are registered with the state securities authorities.

In conclusion, advisers should review their AUM to determine if they will be required to transition. If so, they should begin the registration process early. Early planning should include a review of the location of firm's operations and customers to determine where they will be required to register. Advisers should also review their compliance procedures and customer contracts to ensure that they are in compliance with state regulatory requirements. If your firm needs assistance with the transition process, feel free to contact Rick White at RRS to discuss our services.

By: Rick White

Rick White is Managing Director for Regulatory Services at RRS. Mr. White formerly served as the Director for Florida Division of Securities and has over twenty-seven years of public/private sector regulatory and compliance experience as a senior state regulator and consultant. He can be reached by phone at (850) 385-0928, or by e-mail at RickWhite@RRSCompliance.com.

Renaissance Regulatory Services, Inc.
Compliance Consultants
To Broker-Dealers and Investment Advisers
(561) 368–2245
350 Camino Gardens Blvd.
Suite 105
Boca Raton, FL 33432
www.RRSCompliance.com

Offices in:
Washington - Tallahassee