

Compliance Review

Ongoing Compliance Updates for Independent Investment Advisors

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New Rules Finalize Requirements for Advisers Transitioning From SEC to State Registration

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I. Introduction and Overview

Almost one year after the landmark Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”)¹ was signed into law, the Securities and Exchange Commission (“SEC”) has adopted a series of rules² designed to implement the legislation’s key investment adviser provisions. This article provides a detailed look at those aspects of the new rules that are likely to have the greatest impact on registered investment advisers. Foremost among these is the requirement that thousands of “mid-sized” investment advisers (e.g., advisers with between \$25 million and \$100 million in assets under management) currently registered with the SEC must transition their registration to one or more states. This article is designed to help investment advisers better understand not only what is required of them by the new rules, but also the “when” and “how” of each such requirement.

The key provisions of the rule changes, each of which will be discussed in greater detail in this article, are as follows:

- Advisers with assets under management of between \$25 million and \$100 million are designated as “mid-sized” advisers.
- Mid-sized advisers with less than \$90 million in assets under management are prohibited from remaining registered with the SEC and must register with all applicable states unless an exemption from the prohibition on SEC registration applies.
- Exemptions from the prohibition on registration with the SEC include:
 - (i) Multi-state advisers (meaning those advisers that would be required to register with 15 or more states); and
 - (ii) Pension consultants advising on at least \$200 million of plan assets.
- A mid-sized adviser must remain registered with the SEC if it maintains its principal office and place of business in a state that does not require it to be registered (e.g., Wyoming) or is not subject to examination as an adviser by that state (e.g., New York).

- Mid-sized advisers must remain registered with the SEC until January 1, 2012.
- All investment advisers registered with the SEC on January 1, 2012, must file an amendment to their Form ADV no later than March 30, 2012 (which for most advisers will be their annual updating amendment).
- A mid-sized adviser that is no longer eligible for SEC registration must register with at least one state securities authority and withdraw its SEC registration by June 28, 2012.

The new SEC rules also require changes to both the instructions and the content of Form ADV Part 1. While some of these changes are intended to reflect the new asset threshold for SEC registration, others are aimed at improving the SEC's ability to oversee advisers by collecting additional data about their advisory business. Advisers should be aware that the information the SEC collects on Form ADV Part 1 will be used to determine the adviser's risk profile and resulting allocation of SEC examination resources.

II. Increased Asset Threshold for SEC Registration

Previously, an investment adviser was generally not permitted to register with the SEC unless it had at least \$25 million in assets under management. The Dodd-Frank Act raised the threshold to \$100 million, and the new SEC rules have codified this threshold and created a \$10 million buffer above and below the \$100 million level so that advisers will not have to frequently switch between SEC and state registration.³ However, the applicability of the new threshold and the precise workings of the buffer depend on an investment adviser's current registration status and the specific type of filing being made.

All advisers registered with the SEC as of July 21, 2011—even those with less than \$100 million in assets under management—must remain registered with the SEC until January 1, 2012, unless an exemption from SEC registration is available.

The easiest way to understand the new asset threshold requirements for registration with the SEC is to classify an investment adviser by its current registration status. The registration status of advisers can be broken down into the following categories:

1. Advisers currently registered with the SEC;
2. Advisers applying for initial SEC registration; and
3. Advisers currently registered with one or more states.

A. Advisers Currently Registered With the SEC

All investment advisers that are registered with the SEC on January 1, 2012—regardless of size of assets under management—must file an amendment to their Form ADV no later than March 30, 2012.⁴ For most advisers, this filing will be the same as their annual updating amendment. For advisers with a fiscal year that ends on a date other than December 31, this filing should be done as an “other-than-annual” amendment. For any such adviser, the only difference between the amendment due by March 30 and a typical “other-than-annual” amendment is that the adviser will be required to complete all items in Form ADV Part 1A and not just those items required to be updated in a typical “other-than-annual” amendment.

The SEC will use the asset amount listed in this filing to identify those advisers with assets under management between \$25 million and \$100 million

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(i.e., mid-sized advisers) that are no longer eligible for SEC registration. The market value of an adviser's assets must be determined within 90 days of the date of the actual filing.

The deadline for calculating assets under management for purposes of determining an adviser's eligibility to remain SEC-registered is March 30, 2012.

An SEC-registered adviser *may* remain registered with the SEC if its assets under management are at least \$90 million, *must* remain registered with the SEC if its assets under management equal or exceed \$110 million, and *must* deregister with the SEC (and transition to state registration) if its assets under management fall below \$90 million.

If an adviser's assets under management have fallen below \$90 million, the adviser will have until June 28, 2012, to transition its registration to one or more states and withdraw its registration with the SEC.

An SEC-registered adviser transitioning to state registration must not withdraw its SEC registration until the firm has been notified that it has an effective registration with at least one state. If an investment adviser withdraws its SEC registration *prior* to the effective date of its state registration, it will no longer be registered in any jurisdiction and will be in violation of numerous state and federal regulations.

After June 28, 2012, the SEC will cancel the registration of investment advisers that are no longer eligible for SEC registration and that have either failed to file the required amendment or failed to withdraw their SEC registration.

The following chart summarizes continued SEC eligibility for an investment adviser currently registered with the SEC as of the adviser's next annual updating amendment.

Eligibility to Remain SEC-Registered (Based on AUM)⁵

MUST Deregister With SEC	MAY Remain SEC-Registered	MUST Remain SEC-Registered
If AUM is less than \$90 million	If AUM is at least \$90 million	If AUM is \$110 million or more

B. Advisers Applying for Initial SEC Registration

Beginning on July 21, 2011, an investment adviser initiating a new application for SEC registration *may* register with the SEC if its assets under management are between \$100 million and \$110 million and *must* register with the SEC if its assets under management are at least \$110 million. The new SEC rule raises the threshold above which an investment adviser must register with the SEC from the current \$30 million level to \$110 million. Once registered with the SEC, an adviser need not withdraw its SEC registration until it has less than \$90 million in assets under management as of its most recent annual updating amendment (see discussion above). Therefore, the amendment provides a buffer of 20% of the \$100 million statutory threshold for registration with the SEC, which is the same percentage as the current buffer (i.e., \$25 million to \$30 million in assets under management).

The following chart summarizes a new applicant's eligibility for SEC registration after July 21, 2011.

Eligibility for Initial SEC Registration (Based on AUM)

MUST Register With a State(s)	MAY Register With the SEC	MUST Register With the SEC
If AUM is less than \$100 million	If AUM is between \$100 million and \$110 million	If AUM is \$110 million or more

C. Advisers Currently Registered With One or More States

If, on its next annual updating amendment, a state-registered adviser's assets under management have increased to at least \$100 million (but are less than \$110 million), the adviser *may* register with the SEC or maintain its state registration(s). If, however, the state-registered adviser's assets under management have increased to at least \$110 million, the adviser *must* transition from state registration to registration with the SEC.

The following chart summarizes a state-registered adviser's eligibility to transition to SEC registration as of the adviser's next annual updating amendment.

Eligibility for Transition to SEC Registration (Based on AUM)

MUST Remain State-Registered	MAY Register With the SEC	MUST Register With the SEC
If AUM is less than \$100 million	If AUM is at least \$100 million	If AUM is \$110 million or more

III. Mid-Sized Advisers

As explained in Section I, the Dodd-Frank Act creates a new category of investment advisers called “mid-sized advisers”: those advisers having assets under management of between \$25 million and \$100 million. As indicated earlier, these advisers generally do not meet the assets under management threshold to be eligible for SEC registration. The new SEC rules, however, provide that a mid-sized adviser *must* register with the SEC, even absent the requisite amount of assets under management, if:

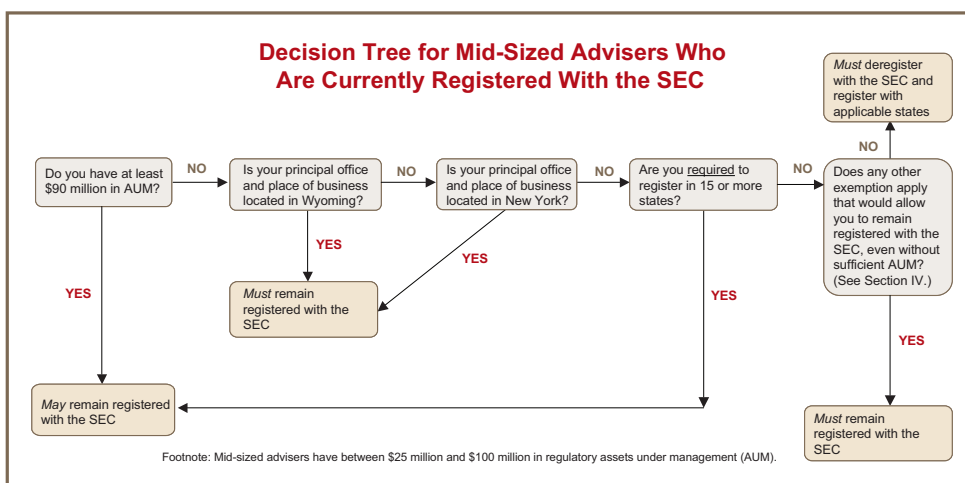
1. The adviser is not required to be registered⁶ in the state where it maintains its principal office and place of business;⁷ or
2. The adviser is not subject to examination by the state securities authority in the state where it maintains its principal office and place of business.

At present, the states that fall into these categories are Wyoming, which does

not register advisers at the state level, and New York, which does not have a state adviser examination program. Thus, any mid-sized adviser that maintains its principal office and place of business in either Wyoming or New York must register or remain registered with the SEC.⁸

After July 21, 2011, all other mid-sized advisers are prohibited from registering with the SEC and will be required to register with one or more state securities authorities unless they qualify for an exemption (discussed in Section IV). As part of the SEC registration process, a mid-sized adviser will be required to affirm, upon initial application for SEC registration and annually thereafter, that one of the above statements is true. An adviser that is no longer able to make this affirmation will have 180 days from its fiscal year-end to withdraw from SEC registration and transition to state registration.

The following diagram summarizes some of the possible registration scenarios for an adviser as of its next annual updating amendment.



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IV. Exemptions From the Prohibition on SEC Registration

Currently, there are numerous exemptions from the prohibition on SEC registration. Therefore, even without sufficient assets under management, an adviser that qualifies for one of these exemptions is *eligible* to register with the SEC. These exemptions include:

- Certain pension consultants;
- Certain investment advisers affiliated with an adviser registered with the SEC;
- Investment advisers expecting to be eligible for SEC registration within 120 days of filing Form ADV;
- Certain multi-state investment advisers; and
- Certain Internet-based investment advisers.

The two most significant changes to the existing exemptions relate to pension consultants and multi-state advisers. The new SEC rules have increased the minimum value of plan assets that an adviser must advise on from \$50 million to \$200 million in order to qualify for the pension consultant exemption. Advisers that are currently relying on the pension consultant exemption and that are advising plan assets of less than \$200 million will be required to deregister from the SEC and transition to state registration (absent any other available exemption). An adviser no longer eligible to rely on the pension consultant exemption will have 180 days from the adviser's fiscal year-end to withdraw from SEC registration.

The multi-state adviser exemption is probably the more familiar and relevant of these changes. This exemption permits advisers that are required to register as an investment adviser with 15 or more states (reduced from the current 30-state requirement) to register (or remain registered) with the SEC. An adviser qualifying for the multi-state exemption may, however, elect to forgo SEC registration and maintain its state registrations. In order

to rely on this exemption, at least 15 of the state registrations must be *required* and not optional for the adviser. To avoid attempts to circumvent deregistering with the SEC, the SEC requires an adviser to include a representation on Schedule D of Part 1A of Form ADV that it has concluded that it must register as an investment adviser with the requisite number of states.

V. Regulatory Assets Under Management

In most cases, it is the amount of an adviser's assets under management that determines whether the adviser must register with the SEC or with one or more states. The new SEC rules reference an investment adviser's "regulatory assets under management"—distinguishing the assets reported in Item 5 of Form ADV Part 1 from the assets under management disclosure that advisory clients now receive as part of an adviser's Form ADV Part 2A. This provides a uniform method of calculating assets under management by eliminating choices previously included in the instructions to Form ADV Part 1, which had enabled some advisers to opt in or out of federal or state registration by including or excluding a class of assets.

Securities Portfolios

An investment adviser must include in its calculation of regulatory assets under management securities portfolios for which it provides continuous and regular supervisory or management services.⁹ Under the revised instructions for Form ADV Part 1, however, an adviser must now include the following types of securities portfolios in this calculation:

1. Family or proprietary accounts;
2. Accounts for which the adviser receives no compensation for its services; and
3. Accounts of clients who are not United States persons.

Previously, an adviser had the option of excluding these types of accounts when determining its

assets under management for annual amendment purposes. Eliminating an adviser's ability to exclude all or some of these categories of assets will prevent an adviser from underreporting its assets to remain below the new registration threshold and avoid SEC oversight.

Valuing the Portfolio

An adviser must include the entire value of each securities portfolio for which it provides continuous and regular supervisory or management services. If an adviser provides continuous and regular supervisory or management services for only a portion of a securities portfolio, it should include in its calculation of regulatory assets under management only that portion of the securities portfolio for which it provides such services. Advisers must exclude, for example, the portion of an account:

1. That is under management by another person; or
2. That consists of real estate or businesses whose operations the adviser "manages" on behalf of a client, but not as an investment.

In addition, the revised instructions for Form ADV Part 1 also clarify that an adviser must calculate its regulatory assets under management on a gross basis (e.g., without deduction of any outstanding indebtedness or other accrued, but unpaid, liabilities).¹⁰ Accordingly, an adviser cannot deduct accrued fees, expenses, or the amount of any borrowing. The existing prohibition against an adviser deducting securities purchased on margin when calculating its assets under management remains in force.

Advisers to Private Funds

When calculating its regulatory assets under management, an adviser must include the value of any private fund over which it exercises continuous and regular supervisory or management services, regardless of the nature of the assets held by the fund. A sub-adviser to a private fund would include only that portion of the value of the portfolio for which it provides continuous and regular supervisory

or management services. An adviser must also include the amount of any uncalled capital commitments¹¹ made to a private fund managed by the adviser.

Advisers are required to use the market value of private fund assets or the fair value of private fund assets where market value is unavailable. This represents a change from the previous instructions for Form ADV Part 1, which permitted an adviser to calculate the value of its assets under management based on whatever method the adviser used to report its assets to clients (e.g., what was in the fund offering documents) or used to calculate fees for investment advisory services.

VI. Amendments to Form ADV Part 1

As detailed above, raising the SEC registration threshold to \$100 million in regulatory assets under management has also required changes to the instructions and content of Form ADV Part 1.¹² When an adviser goes to file its next annual updating amendment (or the required "other-than-annual" amendment), it will discover that these changes include special one-time instructions for the transition filing for mid-sized advisers. These special instructions detail the requirements for new or continued registration with the SEC and, if so required, deregistration with the SEC. The new SEC rules have also brought about other changes that are designed to improve the SEC's ability to oversee investment advisers and assess compliance risks by collecting additional information about advisory firm operations. What follows is a summary of the most significant amendments to Form ADV Part 1.

SEC Registration (Item 2.A)

Item 2.A requires each SEC-registered adviser and each applicant for SEC registration to identify whether, among other options, it is eligible for SEC registration because: (i) it is a large adviser that has \$100 million or more in regulatory assets under management (or at least \$90 million if the adviser is currently SEC-registered and filing an annual

updating amendment) or (ii) it is a mid-sized adviser that does not meet the criteria for state registration or is not subject to examination by the state.

Private Fund Reporting (Item 7.B)

Amended Item 7.B greatly expands the information advisers must now report to the SEC about the private funds they advise. An adviser is also required to complete a separate Section 7.B of Schedule D for each private fund it advises.¹³

Part A of Section 7.B requires an adviser to provide basic information regarding each private fund managed, including information about:

- (i) The organization of the fund, including whether the fund is part of a master-feeder arrangement or is a fund of funds;
- (ii) The fund's general partner and any other advisers to the fund;
- (iii) The gross asset value of the fund;
- (iv) The fund's investment strategy (based on an enumerated list of potential categories);
- (v) The approximate number of beneficial owners of the fund and the percentage of the fund owned by the adviser and its related persons, fund of funds, and non-U.S. persons; and
- (vi) The extent to which clients of the adviser are solicited to invest and have invested in the fund.

Part B of Section 7.B requires advisers to provide information concerning each private fund's primary service providers, including auditors, prime brokers, custodians, administrators, and marketers.

Advisory Business Information: Employees, Clients, and Advisory Activities (Item 5)

The key amendments to Item 5 include:

- (i) Indicating how many of the adviser's employees are licensed insurance agents;
- (ii) Providing an approximate number of clients if over 100;
- (iii) Reporting the approximate percentage of its clients that are not U.S. persons;

(iv) Specifying the types of clients that the adviser advises (adding categories for business development companies, other investment advisers and insurance companies);

(v) Reporting the approximate percentage of assets under management attributable to each client type;

(vi) Adding two additional types of services (portfolio management services for pooled investment vehicles, other than registered investment companies and educational seminars or workshops); and

(vii) Reporting whether it provides investment advice only with respect to limited types of investments.

Other Business Activities and Financial Industry Affiliations (Items 6 and 7)

Items 6 and 7 have been expanded to include additional types of financial services businesses that an adviser must report either as an outside business activity or financial industry affiliation. As a result, an adviser must now account for any related person that is a trust company, registered municipal adviser, registered security-based swap dealer, or major security-based swap participant. The new rules also clarify that responses to Item 7.A relating to natural persons (e.g., an accountant or lawyer) should only be made in the affirmative for persons that have a separate business in that field rather than for those persons that the adviser may employ as accountants or lawyers.

Participation in Client Transactions (Item 8)

Under the amended Item 8, an adviser that indicates that it has discretionary authority to determine the brokers or dealers for client transactions or that it recommends brokers or dealers to clients must additionally report whether any of such brokers or dealers are related persons of the adviser. In addition, an adviser that indicates that it receives soft dollar benefits must also indicate whether all those benefits qualify for safe harbor under Section 28(e) of the Securities Exchange Act

of 1934, as amended, for eligible research or brokerage services. Finally, an adviser must report whether it or its related persons receive direct or indirect compensation for client referrals.

Custody (Item 9)

Item 9 has been revised to include several clarifications and technical amendments, including a requirement that each adviser must indicate the total number of persons that act as qualified custodians for the adviser's clients. The term "persons" includes firms such as broker-dealers and banks that typically serve as custodians.

Reporting \$1 Billion in Assets (Item 1.0)

Newly added Item 1.0 requires each adviser to indicate whether it has \$1 billion or more in total assets shown on the adviser's balance sheet. For purposes of this reporting requirement only, the amount of assets will be determined in the same manner as the amount of "total assets" is determined on the adviser's balance sheet for its most recent fiscal year-end, using the same accounting method used to prepare the balance sheet. The balance sheet assets referred to in Item 1.0 should not be confused with the adviser's assets under management. The SEC will use this information to identify those advisers that could be subject to rules regarding certain excessive incentive-based compensation arrangements.

VII. State Registration Transition Issues

State registration can be daunting. The amount of registration documentation required, the high level of scrutiny state regulators place on every document filed, and the lack of uniformity among state investment adviser regulations—it all adds up to a challenging process. Advisers will not be accustomed to having their registration documents scrutinized and, at times, criticized. After all, when these transitioning advisers first filed for SEC registration, they most likely filed only one document (e.g., Form ADV Part 1) and had no interaction with SEC officials. When these same advisers file for state registration, they will be confronted with

numerous additional filings and frequent interaction with state securities regulators. Transitioning advisers should not despair, however, as a little prior planning and a healthy dose of respect when dealing with state regulators can make the process go much more smoothly.

A. What is the most difficult aspect of the state registration process?

Understanding the unique requirements of your particular state (or states) of registration is the first and most essential step. Unfortunately, it can also be the most confusing. To wit, an adviser registering in Texas needs to know that Texas requires advisory agreements to have a Form ADV Part 2 disclosure provision that mimics the exact language of the Texas Administration Code, while an adviser registering in Wisconsin must know that Wisconsin requires advisory agreements to contain the formula for computing the prepaid fee to be returned in the event of contract termination. Since each state has its own peculiarities, the better a transitioning adviser understands them in advance, the less frustrating the process.¹⁴

B. What is the timing of the state registration process?

For advisers anticipating their "forced" transition from SEC to state registration, the most common question is: How long will it take to become state-registered? Unfortunately, this question is difficult to answer, as the timing depends on many variables. Some of these variables are within the control of an adviser, such as the quality of documents filed and the speed with which additional requests from state securities authorities are met. Other variables are beyond an adviser's control, including the number of other registrants that submitted their application at that time and the amount of resources the state can devote to reviewing new applicants.

Based on past experience, the typical amount of time it takes to become state registered can be approximated as follows.

Scenario	Timing
Best Case	45–60 days
Typical	60–90 days
Worst Case	90–180 days

Given that the potential worst case scenario—180 days—corresponds to the amount of time a mid-sized adviser currently registered with the SEC has to switch to state registration (e.g., January 1, 2012, to June 28, 2012), it is strongly suggested that any adviser certain of its impending transition begin the state registration process in early 2012. Why the rush? With all the uncertainties surrounding the state registration process, one thing that all transitioning advisers can be certain of is that whatever the amount of time it would have taken to become state-registered in a “normal” year will be increased due to the influx of thousands of transitioning advisers.

C. In which states does an adviser need to register?

Typically, an SEC-registered investment adviser transitioning to state registration will need to register in those states where it had notice filed. This is primarily due to the fact that over the years, state registration and notice filing requirements have become virtually identical. Of course, because state registration requirements vary from state to state, it would be prudent to check the registration requirements of each state in which your advisory firm has clients. While most states follow the national *de minimis* rule (which allows an adviser to have up to five clients before registration is required), three states—Texas, Louisiana, and New Hampshire—require registration with only one client.

D. How do state compliance requirements compare to SEC requirements?¹⁴

Since the passage of the Dodd-Frank Act, transitioning advisers have raised questions about the level of compliance scrutiny they will confront at the state level. While these advisers have generally expressed a sense of relief about ridding themselves of SEC oversight, this relief should be tempered with a modicum of caution. Certainly, any transitioning adviser that satisfied the demands of

the SEC’s exacting compliance requirements should not run afoul of state regulators if the adviser keeps a similar type of compliance program in place. What a transitioning adviser must understand, however, is that some states have—if not more stringent requirements than the SEC—different requirements that may serve to trip up an unwary adviser. For example, some states require advisers to file all advertising and marketing material, while other states require advisers to maintain surety bonds and/or net capital requirements. Neither of these are SEC compliance requirements.

One thing that transitioning advisers are likely to discover is that, generally, they will be subject to more frequent examinations at the state level than they were when SEC-registered. The examinations themselves may not be as intense—typically, they are a one- or two-day affair—but they can still be quite disruptive; more often than not, examinations at the state level are unannounced. It is not unusual for representatives of state-registered advisers to arrive at their offices only to find a state securities examiner waiting to begin a regulatory exam of their advisory business.

VIII. The State Registration Process

When viewed as a whole, the state registration process can seem impenetrable. Breaking down the process into its component parts will help transitioning advisers better understand the unique requirements associated with state registration. It will also provide advisers with the information necessary to get an early start on preparing for the pending transition.

This section reviews each of the most significant aspects of the state registration process.

Primary Registration Documents

While registering with the SEC requires the filing of only two documents—Part 1A and Part 2A of Form ADV—registration at the state level typically involves multiple filings. The specific filings may vary

slightly from state to state, but a state registrant can expect to file some combination of the following forms and documents:

- Form ADV Part 1A, Part 1B, and all applicable schedules via the IARD¹⁵ system;
- Form ADV Part 2A (e.g., the firm brochure) and each applicable Part 2B (e.g., the brochure supplement) via the IARD system;
- Form U4 for all individuals providing investment advisory services via the IARD system;
- Copies of investment advisory, financial planning, and/or solicitor's agreements;
- Financial statements; and
- A copy of the advisory firm's privacy notice.

One of the keys to a successful filing is a properly drafted Form ADV Part 2A. In this case, "properly drafted" means a Part 2A that (i) is consistent with your advisory firm's Part 1 of Form ADV, its advisory contracts, its marketing material, and any other written material produced by your advisory firm; (ii) addresses all 19 required items (not just the 18 items required by the SEC) fully and accurately; and (iii) is written in plain English. Though recent rule changes now require all investment advisers to file Part 2A electronically as part of the registration process, transitioning advisers—unlike advisers remaining under the jurisdiction of the SEC—now face an actual review of their Form ADV Part 2A by state regulators.

Advisory Agreements

If Form ADV Part 2A is the most scrutinized registration document, a registrant's investment advisory agreements are a close second. While state securities regulators will not opine as to the overall legality of the client agreement, they will not hesitate to demand that the registrant redraft certain provisions if these provisions are inconsistent with the other registration documents or fail to conform to state law. As a result, a transitioning SEC adviser that has been using the same client agreement with no apparent ill effects may be

(unpleasantly) surprised to find that their current agreement does not satisfy the requirements of state law (or at least the requirements of the state's regulators) and, as a result, requires significant revisions.

While a specific analysis of any particular state's contract law is beyond the scope of this article, there are certain constants that transitioning SEC advisers can depend on when revising advisory agreements. For example, almost all states prohibit the use of "hedge clauses," in which an investment adviser seeks to limit or entirely avoid its civil liability for various types of conduct or omissions arising from the advisory relationship. Therefore, every advisory agreement submitted to state regulators should contain some variation of the following language:

The federal and state securities laws impose liabilities under certain circumstances on persons who act in good faith, and therefore nothing in this Agreement will waive or limit any rights that the client may have under those laws.

Based on the regulations of various states, advisers should consider including the following provisions in their client agreements:¹⁶

- Services that will be provided to the client;
- Term of the agreement, and the procedures and time required to terminate the contract;
- Fee arrangement between the adviser and the client;
- Formula for computing the advisory fee;
- Amount, and manner of calculating the amount, of the prepaid fee to be returned to the client if the contract terminates or a party to the contract does not perform;
- Designation of custodian or an acknowledgment that the adviser will have custody over client funds and/or securities;
- Statement that the adviser cannot assign the contract without the client's consent;

- Acknowledgment that the client has received a copy of the adviser's disclosure statement not less than 48 hours prior to entering into the contract or, if receiving the disclosure statement concurrent with signing the advisory agreement, has five business days to cancel the agreement without penalty;
- Explanation of how proxy voting responsibility is handled;
- Description of the type and frequency of reports to be provided to the client;
- Addresses for sending notifications;
- Description of how investment opportunities are allocated among clients;
- Statement that the adviser's services are not exclusive; and
- Written authorization from the client permitting the adviser to place orders to buy or sell securities on the client's behalf, to buy or sell securities on the client's behalf on the instruction of a third party, and to exercise any discretionary power in placing an order for the purchase or sale of securities.

While most SEC-registered advisers should already have these provisions in their agreements, they must check the laws of each relevant state to ensure that their contract includes any required state-specific provisions or language.

Supplemental Registration Documents

While the primary registration documents are generally familiar to all investment advisers, there are numerous supplemental documents unique to the state registration process. Failure to correctly file these documents is another common cause of delay in the approval of an adviser's state registration. A non-exhaustive list of these supplemental documents to be filed includes:

- Organizational/formation documents (e.g., articles of incorporation, certificate of formation, partnership agreement);

- Affidavit of investment adviser activity prior to registration;
- Workers compensation coverage affidavit;
- Statement of financial condition and a financial condition worksheet;
- Designation of supervisor form;
- Form BR (branch office information);
- Customer authorization to disclose financial records;
- Supplemental application form listing investment adviser representatives;
- Compliance manual;
- Code of ethics;
- Compliance attestation;
- Conflict of interest disclosure;
- Statement of citizenship and immigration status;
- Copies of all marketing and advertising material (including copies of web pages, business cards, and letterheads);
- Tax certification form;
- Proof of errors and omissions insurance;
- Surety bond form;
- Form D (hedge funds);
- Private placement memorandum and subscription agreement (hedge funds); and
- Fingerprint cards for individuals registering as investment adviser representatives.

An applicant for state registration must check with the regulators of the state in which it intends to register for the specific types of documents that are required.

Financial Statements and Net Worth or Net Capital Requirements

Most states conduct a basic review of a registrant's financial condition.

Financial disclosure and minimum financial requirements will likely be the most unfamiliar aspects of the state registration process for a transitioning adviser.

Applicants for state registration typically file a balance sheet and income statement as part of the initial registration process, but they also may be required to submit more detailed financial reports. Those states that do not require audited financial statements will require financial statements to be prepared in accordance with generally accepted accounting principles and accompanied by a notarized attestation that the statements are true and complete. Submitting incorrect, incomplete, or “stale” (i.e., dated more than 45 days from the date the registration application was submitted) financial statements is another common reason for delays in the approval of an adviser’s registration.

Advisers are required to submit financial statements because most states have a minimum net worth or net capital requirement that varies depending on the type of advisory business being conducted. States with minimum net worth or net capital requirements tend to adhere to some variation of the following formula:

- If the investment adviser has custody of client funds or securities, it must maintain a minimum net worth of \$35,000 at all times.
- If the investment adviser has discretionary authority over client funds or securities but does not have custody of client funds or securities, it must maintain a minimum net worth of \$10,000 at all times.
- If the investment adviser accepts prepayment of more than \$500 per client and does so six or more months in advance, it must maintain a positive net worth at all times.

As with other state registration requirements, a transitioning SEC adviser must carefully check the financial reporting rules and minimum capital requirements of each state in which it will register.

Custody

One area where a transitioning SEC adviser might find some welcome relief is with its compliance and reporting requirements under state custody rules. Recent amendments to the SEC’s “custody rule”¹⁷ have greatly expanded the obligations of any SEC-registered adviser that maintains custody of client assets or funds (the most onerous being that certain advisers with custody must now undergo an annual surprise examination by an independent accountant). As of the date of this article, most states have not adopted the SEC’s amended custody regulations—but the reprieve for advisers may be temporary. Historically, states have adopted new SEC rules, either directly or indirectly, as an expected (read: required) best practice.

State custody rules do present their own unique challenges. Primary among these is that each state tends to have a different definition of what constitutes custody. Some states include the direct deduction of advisory fees in their definition of custody, while other states adhere to the SEC practice of excluding direct fee deductions when determining whether an investment adviser has custody. In addition, the compliance requirements for an adviser deemed to have custody may differ from state to state. And, as noted earlier, net worth and minimum capital requirements will vary depending on whether or not an adviser is deemed to have custody.

Registering in Multiple States

In all probability, most of the advisers transitioning from SEC registration to state registration are currently “notice filed” in multiple states. While this should translate into registering as a state adviser in those same states, some states may have different standards for state registration than they do for notice filing. Notice filing is usually a simple matter of checking off boxes next to state names in Item 2B of Form ADV Part 1A, but registering in multiple states is more accurately described as initiating many individual state registrations. As a result, an investment adviser registering in multiple

states must be prepared to navigate the complexities of differing state regulatory schemes. While some states will defer to the regulations of an adviser's home state on matters of compliance and minimum capital requirements, all states require new applicants to file the full complement of registration documents and forms.

Investment Adviser Representatives

Every state-registered investment adviser must have at least one registered investment adviser representative associated with its advisory firm. If individuals providing investment advisory services on behalf of the transitioning SEC-registered adviser are already registered as investment adviser representatives in the advisory firm's home state, no further action is needed in that state. If, however, those individuals are not currently registered as investment adviser representatives in the advisory firm's home state, they will need to register as part of the state registration process. State securities regulators will not approve an applicant's registration until all individuals who provide investment advisory services are registered or proved to be exempt from registration.

In order to register an individual as an investment adviser representative, the advisory firm must file Form U4 on behalf of that individual. While filing Form U4 itself is fairly straightforward, the particulars of each individual registration can be complex. These particulars include determining (i) which individuals provide advisory services on behalf of the advisory firm; (ii) in which states those individuals provide advisory services; (iii) what exemptions from registration, if any, are available to those individuals; and (iv) what licensing and experience requirements must be satisfied. All of this is made even more complex by the fact that each state may have its own interpretation of what constitutes investment advisory services. As with other aspects of state registration, a transitioning adviser should consult the statutes and rules of each individual state in which it has clients to determine the

registration requirements for the firm's investment adviser representatives.

Post-Registration Requirements

Most transitioning advisers should already have compliance programs that meet or exceed state regulatory standards, but there are some unique state practices. How unique? Take Texas, for example. Despite the fact that no federal or state regulation requires investment advisers to adopt anti-money-laundering ("AML") programs, examiners with the Texas State Securities Board cited a state-registered investment adviser for failure to implement adequate AML policies. In response to allegations that it violated the due process rights of state-registered advisers, the Texas State Securities Board stated that the "staff of the Inspections and Compliance Division makes 'best practices' recommendations, as appropriate, including not engaging in money laundering. Since it would be impossible to set forth all criminal laws that investment advisers should not violate, the staff raises them as 'best practices,' thereby placing registrants on notice in case there is a violation later on."

In addition, those states that require applicants to file some type of financial statement as part of the registration process typically also require similar filings on an annual basis.

IX. Withdrawal From SEC Registration

The deadline for a transitioning SEC-registered adviser to file Form ADV-W is June 28, 2012.

Once an advisory firm's registration with a state is deemed effective, the firm can then begin the process of withdrawing from SEC registration by filing Form ADV-W via the IARD system. After logging onto the IARD system, select "New Filing" under the heading "ADV-W." At the bottom of the page are two options: full withdrawal and partial withdrawal. If you are a transitioning adviser, click on the "Partial Withdrawal" link. Advisory firms filing a partial withdrawal are only required to complete the

“Status” section, Items 1A through 1D, and the “Execution” section. You should not complete Item 1E or Items 2 through 8 of Form ADV-W.

In the “Status” section (the first section of Form ADV-W), the prompt “Check the box that indicates what you would like to do” should already have been addressed as follows: “Withdraw from registration in some, but not all, of the jurisdictions with which you are registered.” If, for some reason, this answer has not been selected, check it. The next question in the “Status” section asks you to indicate the jurisdictions from which you’re withdrawing your investment adviser registration. Select choice “(a),” which will indicate your firm’s withdrawal from the SEC.

Items 1A through 1D on Form ADV-W concern the advisory firm’s identifying information.¹⁸ You must provide the firm’s full legal name, SEC file number, CRD number, and name and address of the firm’s contact employee. Note that the name you enter in Item 1A must be the same as the name you entered on your last amended Form ADV (do not report a name change on this Form ADV-W), and the contact employee should be an employee (not outside counsel) who is authorized to receive information and respond to questions about Form ADV-W.

The only remaining task is to sign the “Execution” section. Copies of Form ADV-W must be executed by a person the advisory firm has authorized to file the form. If the advisory firm is a sole proprietorship, the sole proprietor must sign Form ADV-W in his or her individual capacity. If the advisory firm is organized as a partnership, a general partner must sign Form ADV-W in the name of the partnership. If the advisory firm is organized as an unincorporated organization or association that is not a partnership, the managing agent (an authorized person who directs or manages or who participates in the directing or managing of the firm’s affairs) must sign Form ADV-W in the name of the organization or association. If the advisory firm is organized as a corporation, a principal officer duly authorized must

sign Form ADV-W in the name of the corporation. If an officer of any entity is signing the form, the officer’s title must be given.

When you’re finished with the “Execution” section, click the “Completeness Check” button in the left column. If there are no errors, click the “Submit” button to file the form.

X. Additional Information

State Registration Fact Sheet: A State-by-State Guide of Registration Requirements

Available on the Compliance page of schwabadvisorcenter.com

Throughout this article, reference has been made to the availability of various rules, rule releases, checklists, etc. For the reader’s convenience, this section provides links to all such material.

Implementing Release

“Rules Implementing Amendments to the Investment Advisers Act of 1940,” Investment Advisers Act Release No. IA-3221 (June 22, 2011), available at <http://sec.gov/rules/final/2011/ia-3221.pdf>

Exempting Release

“Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers,” Investment Advisers Act Release No. IA-3222 (June 22, 2011), available at <http://sec.gov/rules/final/2011/ia-3222.pdf>

Family Office Release

“Family Offices,” Investment Advisers Act Release No. IA-3220 (June 22, 2011), available at <http://sec.gov/rules/final/2011/ia-3220.pdf>

Frequently Asked Questions

“Frequently Asked Questions Regarding Mid-Sized Advisers,” SEC Division of Investment Management, available at <http://www.sec.gov/divisions/investment/midsizedadviserinfo.htm>

North American Securities Administrators Association (NASAA), available at <http://www.nasaa.org>

XI. Conclusion

Is it proper to conclude with an apology? The author is well aware that even when reduced to their essential elements, the new SEC rules for transitioning to state registration make for difficult reading. The hope, then, is that the information presented in this article can serve as a reference guide to help affected advisers gain a sense of the

transition process and to plan for the work ahead. Alas, for a complete and full understanding of the new SEC rules and the applicable state statutes, there is no way to avoid actually reading the rules in their entirety, studying them, and contacting state regulators to either confirm your understanding or obtain clarification on some aspect of the state registration process.

About the Author

Scott Gottlieb is the founder and president of U.S. Compliance Consultants, LLC, a full-service consulting firm that specializes in compliance and registration services for investment advisers. Their services include investment adviser registration, development of written compliance and supervisory procedures, mock compliance audits, and compliance outsourcing. For additional information on U.S. Compliance Consultants' services and to sign up for the firm's free *Compliance Alert* newsletter, please visit www.uscomplianceconsultants.com or call toll-free 1-888-798-2930.

Mr. Gottlieb brings to U.S. Compliance Consultants more than 15 years of experience in developing, implementing, and monitoring compliance programs for investment advisers, hedge funds, and broker-dealers. Prior to founding U.S. Compliance Consultants, Mr. Gottlieb practiced corporate and securities law in the Connecticut and Los Angeles offices of Kelley, Drye & Warren LLP, an international law firm. Mr. Gottlieb was also a corporate associate in the Connecticut offices of Robinson & Cole, a regional law firm. During the course of his legal career he advised clients on securities regulation, investment adviser compliance, broker-dealer regulatory issues, initial public offerings, private placements, venture capital financings, and international joint ventures.

Mr. Gottlieb is an honors graduate of Tufts University and the University of Connecticut School of Law. Prior to attending law school, Mr. Gottlieb maintained his Series 7 license as a Financial Consultant with Merrill Lynch & Co., Inc. Mr. Gottlieb is a member of the National Society of Compliance Professionals and the Society of Corporate Compliance and Ethics, and is a past member of the American Bar Association's Center for Professional Responsibility.

- ¹ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
- ² See (i) “Rules Implementing Amendments to the Investment Advisers Act of 1940,” Investment Advisers Act Release No. 3221 (June 22, 2011); (ii) “Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers,” Investment Advisers Act Release No. 3222 (June 22, 2011); (iii) “Family Offices,” Investment Advisers Act Release No. 3220 (June 22, 2011).
- ³ The SEC retained the requirement that eligibility for registration be determined annually as part of an adviser’s annual updating amendment.
- ⁴ The reason the SEC uses the March 30 date and not the usual March 31 date for the annual updating amendment filing is that 2012 is a leap year and the regulations require the filing to be made within 90 days of the end of an adviser’s fiscal year. With the added day in February, the 90th day falls on March 30, 2012.
- ⁵ “AUM” is the abbreviation typically used for “assets under management.”
- ⁶ An adviser meets the “not required to be registered” standard if the adviser is exempt from registration under the law of the state in which it has its principal office and place of business, or is excluded from the definition of investment adviser in that state.
- ⁷ “Principal office and place of business” of an investment adviser means the executive office of the investment adviser from which the officers, partners, or managers of the investment adviser direct, control, and coordinate the activities of the investment adviser. See Advisers Act Rule 203A-3(c).
- ⁸ The Implementing Release also listed Minnesota as a state that did not examine advisers, but subsequent to the date of the Implementing Release, the SEC sent out an email stating that this was not the case.
- ⁹ Pursuant to the instructions to Form ADV Part 1A, you provide continuous and regular supervisory or management services with respect to an account if: (a) you have discretionary authority over and provide ongoing supervisory or management services with respect to the account; or (b) you do not have discretionary authority over the account, but you have ongoing responsibility to select or make recommendations, based upon the needs of the client, as to specific securities or other investments the account may purchase or sell and, if such recommendations are accepted by the client, you are responsible for arranging or effecting the purchase or sale. Advisers should consider the following factors when evaluating whether they provide continuous and regular supervisory or management services to an account: (a) terms of the advisory contract; (b) form or compensation; and (c) management practices.
- ¹⁰ An adviser may report net assets managed in Part 2A of Form ADV.
- ¹¹ A capital commitment is a contractual obligation of an investor to acquire an interest in, or provide the total commitment amount over time to, a private fund, when called by the fund.
- ¹² While those unfamiliar with Form ADV Part 1 may think that changes to the “instructions” hardly seem worth mentioning, investment advisers know that the instructions for Form ADV Part 1 play a crucial role in the registration process.
- ¹³ A full discussion of the information required by Section 7.B. of Schedule D is beyond the scope of this article. In this case, there is no substitute for reviewing the actual section, which can be found at <http://sec.gov/rules/final/2011/ia-3221-appd.pdf>.
- ¹⁴ For more information on state specific requirements, please see the State Registration Fact Sheet on the Compliance page of schwabadvisorcenter.com > News & Resources > Compliance.
- ¹⁵ “IARD” stands for Investment Adviser Registration Depository (www.iard.com).
- ¹⁶ For additional information, see the July 2011 *Compliance Review* on best practices for advisory agreements, available on the Compliance page of schwabadvisorcenter.com and at <https://si2.schwabinstitutional.com/SI2/Published/Direct/secure/file/p-4285432?cv21>.
- ¹⁷ See “Custody of Funds or Securities of Clients by Investment Advisers,” Investment Advisers Act Release No. 2968, December 30, 2009, <http://www.sec.gov/rules/final/2009/ia-2968.pdf>. For additional information, please see the *Compliance Review* article “The Amended Custody Rule: What It Means to You” at <https://si2.schwabinstitutional.com/SI2/Published/Direct/secure/file/com-com-94659?cv6> and on the Compliance page of schwabadvisorcenter.com.
- ¹⁸ Items 1A through 1D should be pre-populated with the required content based on the information in your firm’s current Form ADV Part 1. It is prudent, however, to review this section, because information may be outdated.

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