U.S. Registration of Investment Advisers

This review gives a summary description of the federal registration process and certain other regulatory requirements for investment advisers under the Investment Advisers Act of 1940 ("Advisers Act").

A U.S.-registered investment adviser is permitted to provide advice and reports to customers regarding investments in securities, to exercise investment discretion over client securities accounts, and to charge advisory fees that are not based on customer transactions but are instead some combination of a periodic fee, a fee for specific non-transaction services, or a fee over time based upon the size of a customer's account and the nature of the assets in the account. (Unless registered as a broker-dealer, an investment adviser cannot charge fees or commissions that are based on securities transactions). There are not different types or categories of federal registration or activities approvals for an investment adviser. A registered investment adviser is permitted to give whatever legally permissible securities investment advisory services are described in its Form ADV and authorized in its customer contracts.[1]

State and Federal Registration Issues

Yet, determining whether and where to register as an investment adviser can be a complex task. An "investment adviser" is, under the Advisers Act, "a person who, for compensation, engages in the business of advising others … 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." However, certain persons and firms are excluded from this definition, so that registration would not apply to them. These include, only briefly, U.S. banks and branches of non-U.S. banks that are regulated by U.S. regulators, and securities broker-dealers (to the extent that they render advice incidental to their business as such and do not receive special compensation for advice).

Whether an investment adviser should register with the SEC or a state is typically determined by the amount of assets receiving continuous and regular supervisory or management services (often referred to as "assets under management"). The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) amended the Advisers Act to generally prohibit an investment adviser from registering with the SEC if it is registered as an investment adviser with the state in which it maintains its principal office and place of business and has less than $100 million in assets under management. Thus, in general, in order for a firm to register with the SEC as an investment adviser, it must have over $100 million in assets under management at the time of registration or within 120 days of the effective date of the registration.

[1] Providing advice concerning futures contracts may require separate registration with the Commodity Futures Trading Commission and membership in the National Futures Association, and some insurance businesses may require state insurance licenses.

If a firm has less than $100 million assets under management and does not anticipate having $100 million or more within 120 days of the effective date of the registration, then it typically must register with the individual state(s) as an investment adviser.[2] In addition, an investment adviser that is not registered with the SEC is generally required to register as an investment adviser with each state securities commission where the investment adviser maintains a place of business or whether the investment adviser has more than 5 investment advisory clients.[3] Even if an investment adviser is registered with the SEC, certain states may also require that the registered investment adviser make a "notice filing" with the state if such adviser has more than a specified number of clients within the state. The "notice filing" normally consists of filing (i) a Uniform Consent to Service of Process on Form U-2; (ii) a copy of the Form ADV as filed with the SEC (as discussed below); and (iii) a filing fee (which can be $75 to $300 depending on the state.) Most filings are good for one year and are renewed in December of each year.

Finally, there are certain exemptions from registration for certain categories of investment advisers including "family offices"; advisers that advise only "venture capital funds"; advisers that advise only "private funds" and manage less than $150 million in assets, and certain "foreign private advisers." These exemptions are all subject to the adoption of implementing regulations by the SEC pursuant to the Dodd-Frank Act.

Registration Processes

To register as an investment adviser, an applicant must complete and file the Uniform Application for Investment Adviser Registration on Form ADV with the SEC. (The Form is available from the SEC website). Form ADV is filed electronically through the Investment Adviser Registration Depository ("IARD"), which is administered by the Financial Industry Regulatory Authority, Inc. ("FINRA"). The application is considered filed on the date it is accepted by the IARD. The SEC will determine whether the application is complete and in compliance with the applicable provisions of the Advisers Act and its rules. Within forty-five days after the filing (or a period longer if the registrant consents), the SEC must grant registration or institute a proceeding to determine whether to deny registration.

Although the SEC requires a description of experience pointing to proficiency, as described below, it does not mandate any specific proficiency requirements for advisory personnel.

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[2] However, because New York does not inspect its investment advisers, investment advisers in New York must register as investment advisers with the SEC if they have $25 million in assets under management. Investment advisers are subject to a lower threshold in New York because of Section 203A(2)(b) of the Advisers Act, which precludes registration by investment advisers with assets under management between $25 million and $100 million, only if they are required to be registered by their home state and "would be subject to examination" in that state. Because New York requires registration but does not subject registrants to examination, these investment advisers must register with the SEC.

[3] Still, some states do not recognize this *de minimis* exemption and require adviser registration upon the first client in the state.

A. Form ADV: Part 1A

An applicant must complete Part 1A of the Form ADV, along with the applicable accompanying required Schedules and Disclosure Reporting Pages. Part 1A asks a number of questions about the applicant, its business practices, the persons who own and control the applicant, and the persons who provide investment advice on the applicant's behalf. Once granted, a registration will cover the adviser's employees and other persons under its control, provided that their advisory activities are done on behalf of the registered adviser. As a result, employees do not have to register individually with the SEC.

Pursuant to Section 203(C)(1) of the Advisers Act, the form requires the disclosure of the following:

1. The name and form of business of the applicant;

2. The name of the state or other place of organization under which the applicant is organized;

3. The location of the applicant's principal business office and branch office, if any;

4. The names and addresses of the applicant's partners, officers, directors, and persons performing similar functions;

5. The number of the applicant's employees;

6. The education, the business affiliations for the past ten years, and the present business affiliations of the applicant and of its partners, officers, directors, and persons performing similar functions and of any controlling person thereof;

7. The nature of the business of the applicant, including the manner of giving advice and rendering analyses or reports;

8. A balance sheet certified by an independent public accountant and other financial statements;

9. The nature and scope of the authority of the applicant with respect to clients' funds;

10. The basis or bases upon which investment advice is compensated;

11. Whether the applicant, or any person associated with the applicant, is subject to any disqualification which would be the basis for denial, suspension, or revocation of registration; and

12. A statement as to whether the principal business of the applicant consists or is to consist of acting as an investment adviser and a statement as to whether a substantial part of the business of the applicant consists or is to consist of rendering investment supervisory services.

B. Form ADV: Part 1B

Part 1B of the Form ADV asks additional questions required by state securities authorities, along with three additional Disclosure Reporting Pages. If an applicant is applying for SEC registration, it does not have to complete Part 1B. Part 1B includes questions that require the applicant to identify the person responsible for the applicant's supervision and compliance, certain disciplinary history of the applicant and the amount and custody of the assets held by the applicant.

C. Part 2 of Form ADV

The Commission has relatively recently adopted amendments to Part 2 of Form ADV, requiring applicants for registration as investment advisers and registered investment advisers to prepare and deliver to clients and prospective clients narrative brochures written in "plain English" and supplemental brochures with tailored portfolio manager information. These amendments require the registered investment advisers to file the narrative brochures electronically with the SEC, which will make them available to the general public through the Investment Adviser Public Disclosure website. These amendments were designed to provide new and prospective advisory clients with clearly written, meaningful and current disclosure of the business practices, conflicts of interest and background of the investment adviser and its advisory personnel.

The brochure containing all the information required by Part 2 must be provided to a prospective client before or at the time of entering into an advisory agreement with said prospective client, and generally thereafter on an annual basis (or a summary of material changes is required to be provided, with an offer to provide the full document), within 120 days after the end of the adviser's fiscal year. This follows the annual update of Form ADV, required to be filed with the SEC within 90 days after the end of the adviser's fiscal year-end. Current updates are also required for updated disciplinary information and changes in previously disclosed material information.

Notable items of information that are required in the brochure under Part 2A of Form ADV include the following:

> Item 4: *Advisory Business*. Item 4 requires an adviser to describe its advisory business, including (1) the types of services offered, (2) areas of expertise and (3) amount of assets under management.
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> Item 5: *Fees and Compensation*. Item 5 requires advisers to describe the compensation received for advisory services. Advisers must provide a fee schedule, disclose whether fees are negotiable and, if fees are charged in advance, provide an explanation of how prepaid fees will be refunded when the contract terminates. Advisers must disclose the types of other costs incurred by clients as well, including brokerage and custody fees and fund expenses. Advisers who use and receive compensation from an affiliated broker for client transactions must disclose the practice, the conflict of interest that it creates and the way in which the adviser intends to address the conflict.

Item 6: *Performance-Based Fees and Side-By-Side Management*. Item 6 requires all advisers to disclose whether they charge performance-based fees. The SEC is concerned that some clients may be unaware of conflicts of interest that arise from simultaneous management of performance fee and non-performance fee accounts. Accordingly, this item requires advisers with such side-by-side arrangements to disclose the conflicts and the way in which the adviser addresses them.

Item 7: *Types of Clients*. Item 7 requires disclosure of the types of advisory clients and the criteria, such as minimum size, for opening and maintaining an account.

Item 8: *Methods of Analysis, Investment Strategies and Risk of Loss*. Item 8 requires advisers to describe their methods of analysis and investment strategies, including policies and procedures regarding the management of cash balances, and disclose that investing in securities involves risk of loss. In addition, advisers using frequent trading strategies must explain how these strategies can affect investment performance. Finally, the material risks of each significant investment strategy must be disclosed, with more detail if those risks are "unusual."

Item 9: *Disciplinary Information*. Item 9 requires disclosure of material disciplinary events within the previous 10 years relating to the integrity of an adviser or any of its management personnel (the Form provides a list of items that are presumptively material). Disciplinary events more than 10 years old must also be disclosed if the event is so serious that it remains material to the evaluation of the adviser and its integrity.

Item 10: *Other Financial Industry Activities and Affiliations*. Item 10 requires advisers to describe relationships or arrangements with related financial industry participants that create material conflicts of interest. Advisers must explain how these conflicts are addressed. In addition, advisers who select or recommend other advisers for clients, such as pursuant to sub-advisory arrangements, must disclose the compensation arrangement, any conflicts of interest and how such conflicts are addressed.

Item 11: *Code of Ethics, Participation or Interest in Client Transactions and Personal Trading*. Item 11 requires advisers to include a brief description of their code of ethics and offer to provide a copy upon request. If an adviser or one of its related persons recommends to clients, or buys or sells for client accounts, securities in which the adviser or a related person has a material financial interest, the Brochure must disclose this practice, the conflicts of interest it presents and the way in which those conflicts are addressed. Finally, this item requires disclosures regarding each adviser's personal trading policies and procedures.

Item 12: *Brokerage Practices*. Item 12 requires advisers to describe how they select brokers, determine the reasonableness of brokerage fees and address the conflicts arising from the use of "soft dollars." Advisers must explain whether they use soft dollars to benefit all accounts proportionately and whether they "pay up" for soft dollar benefits. Advisers who direct trades to brokers in exchange for client referrals must disclose this practice, the related conflicts of interest and the way they are addressed. Additional disclosures are required regarding directed brokerage arrangements, including whether

advisers routinely recommend or require clients to direct brokerage. Finally, advisers must describe the circumstances under which they aggregate trades and the fact that clients may end up incurring higher brokerage costs if they choose not to aggregate trades when they have an opportunity to do so.

Item 14: *Client Referrals and Other Compensation*. Item 14 requires advisers to disclose client referral arrangements, including arrangements covered by the cash solicitation rule (with additional disclosure for any noncash items) and any arrangement whereby the adviser accepts benefits from a non-client (such as sales awards or prizes from a broker-dealer) for providing advisory services to a client.

Item 15: *Custody*. A registered investment adviser generally is not permitted to have actual custody of client assets, which instead must be held in custody at a bank or broker-dealer. Item 15 requires advisers with custody to make certain required disclosures if a qualified custodian sends account statements, including: (1) that clients will receive account statements directly from the qualified custodian, (2) that clients should carefully review the account statements received from the custodian and (3) if an adviser also sends account statements, that clients should compare the statements they receive from the custodian with the statements received from the adviser.

Item 17: *Voting Client Securities*. This item requires advisers to disclose their proxy voting procedures and tracks the disclosure requirements of rule 206(4)-6 under the Advisers Act.

Item 18: *Financial Information*. Item 18 requires an adviser to make disclosures to its clients if its financial condition becomes impaired.

Part 2B of Form ADV consists of six items related to key personnel of the adviser, referred to as "Supervised Persons." These disclosures consist of the supervised person's educational background and business experience, material disciplinary history, other substantial business activities and any associated material conflicts of interest and sources of additional compensation from persons other than a client. Advisers are also required to describe their procedures for monitoring Supervised Persons and must identify the person(s) responsible for such oversight.

D. Ongoing Compliance Obligations

Once an investment adviser is registered, it has an obligation to comply with many compliance responsibilities. Certain of these ongoing compliance obligations are outlined below. Before engaging in business, registered investment advisers must create compliance and internal control programs, recordkeeping systems and policies and procedures to assure compliance with these requirements.

a. Fiduciary Duty

A registered investment adviser has a fiduciary duty to its advisory clients. This requires investment advisers to act in the best interest of their clients and to provide investment advice in their client's best interests. Under this duty, an investment adviser must not engage in any

activity that conflicts with the interest of any of its clients and the investment adviser must take reasonable care to avoid misleading clients and must provide full and fair disclosure of all material facts to clients and prospective clients. In addition, as a fiduciary, a registered investment adviser is required to seek to obtain the best price and execution for their clients' securities transactions. The term "best execution" means seeking the best price for a security in the marketplace as well as ensuring that, in executing the client transactions, clients do not incur unnecessary brokerage costs and charges.

b. Compliance Program, Code of Ethics, Insider Trading, Proxy Voting

A registered investment adviser is required by SEC Advisers Act Rule 206(4)-7 to adopt and implement written compliance policies and procedures that are reasonably designed to prevent violations of the Advisers Act. These policies and procedures must be designed to prevent, detect, and correct violations of the Advisers Act, and must be reviewed and updated annually. In addition, investment advisers must designate a chief compliance officer ("CCO") to be responsible for administering the policies and procedures. A registered investment adviser is also required to adopt a code of ethics. The code of ethics must set forth the standards of business conduct expected of employees, officers, directors and other people that the investment adviser is required to supervise. The code of ethics must also address personal securities trading by these people. Registered investment advisers must have a program to detect and prevent trading on material non-public information ("insider trading") by the firm itself, its personnel and clients. Elements generally include written policies and procedures, training and supervision of its personnel, the code of ethics, review of the personal investments and trading of "access persons" who have information on investment programs and transactions planned by the adviser, periodic certification of compliance by personnel, information barriers that include physical and electronic restrictions on access to and disclosure of non-public information about issuers and securities transactions and investment programs, in some cases maintenance of a grey list of restricted companies, and review of customer accounts for patterns of suspicious activity. A registered investment adviser must have and disclose a proxy voting policy and document proxy voting under SEC Advisers Act Rule 206(4)-6.

c. Books and Recordkeeping Requirements

A registered investment adviser has an obligation to make and keep accurate and current books and records relating to its investment advisory business. These books and records include advisory business financial and accounting records, records pertaining to providing investment advice and transactions in client accounts with respect to such advice, records that document the authority to conduct business in client accounts and advertising and performance records. These books and records must be kept for specified periods of time under SEC rules.

d. Requirements for Contracts with Clients

A registered investment adviser is also required to include or exclude specific provisions in its contracts with advisory clients. The advisory contracts must convey that the advisory services provided to the client may not be assigned by the investment adviser to any other person without the prior consent of the client. A change in control of the investment adviser is deemed to be an assignment for this purpose, although the contract can provide specifically for a process

of deemed client consent ("negative consent") based upon non-objection by the client after receipt of a written notice to the client of a change in control of the adviser and an opportunity to object in writing to the continuation of the contract. In addition, except in limited circumstances (including contracts with certain categories of very high net worth and institutional clients), contracts cannot include provisions providing for the investment adviser's compensation to be based on the performance of the client's account.[4] Client agreements must specify that they are terminable on short notice (generally 60 or 90 days) by either party without penalty and with or without cause, and generally contain a client acknowledgement of receipt of Form ADV Part II or a disclosure brochure. Use of "hedge clauses" in which the adviser disclaims liabilities in the absence of gross negligence or willful misconduct are restricted by SEC Staff interpretation.

e. Custody Rule and Client Statements

The method of holding custody of client assets is subject to SEC Advisers Act Rule 206(4)-2. Advisers must provide or cause to be provided periodic statements to clients of their advisory accounts. However, the custodian bank or broker can provide statements to customers that meet this requirement.

f. Agency Cross, Principal and Riskless Principal Transactions

Securities transactions by an investment adviser for its customer that are executed against other clients of the adviser or its affiliates, or with the adviser or its affiliates as principal or riskless principal, are restricted under SEC Advisers Act Rule 206(3)-2. Generally speaking, it is far easier and simpler to send transactions for execution away from the adviser or its affiliates than to meet the requirements of this rule.

g. Anti-Fraud and Disclosure Obligations; Referral Fees

Investment advisers are subject to anti-fraud requirements in state and federal securities laws, including a variety of special anti-fraud and disclosure obligations. Some of these restrictions are unique to investment advisers, such as a prohibition on use of testimonials and client endorsements, elaborate guidance and restrictions in SEC staff letters on the use of performance information, and detailed requirements and disclosure obligations for referral fees paid to third parties for referral of clients.

h. Updating Form ADV

A registered investment adviser must update the information contained in its Form ADV as on file with the SEC and relevant states through the IARD System. Some information must be updated promptly when it changes; other information is updated annually.

[4] However, one exception to this rule allows for the typical advisory fee imposed as a percentage of assets under management.

i. Anti-Money Laundering, Account Opening, Customer Privacy

Registered investment advisers are required by the SEC to have and maintain formal customer identification and anti-money laundering (AML) programs, a process for accepting new accounts and obtaining information from new customers for use in investment recommendations and account management and in connection with the AML/know your customer obligations. Investment advisers are subject to rules governing the protection of confidential customer information from improper use and disclosure to others and must disclose to customers the use made of their information.