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Clients&FriendsMemo

Blue Sky Issues of Financial Reform Legislation for Hedge Fund Advisers

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A. Introduction

The "Restoring American Financial Stability Act of 2010" (the "Dodd Bill"),[1] presently being considered by the U.S. Senate, if enacted as proposed, would have significant consequences for investment advisers managing hedge funds and similar private investment funds, whether presently registered, or exempt from registration, with the U.S. Securities and Exchange Commission (the "SEC") under the Investment Advisers Act of 1940 (the "Advisers Act"). Sections 403 and 410 of the Dodd Bill would (i) repeal a key exemption from Advisers Act registration currently relied on by many such advisers and (ii) at the same time, raise the requirements for advisers to register with the SEC, with the results that many advisers (a) won't qualify for SEC registration under the Advisers Act (including some that are already registered) and (b) will instead have to register with the individual States. In sum, a significant number of advisers will become subject to investment adviser registration under one or more state securities ("Blue Sky") laws,[2] and will in many cases find themselves subject to a disparate and non-uniform set of Blue Sky laws, rules, regulations, and policies governing investment advisers and their "investment adviser representatives." Unless Blue Sky Laws are conformed (which does not seem likely) or smaller advisers are given the ability to register with the SEC and benefit from federal preemption of Blue Sky regulation, small advisers will

[1] The original version of the Dodd Bill was introduced by Sen. Christopher Dodd (D-Conn.), the Chair of the Senate Banking, Housing and Urban Affairs Committee, on March 15, 2010; a copy of that bill (which runs 1,336 pages) is available at http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf. On or about March 22, 2010, a 114-page set of "Manager's Amendments" to the original version of the bill was published; a copy of such amendments is available at http://www.economicpopulist.org/files/Dodd_Manageradm_financialreform032210.pdf. On March 22, 2010, the original version of the bill, including the amendments, was passed by the Senate Banking, Housing and Urban Affairs Committee by a party line vote of 13-10 (none of the Republican members of the Committee voted for the Dodd Bill), and was sent to the floor for consideration by the entire Senate. On April 15, 2010, the Dodd Bill was formally introduced as S. 3217; a copy of that version (which now runs 1,410 pages) is available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s3217pcs.txt.pdf; the discussion of the Dodd Bill in this memorandum relates to S. 3217.

On December 11, 2009, H.R. 4173 ("H.R. 4173"), entitled the "Wall Street Reform and Consumer Protection Act of 2009," was passed by the House of Representatives and sent to the Senate. Title V, Subtitle A, comprising Sections 5001 – 5011, of H.R. 4173, and separately entitled the "Private Fund Investment Advisers Registration Act of 2009," includes provisions similar to those in Sections 401 - 416 of the Dodd Bill. Except as otherwise indicated, this memorandum focuses on the Dodd Bill, and not on the comparable provisions of H.R. 4173.

[2] Blue Sky laws are in effect in all 50 states, the District of Columbia, Guam, Puerto Rico, and the U.S. Virgin Islands. References to "states" in this memorandum are intended to encompass all 54 of those jurisdictions.

face substantial additional expenses and potential problems in attempting to comply with these state laws.

B. The Dodd Bill

Title IV of the Dodd Bill (Sections 401 – 416)—which is also separately entitled the "Private Fund Investment Advisers Registration Act of 2010" (the "PFIARA")—includes a number of provisions with implications for investment advisers to hedge funds and other private investment funds, both as regards compliance with the Advisers Act and Blue Sky laws.

Section 402(a) of the Dodd Bill would add a new defined term, "private fund,"[3] which would mean an investment fund that is excepted from the definition of the term "investment company" in the Investment Company Act of 1940 (the "Company Act"), by reason of the exceptions in Company Act §§ 3(c)(1) or 3(c)(7), which are the provisions that hedge funds, private equity funds and other investment funds commonly rely upon. These funds are referred to as "Private Funds," and their investment advisers as "Private Fund Advisers." PFIARA then goes on to add to, or amend a number of provisions in, the Advisers Act, to substantially increase the regulation of Private Fund Advisers (and, indirectly, the Private Funds they advise) under the Advisers Act.[4]

As the most significant starting matter, Section 403 of the Dodd Bill would expand the potential scope of registration under the Advisers Act by generally eliminating the exemption that is available for advisers with fewer than 15 clients in a calendar year,[5] except that the exemption would continue to be available to certain "foreign private advisers."[6] A "foreign private adviser" would be covered by the exemption if it: (a) has no place of business in the United States, (b) has fewer than 15 clients who are domiciled in or residents of the United States, (c) has less than $25 million of aggregate assets under management attributable to clients in the US and to investors in the US in Private Funds advised by the adviser (the SEC may, however, set a higher amount of assets under management by rule), (d) doesn't hold itself out generally to the public as an investment adviser, and (e) doesn't act as an investment adviser to an investment company registered under the Company Act or to a company which has elected to be a "business development company" pursuant to Company Act § 54.

Accordingly, by the Dodd Bill's elimination of the current exemption in Advisers Act § 203(b)(3), unless a Private Fund Adviser previously relying on that exemption can find another exemption from

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3 This definition would be set forth in new Section 202(a)(29) of the Advisers Act.

4 Sections 407 and 408 of the Dodd Bill would add new registration exemptions for investment advisers to venture capital and private equity funds, while Section 409 of the Dodd Bill would authorize the SEC to define certain "family offices" as being excepted from the definition of "investment adviser" in Advisers Act § 202(a)(11). This memorandum does not address such advisers.

5 See Advisers Act § 203(b)(3). At present, Section 203(b)(3) exempts an adviser from registration if it: (a) has fewer than 15 clients during the preceding 12 months, (b) doesn't hold itself out generally to the public as an investment adviser, and (c) doesn't act as an investment adviser to any investment company registered under the Company Act or to a company which has elected to be a "business development company" pursuant to Company Act § 54.

6 Section 402(a) of the Dodd Bill would define "foreign private adviser" in new Section 202(a)(30) of the Advisers Act.

registration, it will become subject to registration with the SEC under the Advisers Act—assuming, of course, that it is eligible to register. The current minimum threshold for SEC registration is $25 million of assets under management; Section 410 of the Dodd Bill would increase the threshold to $100 million of assets under management.[7] Thus, while a Private Fund Adviser might lose its exemption from Advisers Act registration, it still may not qualify for registration under the Advisers Act, with potential adverse consequences under Blue Sky laws, as described below.

C. Current Law Governing Notice Filings by, or Registration of, Investment Advisers under Blue Sky Laws

In the National Securities Markets Improvement Act of 1996 ("NSMIA"),[8] Congress established a bifurcated system of investment adviser regulation between the SEC and the states, replacing the prior arrangement whereby the SEC and states had equal regulatory authority over investment advisers. Under NSMIA, Blue Sky law provisions requiring the registration, licensing or qualification (any such requirements is referred to as a "registration") of investment advisers or supervised persons of investment advisers were preempted, both with regard to advisers registered under Advisers Act § 203 (as well as for persons excepted from the definition of "investment adviser" under Advisers Act § 202(a)(11)).[9]

Pursuant to Section 307 of NSMIA,[10] however, states were authorized to require SEC-registered advisers to make simple "notice filings." These filings were limited to (a) documents filed with the SEC (*i.e.*, Part I of Form ADV), (b) a consent to service of process, and (c) most importantly, a filing fee. In addition, states were authorized to require registration of any "supervised person" of an SEC-registered adviser as an "investment adviser representative," provided that person has a "place of business" located within the state.[11] However, States were not permitted to impose any substantive requirements on SEC-registered advisers in connection with such notice filings. Thus, SEC-registered advisers enjoy distinct privileges under Blue Sky laws, as contrasted with advisers which aren't so registered.

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[7] Section 410 of the Dodd Bill would also add a new Section 203A(a)(1)(C) to the Advisers Act, authorizing registration of an adviser to a company which has elected to be a "business development company" pursuant to Company Act § 54, irrespective of that company's assets.

[8] Public Law 104-290 (Oct. 11, 1996). Title III of NSMIA, Sections 301 – 308, is separately entitled the "Investment Advisers Supervision Coordination Act."

[9] See Advisers Act § 203A(b)(1)(A) and (B), as added by Section 303(a) of NSMIA. Among others, Advisers Act § 202(a)(11) excepts from the definition of "investment adviser" a bank or bank holding company, other than one advising a registered investment company or providing advice through a separate department or division; a lawyer or accountant providing advice solely incidental to the practice of his profession; and a broker or dealer providing advice solely incidental to his broker or dealer business and who receives no special compensation for such advice.

[10] For some inexplicable reason, Section 307 was not codified into the Advisers Act nor as any other provision of the United States Code.

[11] See Advisers Act § 203A(b)(1)(A). The terms "investment adviser representative" and "place of business" are defined in Advisers Act Rule 203A-3(a) and (b), respectively. At present, subject to certain exceptions or exemptions, all states, other than Wyoming, require notice filings for SEC-registered advisers, and most states require registration of "investment adviser representatives" of SEC-registered advisers, to the extent permitted by the Advisers Act.

Accordingly, investment advisers which are not registered with the SEC, either because they qualify for an exemption under the Advisers Act or because they don't satisfy the assets under management test of Advisers Act § 203A(a)(1)(A), generally may be deemed "investment advisers,"[12] and certain of their personnel may be deemed "investment adviser representatives,"[13] *as such terms may be defined by applicable Blue Sky laws*. In turn, unless a definitional exception or registration exemption is available under an applicable Blue Sky law, such persons may be subject to registration as investment advisers or investment adviser representatives under that state law. There are, however, **under current law,** some significant preemptive federal restrictions on state registration of investment advisers in Advisers Act § 222 (as amended by Section 304 of NSMIA), as described below. These **current law** benefits (a) exempt certain advisers from state registration and (b) as to advisers that are registered with more than one state, prevent them from being subject to certain regulatory requirements of multiple states.

Current Exemption From Registration. Advisers Act § 222(d) establishes a "national de minimis standard" before a state can require registration of an adviser. In particular, states are preempted from requiring the registration of an adviser *(but not a notice filing by an SEC-registered adviser)*, if the adviser doesn't have a place of business in the state and had fewer than six clients who are residents of that state during the preceding 12-month period. Advisers Act Rule 222-2 defines the term "client" for this purpose, so that a legal entity would generally count as a single client, even if the legal entity had numerous individual owners.[14]

Current Exemptions from Multiple State Regulation. First, Advisers Act § 222(b) prohibits states from requiring an adviser to maintain any books or records in addition to those required under the laws of the state in which it maintains its principal place of business, provided that the adviser is registered or licensed in that state and is in compliance with the applicable books and records requirements of such state. Second, Advisers Act § 222(c) prohibits states from requiring an adviser to maintain a higher net capital or post any bond in addition to that required under the laws of the state in which it maintains its principal place of business, provided that the adviser is registered or licensed in that state and is in compliance with the applicable net capital or bonding requirements of such state.[15]

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[12] As noted above, states may not register persons who are excepted from the definition of "investment adviser" in Advisers Act § 202(a)(11).

[13] Some Blue Sky laws use the term "investment adviser agent" or some other term, but "investment adviser representative" or "representative" is the term used in this memorandum.

[14] In accordance with the latter rule, an investment adviser may count as a single "client" any legal organization it advises, so long as the adviser provides advice based on the entity's investment objectives, rather than the individual investment objectives of the entity's shareholders, partners, limited partners, members or beneficiaries – *i.e.*, ordinarily, there may be no "look through" to count such persons as separate "clients" of the adviser for purposes of the five-client limit in Advisers Act § 222(d).

[15] Advisers Act Rule 222-1 defines the terms "place of business" and "principal place of business" for purposes of Advisers Act §§ 222(b), (c), and (d).

D. Effect of Dodd Bill on Number of Advisers Required to Register under Blue Sky Laws

Should Section 410 of the Dodd Bill become law, so as to increase the threshold for SEC registration to $100 million of assets under management, it is expect that this would "increase the number of advisors under state supervision by 28%."[16] According to David Tittsworth, executive director of the Investment Adviser Association trade group, the proposed change ". . . would shift about 4,200 SEC-registered investment advisors to state regulation."[17] Thus, a significant number of advisers presently registered with the SEC will potentially become subject to state registration, together with their representatives. Further, if the Advisers Act § 203(b)(3) exemption for Private Fund Advisers (that is, the exemption for advisers with fewer than 15 clients) were repealed, "[a]pproximately 1,300 investment advisers would be affected by the new registration requirements."[18] In sum, considering the combined effects of a repeal of the Advisers Act § 203(b)(3) exemption and an increase of the SEC registration threshold to $100 million of assets, it is expected that a significant number of Private Fund Advisers and their representatives will become subject to state registration.

Conversely, it is anticipated that some Private Fund Advisers presently relying on the Section 203(b)(3) exemption, but currently registered with one or more states, would register with the SEC under the Advisers Act and drop their state registrations (although they may still be required to make notice filings in certain states).

E. Effect of Dodd Bill on Advisers Act § 222(d)

Private Fund Advisers not eligible to register with the SEC (including those newly ineligible to be SEC-registered) may still benefit from the "national de minimis standard" in Advisers Act § 222(d), as described above. On the other hand, current Advisers Act Rule 203(b)(3)-1, promulgated as a "safe harbor" definition of the term "client" for purposes of Advisers Act § 203(b)(3) and incorporated into Advisers Act Rule 222-2, could be repealed, unless the SEC decides to retain it for purposes of determining whether a "foreign private adviser" exceeds the 14-client limit under revised Section 203(b)(3). If Advisers Act Rule 203(b)(3)-1 is repealed or its application is restricted solely to revised Section 203(b)(3), Advisers Act Rule 222-2 would no longer provide a uniform and objective definition of the term "client" for purposes of the *de minimis* standard in Section 222(d). Further, considering the obvious antipathy towards Private Fund Advisers exhibited by the PFIARA provisions, it's also possible that the SEC could amend Rule 222-2, or adopt a new rule defining the term "client" for purposes of Advisers Act Section 222(d) (and possibly for purposes of other provisions of the Advisers Act), which would require a "look-through" so as to count all or some investors in a Private Fund as separate "clients" of a Private Fund Adviser.

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[16] This estimate is from page 7 of a summary of an earlier discussion draft of the Dodd Bill circulated by Sen. Dodd in November 2009, available at http://banking.senate.gov/public/_files/FinancialReformDiscussionDraftRevised111009.pdf.

[17] Melanie Waddell, *Danger & Opportunity: Staggering Toward Reform*, INVESTMENT ADVISOR, Dec. 1, 2009, available at http://www.investmentadvisor.com/Issues/2009/December-2009/Pages/Staggering-Toward-Reform.aspx.

[18] Congressional Budget Office Cost Estimate on H.R. 3818 (Nov. 13, 2009) at 2; a copy of this report is available at http://www.govtrack.us/data/us/111/bills.cbo/h3818.pdf.

F. Jurisdictional and Definitional Concerns for Non-SEC-Registered Private Fund Advisers and Their Investment Adviser Representatives under Blue Sky Laws

In any case, an investment adviser not registered with the SEC will have to consider whether it and any of its personnel may be subject to registration in various states, which first requires consideration as to whether it might fall within the jurisdiction of a particular Blue Sky law because it would be deemed to be "transacting business" in the state. In this regard, under most Blue Sky laws, an investment adviser and its investment adviser representatives would generally be deemed to be transacting business in the state and subject to any registration requirements if they offer investment advice (by telephone, mail, fax, e-mail, Internet, courier, in person, or by any other means) to prospective or actual clients within or from the state (note that, in the case of clients which are corporations or other entities, what matters is the location of the entity's office with which the adviser does business, which may not be the same state where the client entity was organized).[19]

Thus, an adviser not registered with the SEC and its representatives may be subject to registration in multiple states, regardless of whether they have a place of business in a particular state. For example, an adviser with its sole office in State A but with no clients in State A, 15 clients in State B, and 4 clients in State C, may be required to be registered in State A because it's offering advice from that state, as well as in State B, but not in State C, either by reason of Advisers Act § 222(d) or a comparable definitional exception or registration exemption under State C's Blue Sky law (see below).

Once a Private Fund Adviser not registered with the SEC has determined which Blue Sky laws may apply to its business, it must then determine whether it would be deemed an "investment adviser," and whether any of its personnel would be deemed "investment adviser representatives," within the meaning of such statutes. Most Blue Sky laws define the term "investment adviser" in similar fashion to Advisers Act § 202(a)(11).[20]

As regards "investment adviser representatives" of non-SEC registered advisers, the definition of that term is governed solely by Blue Sky law provisions. Thus, for example, 2002 USA § 102(16), which is believed to be fairly typical of most Blue Sky laws, defines the term "investment adviser representative" to mean, in relevant part:

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[19] *See, e.g.*, Sections 201(c) and 414 of the 1956 version of the Uniform Securities Act (the "1956 USA"), and Sections 403(a), 404(a), and 610 of the 2002 version of the Uniform Securities Act (the "2002 USA"). One of these Acts has been adopted, but rarely in uniform fashion, by all states, other than California, Florida, Illinois, Louisiana, New York, North Dakota, Ohio, Tennessee, and Texas.

[20] By reason of Advisers Act § 203A(b)(1)(B), persons excepted from the federal definition will not be subject to state registration, regardless of how the state law may define the term.

> an individual employed by or associated with an investment adviser . . . and who makes any recommendations or otherwise gives investment advice regarding securities, manages accounts or portfolios of clients, determines which recommendation or advice regarding securities should be given, provides investment advice or holds herself or himself out as providing investment advice, receives compensation to solicit, offer, or negotiate for the sale of or for selling investment advice, or supervises employees who perform any of the foregoing. The term does not include an individual who: (A) performs only clerical or ministerial acts . . .

As is typical for Blue Sky laws, however, there are variations among the states in how the term "investment adviser representative" is defined. Thus, an adviser must carefully review each applicable Blue Sky law to determine which of its personnel, if any, would be deemed to be an "investment adviser representative" potentially subject to registration thereunder.

G. Jurisdictional and Definitional Concerns for SEC-Registered Private Fund Advisers and Investment Adviser Representatives under Blue Sky Laws

As a general rule, the same jurisdictional provisions under Blue Sky laws described in part F. above will govern whether a Private Fund Adviser registered with the SEC must effect a notice filing with a given state. Thus, any such adviser will first have to consider whether it would be deemed to be "transacting business" in a given state under its Blue Sky law, so as to potentially trigger the notice filing requirement. Unfortunately, as previously noted, Advisers Act § 222(d) literally preempts only state registration requirements, *but not state notice filing requirements*. Accordingly, while most states have enacted a *de minimis* exception or exemption from notice filings identical or comparable to Advisers Act § 222(d), it would appear that they are free to define the term "client" for purposes of those exceptions or exemptions as they deem appropriate, and could require a Private Fund Adviser to "look through" a Private Fund and count any local investors as "clients" for purposes of any numerical limits in such provisions.

As regards state registration of "investment adviser representatives" of SEC-registered Private Fund Advisers, Advisers Act § 203A(b)(1)(A) and Advisers Act Rule 203A-3 thereunder preempt Blue Sky laws with regard to any "supervised person" who is an "investment adviser representative" with a "place of business" in the state. Initially, the term "supervised person" is defined in Advisers Act § 202(a)(25) to mean:

> 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.

Accordingly, if an individual providing advice for an SEC-registered adviser is not "subject to the supervision and control of the investment adviser" (*i.e.*, because he or she is claiming independent contractor status), that person would not be covered by the preemptive effect of Advisers Act § 203A(b)(1)(A).

Advisers Act Rule 203A-3(a) defines the term "investment adviser representative" to mean a supervised person who has more than five clients who are natural persons, and more than 10% of whose clients are natural persons. However, the Rule excepts natural persons who are "qualified clients" within the meaning of Advisers Act Rule 205-3(d)(1), a Rule which permits payment of compensation to a registered investment adviser based on a share of capital gains upon, or capital appreciation of, the funds of certain types of "qualified clients."[21] In turn, Advisers Act Rule 203A-3(a) excludes from the definition a supervised person who "does not on a regular basis solicit, meet with, or otherwise communicate with clients of the investment adviser," or who provides only impersonal investment advice which doesn't meet the objectives or needs of specific individuals or accounts. Further, Advisers Act Rule 203A-3(b) defines the term "place of business" to mean an office at which the representative regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients, or is held out to the public as a location at which the representative conducts such activities.

It is noted, however, that Advisers Act Rule 203A-3(a)(4) defines the term "client" for purposes of that rule, by reference to Advisers Act Rule 203(b)(3)-1, so that a Private Fund advised by a Private Fund Adviser would ordinarily be deemed the "client," and not any investors therein. Thus, as discussed in part E. above, if the SEC were to use the enactment of Section 403 of the Dodd Bill as a pretext to repeal Rule 203(b)(3)-1 or to amend it so as to apply solely to revised Advisers Act § 203(b)(3), and doesn't amend Advisers Act Rule 203A-3 or adopt a new rule defining the term "client" for purposes of that rule or in general, it's possible that investors in a Private Fund advised by a Private Fund Adviser would be considered to be separate "clients" of the Adviser for purposes of determining whether a supervised person of the Adviser must register as a representative in a given state.

Accordingly, while at present the SEC has effectively limited the states' ability to register supervised persons of SEC-registered investment advisers to those individuals with a physical office in the state who provide advisory services to a significant number of so-called "retail" clients, it's possible that the revisions contemplated by the Dodd Act, coupled with action (or inaction) on the part of the SEC, could expand the number of states in which "investment adviser representative" registration may be required. In the case of Private Fund Advisers, however, since natural persons investing in the Private Funds they advise are typically "qualified clients" within the meaning of Advisers Act Rule 205-3(d)(1) (so that the adviser may receive performance-based compensation), even if a "look-through" were required to count such investors as "clients" of the adviser, it would be anticipated that it would be fairly rare for a supervised person of an SEC-registered Private Fund Adviser to be subject to state registration as a representative.

[21] In particular, a natural person with at least $750,000 under the adviser's management, or who has a net worth (alone or joint with spouse) of more than $1,500,000, is a "qualified client" under Rule 205-3(d)(1).

H. Definitional Exceptions and Exemptions from Registration and Notice Filings for Private Fund Advisers and Investment Adviser Representatives under Blue Sky Laws

Once a Private Fund Adviser determines that it and its personnel may be subject to registration or, in the case of an SEC-registered Private Fund Adviser, a notice filing, under a particular Blue Sky law because it may be deemed to be transacting business in the state, it should look for definitional exceptions or registration exemptions thereunder. Irrespective of the *de minimis* exemption provided by Advisers Act § 222(d), most Blue Sky laws presently except from the definition of the term "investment adviser," or exempt from investment adviser registration or a notice filing, a person with no place of business in the state if (a) its only clients in the state are certain institutions, or (b) during any period of 12 consecutive months the person has no more than five clients in the state, other than the permitted institutions.[22] In the case of Blue Sky laws providing such a definitional exception, the adviser's personnel would not be "investment adviser representatives" subject to registration, because they wouldn't be employed by or associated with an "investment adviser"; in the case of Blue Sky laws providing an exemption from investment adviser registration or a notice filing, there are comparable exemptions from investment adviser representative registration for a person employed by or associated with an adviser exempt from registration or a notice filing.[23] It is noted that these exceptions and exemptions in the Blue Sky laws are far from uniform – for example, some states (such as New York) don't condition their exemptions on the adviser's having no place of business in the state, the permitted institutional clients may vary significantly from state to state, and most Blue Sky laws are silent as to how to count "clients" for purposes of their *de minimis* exceptions or exemptions. Accordingly, an adviser and its personnel seeking to rely on such state exceptions or exemptions must be careful to assure themselves that they're either restricting their clients in the state to permitted institutions, or that they haven't exceeded the permitted number of non-institutional clients.

I. Registration Requirements for Non-SEC-Registered Private Fund Advisers and Investment Adviser Representatives under Blue Sky Laws

In the absence of the availability of Advisers Act § 222(d) preemption or a definitional exception or registration exemption under an applicable Blue Sky law, a Private Fund Adviser not registered with the SEC and its personnel will become subject to registration thereunder. Unlike registrations under the Advisers Act, state investment adviser registrations may be far more complicated, time-consuming, and expensive, and, of course, there's no federal counterpart to state investment adviser representative registration.

While most states require investment adviser applicants to submit at least Part I.A of the same Form ADV advisers are required to file with the SEC, together with the requisite filing fee, many states typically also require applicants to file Parts I.B and II of Form ADV, together with additional documentation and a variety of state-specific forms. In the case of investment adviser

[22] *See*, *e.g.*, 1956 USA § 401(f) and 2002 USA §§ 403(b)(1)(A) and (B), 403(b)(2), 405(b)(1)(A) and (B), and 405(b)(2).

[23] *See*, *e.g.*, 2002 USA § 404(b)(1).

representative applicants, they are typically required to submit a "Form U4" (the same application used by registered representatives of broker-dealers), together with the requisite filing fee, and proof that they passed the Uniform Investment Adviser Law Examination (Series 65) administered by the Financial Industry Regulatory Authority ("FINRA") or another acceptable FINRA exam, or that they have earned a certification from one of certain designated professional organizations (such as Chartered Investment Counselor, Chartered Financial Analyst, or Certified Financial Planner). Certain states require advisers to satisfy minimum net capital requirements and/or post surety bonds (there are no such requirements for SEC-registered advisers).

In identical or comparable fashion to the Advisers Act and the SEC's rules thereunder, among other requirements, state laws and rules also typically require advisers to maintain certain books and records, to provide a copy of Part II of their Form ADV's or a comparable brochure to clients and prospective clients, to comply with certain conditions with regard to their advisory contracts (including restrictions on certain types of fees), and to file periodic reports with the state. In most states, advisers and investment adviser representatives must renew their registrations annually, and certain states require advisers to separately register each branch office in the state.

While Advisers Act §§ 222(b) and 222(c) provide some relief to state-registered advisers by allowing the Blue Sky law of the adviser's principal place of business to control its books and records, net capital and bonding requirements, the initial and ongoing requirements for registered advisers and their representatives may still vary significantly from state to state, as may the manner in which particular states administer and enforce their laws and rules. Thus, for example, while New York doesn't impose any net capital or surety bond requirements on its registered advisers, New Jersey requires advisers who have custody of clients' funds or securities to either maintain a minimum capital of $25,000 or post a $25,000 surety bond. Likewise, while New York has no restrictions on advisory contracts, Alaska's law prohibits compensation of advisers on the basis of a share of capital gains upon, or capital appreciation of, a client's funds, in similar fashion to Advisers Act § 205(a)(1), but goes on to permit the state administrator, on request, to waive that prohibition for contracts conforming to Advisers Act § 205. Accordingly, advisers registered in Alaska must specifically request and obtain, on a case-by-case basis and at the sole discretion of the administrator, a waiver to permit fees which would be automatically allowable under the exemption in SEC Advisers Act 205-3. In addition, state requirements regarding custody of client funds and securities vary and may be incompatible with one another.

In sum, while advisers subject to state registration must comply with requirements comparable to those imposed on SEC-registered advisers, in many, if not most, instances, state requirements are more burdensome than the SEC's.

J. Recommendations

If Sections 403 and 410 of the Dodd Bill were to be enacted as proposed, it is imperative that a definition of "client" be retained for purposes of Advisers Act § 222(d) and Advisers Act Rule 203A-3, and preferably without a requirement that an adviser "look through" an entity it advises to count investors as separate clients, so as to preserve the preemptive effect of those provisions, and avoid a "crazy quilt" of Blue Sky laws, rules or interpretations as to how clients should be counted for purposes of those provisions.

Furthermore, considering the increase in the SEC registration threshold proposed by Section 410 of the Dodd Bill, Advisers Act § 222(d) should be amended so as to extend its preemptive reach to state notice filings for SEC-registered advisers. The present version of Section 222(d) illogically applies solely to advisers not subject to SEC registration, and there is little investor protection justification in permitting states to require notice filings by SEC-registered advisers managing $100 million or more of assets with no place of business and fewer than six clients in the state, yet be preempted from requiring registration of an adviser too small to qualify for SEC registration.

Finally, in the interest of fostering greater uniformity among the states and creating a "level playing field" for state-registered advisers and SEC-registered advisers, consideration should be given to amending Advisers Act § 222 so as to: (a) prohibit states from imposing, by law, rule, regulation, order, or other administrative action, requirements with regard to state-registered advisers' books and records, reports, advisory contracts, custody arrangements, and other practices, which differ from, or are in addition to, the requirements in those areas established under Advisers Act §§ 204, 205, and 206, in analogous manner to the restrictions imposed under Section 15(h)(1) of the Securities Exchange Act of 1934, as amended by NSMIA, on state regulation of broker-dealers; and (b) restrict states' ability to require registration of investment adviser representatives, except for those representatives with a "place of business" in the particular state, so as to curtail the burdens and significant expenses of multiple and duplicative state filings for such individuals.

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Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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