CHAPTER 5

Registration of Broker Dealers, Investment Advisers, and Agents

INTRODUCTION

In this section we will examine the state registration process for broker dealers, investment advisers, and agents. An important part of this section will be to know when registration is required and when an exemption is offered to the subject in question.

REGISTRATION OF BROKER DEALERS

Prior to conducting business in any state, a broker dealer must be properly registered or exempt from registration in that state. The first test when deciding if the broker dealer must register is determining whether the firm has an office in the state. If the firm maintains an office within the state, it must register with that state. A broker dealer wishing to become registered in a state must first file an application with the state securities administrator. The broker dealer must also pay all filing fees and sign a consent to service of process. By signing the consent to service of process, the broker dealer appoints the administrator as its attorney in fact and allows the administrator to receive legal papers for the applicant. Any legal papers received by the administrator will have the same force and effect as if they were served on the broker dealer. All applications must also include:

- Type of organization (e.g., corporation, partnership).
- Address of business.

- Description of business to be conducted.
- Backgrounds and qualifications of officers and directors.
- Disclosure of any legal actions.
- Financial condition.

The firm's registration will become effective at noon 30 days after the initial application has been received or at noon 30 days after the administrator has received the last piece of required information. Registering a broker dealer in a state automatically requires that any officers and directors who act in a sales capacity register as agents. A broker dealer will not be deemed to have a place of business in a state where it does not maintain an office simply by virtue of the fact that the firm's website is accessible from that state so long as the following conditions are met:

- The firm's website clearly states that the firm may only conduct business in states where it is properly registered to do so.
- The firm's website only provides general information about the firm and does not provide specific investment advice.
- The firm may not respond to Internet inquiries with the intent to solicit business without first meeting the registration requirements in the state of the prospective customer.

FINANCIAL REQUIREMENTS

A broker dealer must be able to meet the minimum capital requirements set forth by the state securities administrator. If the broker dealer is unable to meet this capital requirement, it must post a surety bond to ensure its solvency. Broker dealers that meet the Securities and Exchange Commission's (SEC) minimum net capital requirements are exempt from the Uniform Securities Act's capital and surety bond requirements. The administrator may also require that an officer or agent of the broker dealer take an exam that may be oral, written, or both.

AGENT REGISTRATION

It is unlawful for a broker dealer to employ any agent who is not duly registered under the Uniform Securities Act (USA). When determining if an agent must

register, you must first look at whom the agent works for. If the agent works for a broker dealer, the agent must register. Agents must register in their state of residence even if their firm is located in another state.

EXAMPLE An agent who lives in New Jersey and who commutes to an office in New York must register in both New Jersey and New York.

Agents must also register in the states where they sell securities or offer to sell securities as well as where they advertise. If the firm does not have an office in the state, it may or may not be required to register depending on whom it does business with. If a broker dealer does not have an office in the state and engages in securities transactions with the general public, then it must register. If a broker dealer with no office in the state conducts business exclusively with any of the following, it is not required to register in that state:

- Other broker dealers.
- Issuers of securities.
- Investment companies.
- Insurance companies.
- Banks.
- Savings and loans.
- Trust companies.
- Pension plans with more than $1,000,000 in assets.
- Other financial institutions.
- Institutional buyers.
- Existing customers with less than 30 days temporary residency in the state (on vacation or business trips).

The only exception is for officers and directors of a broker dealer who have no involvement with customers, securities transactions, or supervision. If the agent works for an exempt issuer, the agent is exempt from registration no matter what security is involved. Exempt issuers are:

- U.S. and municipal governments.
- Canadian federal and municipal governments.
- Foreign federal governments recognized by the United States.
- Banks, savings and loans, and trust companies.

Agents are also exempt from registering if they represent an issuer in the sale of an exempt security such as:

- Bankers' acceptances or time drafts with less than 270 days to maturity sold in denominations of $50,000 or more.
- Investment contracts relating to employee savings, stock purchases, pension plans, or other benefit plans as long as no commission is received for such sales.

Agents may also qualify for the *de minimis* exemption if they meet the following conditions:

- They are registered with FINRA.
- They are registered with at least one other state.
- They are not ineligible to register.
- Their broker dealer is registered in the state.

If the above conditions are met, an agent may conduct business with clients who are in the state in question for up to 30 days. If the client has moved to the state in question, the agent may conduct business with the client for up to 60 days while his or her registration is pending in that state.

REGISTERING AGENTS

Most states require that agents successfully complete either the Series 63 or the Series 66 exam before they may conduct business within their state. In addition to successfully passing the Series 63 or Series 66, agents must also:

- Abide by and understand state securities laws and regulations.
- Recognize that the state may require additional certification regarding the state's securities laws.
- Understand that they may not conduct business until they are properly registered.

TESTFOCUS!

- An agent does not become registered in a state simply by passing the exam. Agents become registered only when the state securities administrator notifies them that they have become registered.

- An agent may not be registered in any state without being employed by a broker dealer or issuer, and no broker dealer or issuer shall employ an agent that is not duly registered.

CHANGES IN AN AGENT'S EMPLOYMENT

When an agent changes firms, the agent, former employer, and new employer all must notify the state securities administrator. This is done in most cases quite easily through the Central Registration Depository (CRD) system for all firm and agent information. An agent's termination becomes effective 30 days after notifying the state unless the administrator is in the process of suspending or revoking the agent's registration. The administrator may still revoke an agent's registration for up to one year after the agent's registration has been terminated.

MERGERS AND ACQUISITIONS OF FIRMS

If a broker dealer from out of state is acquiring a broker dealer in state, the successor firm must file an application for registration within the state. The successor firm's registration will become effective upon completion of the transaction. The registration fees for the successor firm will be waived.

RENEWING REGISTRATIONS

All state registrations expire on December 31, and all broker dealers, investment advisers, and agents are required to file a renewal application and pay a renewal fee.

CANADIAN FIRMS AND AGENTS

Canadian firms and agents may engage in securities transactions with financial institutions and existing customers without registering under the USA as long as they do not maintain an office within the state. A Canadian broker dealer or agent who is a member in good standing with a Canadian securities regulator is allowed to register through a simplified registration process. The state registration will become effective 30 days after the application has been received with the consent to service process. The Canadian broker dealer must advise the state of any disciplinary action.

INVESTMENT ADVISER STATE REGISTRATION

It is unlawful for an investment adviser to conduct securities business without being duly registered or exempt from registration. State registration exemptions are provided for investment advisers who:

- Are federally registered.
- Manage portfolios for investment companies.
- Manage portfolios in excess of $110,000,000.
- Have no office in the state and conduct business exclusively with financial institutions.
- Have no office in the state and offer advice to no more than five clients in any 12-month period. This is known as the *de minimis* exemption.

If an investment adviser with no office in the state advertises to the public the ability to meet and offer investment advisory services with clients in a hotel or other temporary location, then the investment adviser is required to register with the state.

An investment adviser will not be deemed to have a place of business in a state where it does not maintain an office simply by virtue of the fact that the firm's website is accessible from that state so long as the following conditions are met:

- The firm's website clearly states that the firm may only conduct business in states where it is properly registered to do so.
- The firm's website only provides general information about the firm and does not provide specific investment advice.
- The firm may not respond to Internet inquiries with the intent to solicit business without first meeting the registration requirements in the state of the prospective customer.

THE NATIONAL SECURITIES MARKET IMPROVEMENT ACT OF 1996 (THE COORDINATION ACT)

The National Securities Markets Improvement Act of 1996 eliminated regulatory duplication of effort and established registration requirements for

investment advisers. A federally covered investment adviser must register with the SEC and is any investment adviser:

- That manages at least $110,000,000.
- That manages investment company portfolios.
- That is not registered under state laws.

All federally registered investment advisers must pay state filing fees and notify the administrator in the states in which they conduct business. The state securities administrator may not audit a federally covered investment adviser unless that adviser's principal offices is located in that administrator's state. Investment advisers are required to register with the state if they manage less than $100,000,000. Once investment advisers reach $100,000,000 in assets under management (AUM), they become eligible for federal registration.

Investment advisers who manage between $100,000,000 and $110,000,000 may choose to register either with the state or with the SEC. Investment advisers who think that their asset base will exceed $110,000,000 should register with the SEC. Investment advisers who manage $110,000,000 or more must register with the SEC.

If a federally covered investment adviser's AUM falls below $90,000,000, the adviser must withdraw its federal registration by filing Form ADV-W and register with the appropriate states within 180 days. Like most regulations, there are rare exceptions to the rule of when an investment adviser may register with the SEC. The Dodd-Frank Wall Street Reform Act of 2010 increased the AUM for federal registration to its current levels and defined three categories of investment advisers:

- Small adviser: Advisers with less than $25,000,000 AUM.
- Mid-size advisers: Advisers with $25,000,000–$100,000,000 AUM.
- Large advisers: Advisers with more than $100,000,000 AUM.

Pension consultants must have at least $200,000,000 AUM to be eligible to become federally registered.

INVESTMENT ADVISER REPRESENTATIVE

All investment adviser representatives who maintain an office within the state must register within the state. An investment adviser representative is an individual who:

- Gives advice on the value of the securities.

- Gives advice on the advisability of buying or selling securities.
- Solicits new advisory clients.
- Is an officer, director, partner, or supervisor of the investment adviser.

An investment adviser may not employ any representative who is not properly registered. Clerical and administrative employees are not considered representatives and do not need to register. An investment adviser representative who has no place of business in the state and who offers to meet a client in a hotel or other place of convenience is not considered to have an office in the state so long as the representative does not advertise the office and only offers the ability to meet directly to clients.

TESTFOCUS!

Investment adviser representatives who represent federally covered investment advisers must register with the state where they work as well as where they have clients, even though their firm is not required to register.

STATE INVESTMENT ADVISER REGISTRATION

An investment adviser must file the following with the state securities administrator before becoming registered:

- Application Form ADV
- Filing fees
- Consent to service of process

CAPITAL REQUIREMENTS

An investment adviser must maintain a minimal level of financial solvency. For advisers with custody of customers' cash and securities, the investment adviser must maintain minimum net capital of $35,000. Advisers who are unable to meet this requirement may post a surety bond. Deposits of cash and securities will alleviate the surety bond requirement. Advisers are considered to have custody if they have their customers' cash and securities held at their firm or if they have full discretion over their customers' accounts. Full discretion allows the adviser to withdraw cash and securities from the customer's account without consulting the

customer. Advisers who have only limited discretionary authority over customers' accounts need to maintain a minimum of $10,000 in net capital. Advisers with limited discretionary authority may only buy and sell securities for the customer's benefit without consulting the customer. They may not withdraw or deposit cash or securities without the customer's consent. If a state registered investment adviser meets the capital requirements in its home state it will be deemed to have met the capital requirements in any other state in which the adviser wishes to register even if the other states have higher net capital or bonding requirements. Should a state registered adviser's net capital fall below the minimum requirement, the adviser must notify the state administrator by the close of the next business day of the adviser's net worth. The adviser must then file a financial disclosure report with the administrator by the end of the next business day. Investment adviser representatives are not required to maintain a minimum level of liquidity.

EXAMS

The state securities administrator may require investment adviser representatives as well as the officers and directors of the firm to take an exam, which may be oral, written, or both. All registrations become effective at noon 30 days after the application has been filed. The administrator may require that an announcement of the investment adviser's intended registration be published in the newspaper.

Requirement	Broker Dealer	Investment Adviser	Agents
Net capital	Yes	Yes	No
Surety bond	Yes	Yes	Yes
Exams	Yes	Yes	Yes
Fees	Yes	Yes	Yes

ADVERTISING AND SALES LITERATURE

All advertising and sales literature for an investment adviser must be filed with the state securities administrator. The administrator may require prior approval of:

- Form letters
- Prospectuses
- Pamphlets

The following records must be kept for a minimum of three years for broker dealers and five years for investment advisers unless the state securities administrator requires a different period of time:

- Advertising and sales literature
- Account statements
- Order tickets/order memorandum

All investment advisers must keep accurate records relating to the following:

- Cash receipts and disbursements.
- Income and expense ledgers.
- Order tickets, including customer's name.
- Adviser's name, including executing broker and discretionary information.
- Ledgers and confirmations for all customers for whom the adviser has custody.
- Financial statements and trial balance.
- All written recommendations to customers.
- Copies of advertisements, circulars, and articles sent to more than 10 people.
- Copies of calculations sent to more than 10 people.

All books and records must be kept for five years readily accessible and for two years at the adviser's office. Records may be kept on a computer or microfiche as long as the data may be viewed and printed.

BROCHURE DELIVERY

An investment adviser is required to provide all prospective clients with a brochure or with Form ADV Part 2 at least 48 hours prior to the signing of the contract or at least at the time of the signing of the contract if the client is given a five-day grace period to withdraw without penalty. The brochure or Form ADV Part 2 will state:

- How and when fees are charged.
- The types of securities the adviser does business in.

- How recommendations are made.
- The type of clients the adviser has.
- The qualifications of officers and directors.

TAKENOTE!

A balance sheet must be given to clients if the adviser has custody of client funds or requires prepayment of advisory fees of more than $500 more than six months in advance.

THE ROLE OF THE INVESTMENT ADVISER

An investment adviser charges a fee for his or her services for advising clients as to the value of securities or for making recommendations as to which securities should be purchased or sold. Unlike a broker dealer, the investment adviser has a contractual relationship with his or her clients and must always adhere to the highest standards of professional conduct.

ADDITIONAL COMPENSATION FOR AN INVESTMENT ADVISER

In addition to the fees charged by an investment adviser, an investment adviser may also:

- Receive commissions for executing a customer's transaction through certain broker dealers.
- Act as a principal in a customer's transaction.

The above sources of additional revenue must be disclosed to the client in writing prior to the investment adviser executing such transactions.

AGENCY CROSS TRANSACTIONS

An agency cross transaction is one in which the investment adviser represents both the purchasing and selling security holder either as an investment adviser or as a broker dealer. If the investment adviser is going to execute an

agency cross transaction, the adviser must get the client's authorization in writing. The authorization may be pulled at any time verbally, and the adviser may not have solicited both sides of the trade. The investment adviser still maintains a duty to obtain the best execution for both clients and may not execute the cross at a price that favors one client over the other. The adviser must send notice to its clients annually detailing the number of all agency cross transactions completed by the adviser.

DISCLOSURES BY AN INVESTMENT ADVISER

An investment adviser must update its form ADV annually within 90 days of its fiscal year end. Additionally, the investment adviser must provide each client with an updated brochure annually within 120 days of the adviser's fiscal year end. The brochure must be provided free of charge and must provide a summary of material changes to the advisory firm, including:

- Conflicts of interest.
- Sources of recommendations.
- Location of customers' funds for advisers with custody.
- Any legal actions taken against the adviser.
- Material facts.
- Soft-dollar arrangements.

If the change to the investment adviser's business is material, it must be disclosed promptly. Of critical importance is to know what changes to the investment advisory firm are deemed material and when those changes must be disclosed. Most investment advisory firms other than small sole proprietorships are organized either as corporations or as partnerships. A material change to the ownership or control of the adviser is considered to be material and must be disclosed promptly. If the adviser is a corporation and one of the firm's major stockholders sells, pledges, or assigns its block of controlling voting shares, this would be seen as both material and as an assignment of the contract and must be disclosed promptly. If the nature of the transfer is deemed to be an assignment, the client would also have to give consent to continue the relationship. However, disclosure is not required if an officer of the corporation leaves. If the advisory firm is organized as a partnership and a major partner dies or departs from the partnership, this would be considered material and as an assignment. Therefore, the material change must be

disclosed promptly, and the client must give consent to continue the advisory relationship. However, if the partnership adds or removes minority partners, these events would not be deemed material.

An investment adviser may not:

- Borrow from a customer.
- Commingle customers' funds with the adviser's funds.
- Accept an order from a party not named on the account of the customer.
- Churn customer accounts.
- Make unsuitable recommendations.
- Charge unreasonable fees.

An investment adviser with custody of a customer's funds must:

- Segregate all customer funds and securities.
- Give the customer a written notice of the location of the funds.
- Establish a separate bank account for the customer's funds.
- Provide quarterly statements showing all transactions and the account status.
- Go through an annual surprise audit.

TAKENOTE!

The state securities administrator may or may not allow advisers to have custody of clients' funds. If custody is allowed, the adviser must notify the state that it has custody and adhere to all requirements relating to custody of client funds.

INVESTMENT ADVISER CONTRACTS

All investment adviser contracts must be in writing and must contain disclosures of:

- Length.
- Services to be provided.
- Fees to be charged and how they are assessed.