

# **Chapter Six**

## **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 if the firm has an office in the state. If the firm maintains an office within the state it must register with that state. An agent 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 their 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 they may or may not be required to register depending on whom they do business with. If a broker dealer does not have an office in the state and engages in securities transactions with the general public, then they must register. If a broker dealer with no office in the state conducts business exclusively with any of the following, they are 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)

## **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. 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

An agent is also exempt from registering if they represent an issuer in the sale of an exempt security such as:

- ✓ Banker's 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

An agent may also qualify for the de minimus exemption if they meet the following conditions:

- ✓ They are registered with the NASD
- ✓ 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 the 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 their registration is pending in that state.

## **Registering Broker Dealers**

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 consent to service of process. By signing the consent to service of process, the broker dealer appoints the administrator as their 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 (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 in that state.

### **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, they must post a surety bond to ensure their solvency. Broker dealers that meet the Securities Exchange Commission's (SEC) minimum net capital requirements are exempt from USA'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.

### **Registering Agents**

Most states require that agents successfully complete the Series 66 exam before they may conduct business within their state. In addition to successfully passing the Series 66, an agent 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

### **Test Focus!**

- ✓ An agent does not become registered in a state simply by passing the exam. An agent becomes 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 their registration has been terminated.

### **Mergers and Acquisitions of Firms**

If another 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 renewal application and pay a renewal fee.

### **Canadian Firms and Agents**

A Canadian firm or agent 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 \$25,000,000
- ✓ 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 minimus exemption

## **The National Securities Market Improvement Act of 1996**

The National Securities Markets Improvement Act of 1996, also known as the coordination act, 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 \$30,000,000
- ✓ Manages investment company portfolios
- ✓ 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. An investment adviser is required to register with the state if they manage less than \$25,000,000. An investment adviser who manages between \$25,000,000 and \$30,000,000 may choose to register either with the state or with the SEC. If the investment adviser thinks that their asset base will exceed \$30,000,000, they should register with the SEC. Investment advisers who register with the SEC must file form ADV part I. The SEC will normally grant the adviser's registration within 45 days of the adviser's filing or begin a hearing process to determine the adviser's eligibility to become registered. Advisers will also have to file form ADV part I with the SEC within 90 days of the adviser's fiscal year end to continue their federal level registration. If the adviser is no longer eligible to maintain a federal level registration they must file form ADVW within 90 days and become registered at the state level. If an investment adviser is based in a state that does not require the registration of investment advisers they must register with the SEC.

## **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 duly registered. Clerical and administrative employees are not considered Representatives and do not need to register. A Representative of an investment adviser has a much greater suitability obligation than a Representative of a broker dealer.

## **State Investment Adviser Registration**

An investment adviser must file the following with the state securities administrator before they become 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 customer's cash and securities, the investment adviser must maintain minimum net capital of \$35,000. If the adviser is unable to meet this requirement, they may post a surety bond. Deposits of cash and securities will alleviate the surety bond requirement. An adviser is 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 customer's accounts need to maintain a minimum of \$10,000 in net capital. An adviser 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. 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.

<b><u>Requirement</u></b>	<b><u>Broker Dealer</u></b>	<b><u>Investment Adviser</u></b>	<b><u>Agents</u></b>
<b>Net capital</b>	Yes	Yes	No
<b>Surety bond</b>	Yes	Yes	Yes
<b>Exams</b>	Yes	Yes	Yes
<b>Fees</b>	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 both broker dealers and 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 II 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 II 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

### **TAKE NOTE!**

A balance sheet must be given to clients if the adviser has custody of client funds or requires pre payment 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 and receives advisory fees and commissions from both parties. If the investment adviser is going to execute an agency cross transaction, they must get the advisory 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. Advisers who execute agency cross transactions must send clients an annual report detailing the number of agency cross transactions executed by the adviser and the amount of commission received by the adviser.

### **Disclosures by an Investment Adviser**

An investment adviser must disclose all of the following:

- ✓ Conflicts of interest
- ✓ Sources of recommendations
- ✓ Location of customer's funds for advisers with custody
- ✓ Any legal actions taken against the adviser
- ✓ Material facts
- ✓ The use of third party research to make recommendations

### **An investment adviser may not:**

- ✓ Borrow from a customer
- ✓ Comingle customer's 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 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 account status
- ✓ Go through an annual surprise audit

**TAKE NOTE!**

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 they have 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
- ✓ The amount of any prepaid fees to be returned upon cancellation of the contract
- ✓ A statement prohibiting the investment adviser from assigning the contract without the customer's consent
- ✓ A notification of any changes in the adviser's management
- ✓ Limits on the adviser's discretionary authority over the customer's account, if any

**TAKE NOTE!**

If an investment adviser uses an outside solicitor to refer business, such as an accounting firm, the client must get both the advisory's brochure and the solicitor disclosure document or solicitor's brochure.

**Additional Roles of Investment Advisers**

As the business services offered by various professionals have expanded, so has the definition of who must register as an investment adviser. Sports and entertainment representatives now often advise their clients on how or with whom to invest their earnings. As a result, the representative is considered an investment adviser, even if investment advice is only a small part of the services they perform. Individuals who advise pension funds on the merits of portfolio managers or who act as pension consultants must also register as investment advisers.

## **Private Investment Companies/Hedge Funds**

A private investment company or 3 C7 funds may charge performance-based compensation to clients, provided that the clients have a minimum of \$750,000 of assets under the adviser's management or have a net worth of \$1,500,000. Corporations with \$25 million in assets and individuals with at least \$5 million in investments may also participate.

## **Fulcrum Fees**

Advisers who manage accounts for investment companies or accounts with a value greater than \$1 million, if those accounts are not for trusts or retirement plans, may charge fulcrum fees. A fulcrum fee provides the adviser with additional compensation for outperforming a broad-based index such as the S & P 500 and less compensation for under performing the index. The amount of the additional compensation received for outperforming the index must be equal to the amount of compensation that would be lost for underperformance. The index used as the basis to determine the adviser's performance must contain similar securities and risks.

## **Wrap Accounts**

A wrap account is an account that charges one fee for both the advice received as well as the cost of the transaction. All clients who open wrap accounts must be given the wrap account brochure that will provide all of the information that is found on Form ADV part II.

## **Soft Dollars**

Brokerage firms will oftentimes provide investment advisers with services to assist the investment adviser in their business that go beyond execution and research. These services are provided in exchange for commission business and are known as soft dollars. The services received should normally be research related. However there are instances when the services received are used for other purposes. Investment advisers must ensure that the services received are for the benefit of the client and need to pay careful attention to the disclosure requirements relating to soft dollars. The SEC has divided soft dollar consideration into the following categories:

- ✓ Goods/Services
- ✓ Accounting Fees
- ✓ Association Membership Fees
- ✓ Cable Television
- ✓ Commission Rebates
- ✓ Computer Hardware
- ✓ Computer Software
- ✓ Conferences/Seminars
- ✓ Consulting Services
- ✓ Courier/Postage/Express Mail
- ✓ Custodial Fees
- ✓ Electronic Databases

- ✓ Employee Salary/Benefits
- ✓ Execution Assistance
- ✓ Industry Publications
- ✓ Legal Fees
- ✓ Management Fees
- ✓ Miscellaneous Expenses
- ✓ Office Equipment/Supplies
- ✓ On-line Quotation and News Services
- ✓ Portfolio Management Software
- ✓ Rent
- ✓ Research/Analysis Reports
- ✓ Telephone Expenses
- ✓ Travel Expenses
- ✓ Tuition/Training Costs
- ✓ Utilities Expenses

**TAKE NOTE!**

Not all of the above items are for the research benefit of clients.