

**THE REGULATION OF INVESTMENT ADVISERS AFTER THE NATIONAL  
SECURITIES MARKET IMPROVEMENT ACT OF 1996**

by William E. Doyle<sup>T</sup>

Recent changes in federal and state securities laws—particularly in the area of investment adviser regulation, will help regulators protect consumers from unscrupulous or just incompetent investment advisers. The individuals who actually interact with the public and render advice—the representatives will now have to be registered in Kentucky.

In late 1996, Congress passed the National Securities Markets Improvement Act “NSMIA” which produced sweeping changes in the regulatory scheme for investment advisers and their representatives.<sup>1</sup> In a nutshell, investment advisers are entities (usually companies but they can be sole proprietorships) which, for compensation, advise investors as to whether they should purchase or sell securities. Prior to enactment of the NSMIA, the various states and the United States Securities and Exchange Commission (“SEC”) had concurrent regulatory authority over investment advisers with some exceptions. Under the old rules, an investment adviser needed to register with the SEC and with each state in which it did business, either through a physical location or by mail and telephone. As a condition of its registration, the investment adviser was subject to examination by regulators of all the states in which it transacted business and by the SEC.

NSMIA established a new regulatory scheme whereby the SEC would primarily regulate to the exclusion of the states investment advisers with assets under management in excess of \$25 million. States would primarily regulate the smaller investment advisers.<sup>2</sup> The SEC also was granted exclusive authority over investment advisers that advise mutual funds, regardless of size. The precise meaning of terms such as “assets under management”<sup>3</sup> and the method of making such a valuation are defined by the SEC.<sup>4</sup> The two classes of investment advisers are also now referred to as “covered” advisers (registered with the SEC) and state registered advisers.

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<sup>1</sup> See 15 USC §80b-20, USC Public Law 104-290, National Securities Improvement Act of 1996, Section 301

<sup>2</sup> See 15 USC §80b-3a(a)(1)(A), PL 104-290, Section 203A

<sup>3</sup> See Rule 203A-1 Eligibility for Commission registration and Form ADV (17 CFR 279.1)

<sup>4</sup> See Instruction 7 to Form ADV, Section I

NSMIA left jurisdiction over the “smaller” investment advisers to the states. A multi-state adviser is now governed by the laws and rules of its home state, but only if the adviser is in compliance with regulations of and is registered in its home state.<sup>5</sup>

Some states require registration for the representatives or agents of an investment adviser as well as the firm itself. Kentucky did not do so in the past, but, effective July 15, 1998, the representatives or agents of a state registered investment adviser will need to be registered in Kentucky.<sup>6</sup> Furthermore, the representatives or agents of an investment adviser subject to SEC jurisdiction (the new “covered” adviser) will also have to register in Kentucky if the representative has a place of business in Kentucky, even though the firm itself will not have to register [Note however: Effective 8/31/98, if the rep has 5 or fewer clients in this state, per federal regulation change, the rep does not have to register with the state].<sup>7</sup> The firm in this case will make a “notice” filing in Kentucky which, in essence, consists of copies of the documents filed with the SEC.

States always maintain jurisdiction over fraudulent or deceptive conduct of an investment adviser and/or its representatives regardless of whether the adviser is covered or based in the state provided that jurisdiction otherwise attaches (i.e. minimum contacts).<sup>8</sup> A covered adviser would not be exempt from state securities antifraud statutes. However, only the SEC will now examine covered advisers and only the state regulators will examine the remaining investment advisers. The regulatory pie has now been divided.

This new regulatory scheme will ultimately enhance the ability of regulators to detect and protect against fraud. Whereas, under the old scheme regulatory oversight—and responsibility was shared, it now falls squarely with the federal regulator of the state regulator. That clear delineation of responsibility will enable the regulators to better focus limited resources to maximize protection of the investing public.

The Division of Securities will be sponsoring a ½ day program to educate Kentucky’s investment advisers about their new responsibilities under the Blue Sky Law on August 17, 1998, at the Marriott Griffin Gate in Lexington. More information about this free educational program may be obtained by

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<sup>5</sup> See 15 USC §80b-18a(b), PL 104-290, Section 222(b)

<sup>6</sup> See KRS 292.330(1)

<sup>7</sup> See KRS 292.330(2) and 15 USC §80b-3a(b)(1)(A), PL 104-290, Section 203A(b)(1)(A)

<sup>8</sup> See 15 USC §80b-3a(b)(2), PL 104-290, Section 203A(b)(2)

calling the Division at 1 800 223-2579. The chart that follows outlines the key filing and other requirements applicable to both state- and federally-registered investment advisers located in Kentucky.

# Investment Adviser Regulation In Kentucky Post NSMIA<sup>i</sup>

## State Regulated Investment Advisers Domestic (Principal Place of Business is Kentucky) State Regulated Advisers

Situation	Filing Requirements	Books and Records, Net Capital, Bonding.
1. Investment Adviser is a Domestic (Principal Place of Business is Kentucky) State Regulated Adviser, has place of business in Kentucky with less than six clients <sup>1</sup> in Kentucky.	➤ IA must register in Kentucky because of the domicile. The number of Kentucky clients is irrelevant.	➤ Kentucky Law and Regulations govern.
2. Investment Adviser is a Domestic (Principal Place of Business is Kentucky) State Regulated Adviser, has place of business in Kentucky with more than five clients in Kentucky.	➤ IA must register in Kentucky because of the domicile. The number of Kentucky clients is irrelevant.	➤ Kentucky Law and Regulations govern.

## Foreign (Principal Place of Business outside Kentucky) State Regulated Advisers

Situation	Filing Requirements	Books and Records, Net Capital, Bonding. <sup>9</sup>
1. Investment Adviser is a Foreign (Principal Place of Business outside Kentucky) State Regulated Adviser, has place of business in Kentucky with less than six clients in Kentucky.	➤ IA must register in Kentucky because of the presence of an actual place of business in Kentucky. The number of Kentucky clients is irrelevant.	➤ Foreign State Law and Regulations govern.
2. Investment Adviser is a Foreign (Principal Place of Business outside Kentucky) State Regulated Adviser, has place of business in Kentucky with more than five clients in Kentucky.	➤ IA must register because of the presence of an actual place of business in Kentucky. The number of Kentucky clients is irrelevant.	➤ Foreign State Law and Regulations govern.
3. Investment Adviser is a Foreign (Principal Place of Business outside Kentucky) State Regulated Adviser, has no place of business in Kentucky with less than six clients in Kentucky.	➤ IA does not have to register in Kentucky because of the de minimis rule. No registration or notice is required.	➤ Foreign State Law and Regulations govern.
4. Investment Adviser is a Foreign (Principal Place of Business outside Kentucky) State Regulated Adviser, has no place of business in Kentucky with more than five clients in Kentucky.	➤ IA must register because of the number of clients which exceeds the limit in the de minimis rule.	➤ Foreign State Law and Regulations govern.

<sup>9</sup> This Column is based on the assumption that the Foreign State Invest Adviser is properly registered in its home (principal place of business) state and in compliance with all applicable books and records and net capital requirements of the state in which it has its principal place of business. In the event it is not properly registered in the home state or not in compliance with all applicable books and records requirements or net capital requirements of the home state, it would be subject to the laws and regulations of Kentucky. See Title III—Investment Advisers Supervision Coordination Act, Sections 222 (b)(1) and (b)(2) and (c)(1) and (c)(2) of the National Securities Markets Improvement Act of 1996 (Public Law 104-290).

**Federal Covered Advisers (Registered with the S.E.C.)**

<b>Situation</b>	<b>Filing Requirements</b>	<b>Books and Records, Net Capital, Bonding.</b>
1. Investment Adviser is a Federal Covered Adviser (Registered with the S.E.C.), has place of business in Kentucky with less than six clients in Kentucky.	➤ IA must file a Notice in Kentucky.	➤ Federal Law and Regulations govern.
2. Investment Adviser is a Federal Covered Adviser (Registered with the S.E.C.), has place of business in Kentucky with more than five clients in Kentucky.	➤ IA must file a Notice in Kentucky.	➤ Federal Law and Regulations govern.
3. Investment Adviser is a Federal Covered Adviser (Registered with the S.E.C.), has no place of business in Kentucky with less than six clients in Kentucky.	➤ IA does not have to file anything in Kentucky. No registration or notice is required.	➤ Federal Law and Regulations govern.
4. Investment Adviser is a Federal Covered Adviser (Registered with the S.E.C.), has no place of business in Kentucky with more than five clients in Kentucky.	➤ IA must file a Notice in Kentucky.	➤ Federal Law and Regulations govern.

**Representatives of State Regulated Investment Advisers**

**Investment Adviser Representative is employed by a Domestic (Principal Place of Business is Kentucky) State Regulated Adviser**

<b>Situation</b>	<b>Filing Requirements</b>
1. Investment Adviser Representative is employed by a Domestic (Principal Place of Business is Kentucky) State Regulated Adviser, the Investment Adviser Representative has place of business in Kentucky with less than six clients in Kentucky.	➤ IA Representative must register in Kentucky (effective 7-15-98) because of place of business in Kentucky. The number of Kentucky clients is irrelevant.
2. Investment Adviser Representative is employed by a Domestic (Principal Place of Business is Kentucky) State Regulated Adviser, the Investment Adviser Representative has place of business in Kentucky with more than five clients in Kentucky.	➤ IA Representative must register in Kentucky (effective 7-15-98) because of place of business in Kentucky. The number of Kentucky clients is irrelevant.
3. Investment Adviser Representative is employed by a Domestic (Principal Place of Business is Kentucky) State Regulated Adviser. The Investment Adviser Representative has no place of business in Kentucky and has less than six clients in Kentucky. The IA Representative offers services in Kentucky.	➤ IA Representative must register in Kentucky (effective 7-15-98) because of the firm's place of business in Kentucky. Even though the IA Representative does not have more than five Kentucky clients, the firm's registration triggers registration for the IA Representative even for just one client in Kentucky.
4. Investment Adviser Representative is employed by a Domestic (Principal Place of Business is Kentucky) State Regulated Adviser, has no place of business in Kentucky and has more than five clients in Kentucky.	➤ IA Representative must register in Kentucky (effective 7-15-98) because of exceeding the de minimis rule.
5. Investment Adviser Representative is employed by a Domestic (Principal Place of Business is Kentucky) State Regulated Adviser that registers in Kentucky, but the Representative has no place of business in Kentucky and no clients in Kentucky.	➤ IA Representative does not file anything in Kentucky. No registration or notice is required.
6. Investment Adviser Representative is employed by a Domestic (Principal Place of Business is Kentucky) State Regulated Adviser, has at least one but less than six Kentucky clients and no place of business in Kentucky.	➤ The IA Representative must register as does the firm because the de minimis rule belongs to the firm and not the IA Representative. The IA Representative registers because the firm has a place of business in Kentucky.

**Representatives of State Regulated Investment Advisers—Continued**

**Investment Adviser Representative is employed by a Foreign (Principal Place of Business outside of Kentucky) State Regulated Adviser**

<b>Situation</b>	<b>Filing Requirements</b>
1. Investment Adviser Representative is employed by a Foreign (Principal Place of Business outside Kentucky) State Regulated Adviser, the Investment Adviser Representative has place of business in Kentucky with less than six clients in Kentucky.	➤ IA Representative must register in Kentucky (effective 7-15-98) because of the IA Representative's place of business in Kentucky. The number of Kentucky clients is irrelevant.
2. Investment Adviser Representative is employed by a Foreign (Principal Place of Business outside Kentucky) State Regulated Adviser, the Investment Adviser Representative has place of business in Kentucky with more than five clients in Kentucky.	➤ IA Representative must register in Kentucky (effective 7-15-98) because of the place of business in Kentucky. The number of Kentucky clients is irrelevant.
3. Investment Adviser Representative is employed by a Foreign (Principal Place of Business outside Kentucky) State Regulated Adviser, has no place of business in Kentucky with less than six clients in Kentucky. The Kentucky clients of the other IA Representatives in the firm plus the subject IA Representative does not total more than five.	➤ IA Representative does not need to register in Kentucky because of de minimis rule. However, if other IA Representatives in the firm have Kentucky clients, the de minimis option for the subject IA Representative could be lost for all of the IA Representatives. In that case (the firm having more than five Kentucky clients), all IA Representatives with Kentucky clients would have to register regardless of how many Kentucky clients each IA Representative served. <sup>10</sup>
4. Investment Adviser Representative is employed by a Foreign (Principal Place of Business outside Kentucky) State Regulated Adviser, has no place of business in Kentucky with more than five clients in Kentucky.	➤ IA Representative must register in Kentucky because of doing business in excess of the de minimis rule.
5. Investment Adviser Representative is employed by a Foreign (Principal Place of Business outside Kentucky) State Regulated Adviser that registers in Kentucky, but the Representative has no place of business in Kentucky and no clients in Kentucky.	➤ IA Representative does not file anything in Kentucky. No registration or notice is required.
6. Investment Adviser Representative is employed by a Foreign (Principal Place of Business outside Kentucky) State Regulated Adviser that registers in Kentucky, has at least one but less than six Kentucky clients and no place of business in Kentucky.	➤ The IA Representative must register as does the firm because the de minimis rule belongs to the firm and not the IA Representative. The IA Representative registers because the firm has to register.

<sup>10</sup> Note that in this situation the Investment Adviser (the firm) would likewise not have to register until such time as the firm had more than five (5) Kentucky clients.

### Representatives of Federal (Registered with the S.E.C.) Covered Advisers

Situation	Filing Requirements
1. Investment Adviser Representative is employed by a Federal Covered Adviser (Registered with the S.E.C.), has place of business in Kentucky with less than six clients in Kentucky.	➤ Effective 8/31/98, if the rep has 5 or fewer clients in this state, per federal regulation change, the rep does not have to register with the state.
2. Investment Adviser Representative is employed by a Federal Covered Adviser (Registered with the S.E.C.), the IA Representative has place of business in Kentucky with more than five clients in Kentucky.	➤ IA Representative must register in Kentucky.
3. Investment Adviser Representative is employed by a Federal Covered Adviser (Registered with the S.E.C.), has no place of business in Kentucky with less than six clients in Kentucky.	➤ IA Representative does not file anything in Kentucky. No registration or notice is required.
4. Investment Adviser Representative is employed by a Federal Covered Adviser (Registered with the S.E.C.), has no place of business in Kentucky with more than five clients in Kentucky.	➤ IA Representative does not file anything in Kentucky. No registration or notice is required.
5. Investment Adviser Representative is employed by a Federal Covered Adviser (Registered with the S.E.C.) that files a Notice in Kentucky, but the Representative has no place of business in Kentucky and no clients in Kentucky.	➤ IA Representative does not file anything in Kentucky. No registration or notice is required.
6. Investment Adviser Representative is employed by a Federal Covered Adviser (Registered with the S.E.C.) that files a Notice in Kentucky, has at least one but less than six Kentucky clients and no place of business in Kentucky.	➤ IA Representative does not file anything in Kentucky. No registration or notice is required.

<sup>1</sup> National Securities Markets Improvement Act of 1996 (Public Law 104-290), “NSMIA.”

<sup>2</sup> “Clients” does not include institutional type customers such as other investment advisers, broker-dealers, banks, savings institutions, trust companies, insurance companies, or investment companies as defined in the Investment Company Act of 1940 (i.e. mutual funds). In determining the number of Kentucky “clients,” those kinds of clients should not be counted. See KRS 292.310(7)(f)1. Also, for purposes of identifying the state for each “Kentucky” client, the resident state of the client should be controlling.