UNIT 7

Financial Reporting

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- LO 7.a **Recognize** the relationship between assets, liabilities, and owners' equity.
- LO 7.b **Identify** the effects on the balance sheet from certain corporate actions.
- LO 7.c **Recognize** income statement items.
- LO 7.d **Identify** the use of the statement of cash flows.
- LO 7.e **Distinguish** between the different forms used in SEC reporting.

Your exam will include approximately four questions from the topics covered in Unit 7.

INTRODUCTION

This unit deals with the methods used by publicly traded companies to report their financial results. Just as a credit card company evaluates your financial condition when determining if you are worthy of their credit card (and the amount of your credit limit), analysts view the company's financial statement to determine the strength of the issuer and growth and/or income opportunities for investors.

LESSON 7.1: THE USE OF FINANCIAL STATEMENTS

LO 7.a Recognize the relationship between assets, liabilities, and owners' equity.

A corporation's **financial statements** provide a fundamental analyst with the information needed to assess that corporation's profitability, liquidity, financial strength (ability of cash flow to meet debt payments), and operating efficiency. By examining how certain numbers from one statement relate to prior statements and how the resulting ratios relate to the company's competitors, the analyst can determine how financially viable the company is.

Publicly traded companies issue quarterly and annual financial reports to the SEC. A company's balance sheet and income statement are included in these reports.

Balance Sheet

The **balance sheet** provides a snapshot of a company's financial position at a specific point in time. It identifies the value of the company's **assets** (what it owns) and its **liabilities** (what it owes). The difference between these two figures is the corporation's **owners' equity**, or **net worth.**

The **balance sheet equation** is:

Assets – liabilities = owners' equity; or

Assets = liabilities + owners' equity.

The balance sheet gets its name from the fact that its two sides must balance. The balance sheet equation mathematically expresses the relationship between the two sides of the balance sheet. Simply stated, everything that is owned (assets) minus everything that is owed (liabilities) is equal to the net worth (owners' or shareholders' equity) of the entity.

Assets

Assets appear on the balance sheet in order of liquidity, which is the ease with which they can be turned into cash. Assets that are most readily turned into cash are listed first, followed by less liquid assets. Balance sheets commonly identify three types of assets: **current assets** (cash and assets easily turned into cash), **fixed assets** (physical assets that could eventually be sold), and **other assets** (usually intangible and only of value to the corporation that owns them).

Current Assets

Current assets include all cash and other items expected to be converted into cash within the next 12 months, including the following:

- Cash and equivalents include cash and short-term safe investments, such as money market instruments that can be readily sold, as well as other marketable securities.
- Accounts receivable include amounts due from customers for goods delivered or services rendered, reduced by the allowance for bad debts.
- Inventory is the cost of raw materials, work in process, and finished goods ready for sale.
- Prepaid expenses are items that a company has already paid for but has not yet benefited from, such as prepaid advertising, rents, insurance, and operating supplies.

Fixed Assets

Fixed assets are property, plant, and equipment. Unlike current assets, they are not easily converted into cash. Fixed assets, such as factories, have limited useful lives because wear and tear eventually reduce their value. For this reason, their cost can be **depreciated** over time and deducted from taxable income in annual installments to compensate for loss in value. They are shown at original cost less the accumulated depreciation. This value may be more, less, or about the same as the current market value.

Other Assets

Intangible assets are nonphysical properties, such as formulas, brand names, contract rights, and trademarks. Goodwill, also an intangible asset, reflects the corporation's reputation and relationship with its clients. The value of these assets may be written down against income through a process known as **amortization** (very similar to depreciation).

TAKE NOTE

Although intangible assets may have great value to the corporation owning them, they generally carry little value to other entities.

Liabilities

Total liabilities on a balance sheet represent all financial claims by creditors against the corporation's assets. Balance sheets usually include two main types of liabilities: **current liabilities** and **long-term liabilities.**

Current Liabilities

Current liabilities are corporate debt obligations due for payment within the next 12 months. These include the following:

- **Accounts payable**—amounts owed to suppliers of materials and other business costs
- **Accrued wages payable**—unpaid wages, salaries, commissions, and interest
- **Current long-term debt**—any portion of long-term debt due within 12 months
- **Notes payable**—the balance due on equipment purchased on credit or cash borrowed
- **Accrued taxes**—unpaid federal, state, and local taxes

TAKE NOTE

In Unit 20, we will discuss the various financial statement ratios. At this time, we do want to define one term related to our current topic. A corporation's *working capital* is the difference between its current assets and its current liabilities. Hopefully, that is a positive number.

Long-Term Liabilities

Long-term debts are financial obligations due for payment more than 12 months in the future. Examples would include bonds and mortgages.

TAKE NOTE

Long-term debts include mortgages on real property, long-term promissory notes, and outstanding corporate bonds.

TEST TOPIC ALERT

Under current accounting practice, deferred tax credits are treated as a liability.

Sample Balance Sheet

	Balance Sheet Amalgamated Widget as of Dec. 31, 2021		
ASSETS	Cash and equivalents	$5,000,000	$40,000,000
Current assets	Accounts receivable	15,000,000	
	Inventory	19,000,000	
	Prepaid expenses	1,000,000	
	Total current assets		
Fixed assets	Buildings, furniture, and fixtures	$40,000,000	$55,000,000
	(at cost less $10 million accumulated depreciation)	15,000,000	
	Land		
	Total fixed assets		
Other (intangibles, goodwill)		$5,000,000	$100,000,000
Total assets			
LIABILITIES AND NET WORTH	Accounts payable	$5,000,000	$10,000,000
Current liabilities	Accrued wages payable	4,000,000	
	Accrued taxes payable	1,000,000	
	Total current liabilities		
Long-term liabilities	8% 20-year convertible debentures		$50,000,000
Total liabilities			$60,000,000
Net worth	Preferred stock $100 par ($5 noncumulative convertible 200,000 shares issued)	$20,000,000	
	Common stock $1 par (1 million shares)	1,000,000	
	Capital in excess of par	4,000,000	
	Retained earnings	15,000,000	
Total net worth			$40,000,000
Total liabilities and net worth			$100,000,000

Shareholder Equity

Shareholder equity, also called **net worth** or **owners' equity**, is the stockholder claims on a company's assets after all of its creditors have been paid. Shareholder equity equals total assets less total liabilities. On a balance sheet, three types of shareholder equity are identified: capital stock at par, capital in excess of par, and retained earnings.

Capital Stock at Par

Capital stock includes preferred and common stock, listed at par value. **Par value** is the dollar value per share assigned when a corporation's owners (the stockholders) first contributed capital. Par value of common stock is an arbitrary value with no relationship to market price. As you saw in Unit 1, it plays an important role with preferred stock.

Capital in Excess of Par

Capital in excess of par, often called **additional paid-in capital, capital surplus,** or **paid-in surplus,** is the amount of money over par value that a company received when issuing its common stock. For example, if the par value was $1 per share and the stock was issued at $5 per share, there is a paid-in surplus of $4 per share.

Retained Earnings

Retained earnings, sometimes called **earned surplus** or **accumulated earnings**, are profits that have not been paid out in dividends. Retained earnings represent the total of all earnings held since the corporation was formed, less dividends paid to stockholders. Operating losses in any year reduce the retained earnings from prior years.

TEST TOPIC ALERT

Treasury stock is stock that has been issued and then reacquired by the issuing corporation. Those shares are no longer considered *outstanding* in the hands of the public because they are, so to speak, held in the corporation's "treasury." When a company has done this, the cost of those reacquired shares is shown in the owner's equity portion of the balance sheet as a negative number. This has the effect of reducing the company's net worth.

Capital Structure

A company's **capitalization** is the combined sum of its long-term debt and equity securities. The **capital structure** is the relative amounts of debt and equity that compose a company's capitalization. Some companies finance their businesses with a large proportion of borrowed funds; others finance growth with retained earnings from normal operations and little or no debt.

Looking at the balance sheet, a corporation builds its capital structure with equity and debt including the following four elements:

- Long-term debt
- Capital stock (common and preferred)
- Capital in excess of par
- Retained earnings (earned surplus)

EXAMPLE

(See the following table for reference and explanation of the following terms.) The total capitalization on the sample balance sheet is $90 million ($50 million in long-term debt, $20 million in preferred stock, and $20 million in common shareholders' equity). Remember, capital stock + capital in excess of par + retained earnings = shareholders' equity (net worth).

Capitalization Table	
Long-term debt	$50 million
Preferred stock (1 million shares @ $20 par value)	$20 million
Common stock (1 million shares @ $1 par value)	$1 million
Capital surplus (common stock issue price $4 per share)	$4 million
Retained earnings	$15 million
Total equity capital	$40 million
Total capitalization (long-term debt + equity)	$90 million

LO 7.b Identify the effects on the balance sheet from certain corporate actions.

If a company changes its capitalization by issuing stock or bonds, the effects will show up on the balance sheet.

Issuing Securities

The example balance sheet indicates the company issued 1 million shares of $1 par common stock. If it issues another 1 million shares, the net worth (shareholders' equity) will increase by the additional capital raised, and the amount of cash on the asset side of the balance sheet will increase.

Convertible Securities

When an investor converts a convertible debt security into shares of common stock, the amount of liabilities decreases, and the owners' equity increases. The changes are on the same side of the balance sheet, so there is no change to the assets.

Bond Redemption

When bonds are redeemed—that is, the debt is repaid—liabilities on the balance sheet are reduced. The offsetting change would be a decrease in cash on the asset side of the balance sheet. The company would have less debt outstanding, but it would also have less cash. The balance sheet balances. Therefore, because the current asset (cash) was used to redeem the long-term liability (bond), working capital is reduced. However, because there would no longer be semiannual interest payments due on the debt, the future effect of the retirement of the bonds would be to increase the company's cash flow.

Dividends

When a cash dividend on the company's stock is declared, retained earnings are lowered and current liabilities are increased. The declaration of a cash dividend establishes a current liability until it is paid. Once paid, it reduces cash in current assets and also reduces current liabilities.

Stock Splits

A stock split does not affect shareholders' equity. On the balance sheet, only the par value per share and number of shares outstanding change.

Financial Leverage

Financial leverage is a company's ability to use long-term debt to increase its return on equity. A company with a high ratio of long-term debt to equity is said to be **highly leveraged**.

Stockholders benefit from leverage if the return on borrowed money exceeds the debt service costs. But leverage is risky because excessive increases in debt raise the possibility of default in a business downturn.

In general, industrial companies with debt-to-equity ratios of 50% or higher are considered highly leveraged. However, utilities, with their relatively stable earnings and cash flows, can be more highly leveraged without subjecting stockholders to undue risk. If a company is highly leveraged, it is also affected more by changes in interest rates.

PRACTICE QUESTION

As a result of corporate transactions, a company's assets remain the same and its owners' equity decreases. Which of the following statements is **true**?

A. Prepaid expenses decrease.
B. Total liabilities increase.
C. Accrued expenses decrease.
D. Net worth increases.

Answer: B. Sometimes questions are best answered by analyzing the question before we even look at the answer choices. We are told in the question that assets have remained the same, but somehow the net worth (owners' equity) has gone down. If the balance sheet formula is Assets − Liabilities = Net worth, then somehow the liabilities must have increased. That seems to make choice B a straightforward answer, but let's just check the others to be sure. Prepaid expenses are an asset—it can't be choice A, because we know assets haven't changed. Choice D is so simple that students sometimes choose it because they think there is a "trick" somewhere. No trick here—if owners' equity goes down, that is the net worth, so we can't choose "net worth increases." Finally, accrued expenses are a liability, so if they decrease, net worth goes up, not down. If you take these questions step by step, they tend to be very logical.

PRACTICE QUESTION

Which of the following corporate actions will lead to an increase in a company's owners' equity?

A. Issuing $10 million of 6% $100 par preferred stock
B. Issuing $10 million of 4% debentures
C. Payment of a cash dividend to common shareholders
D. Redemption of outstanding debt securities at a price in excess of par value

Answer: A. Stock represents equity in a corporation; issuing additional stock is a straightforward method of increasing net worth (owners' equity). Issuing a debt security brings in cash, but that is offset by the new debt. Payment of a cash dividend reduces cash on hand but reduces the declared dividend current liability by an equal amount. Eliminating debt is good but, when done so at a price in excess of the par value results, is a decrease to owners' equity.

TAKE NOTE

The balance sheet reports what resources (assets) a company owns and how it has funded them. How the firm has financed the assets is revealed by the capital structure—for example, long-term debt and owners' equity (preferred stock, common stock, and retained earnings).

LO 7.c Recognize income statement items.

Income Statement

The **income statement,** sometimes referred to as the profit and loss or P&L statement, summarizes a company's revenues (sales) and expenses for a fiscal period, usually quarterly, year to date, or the full year. It compares revenue against costs and expenses during the period. Fundamental analysts use the income statement to judge the efficiency and profitability of a company's operation. Just as with the balance sheet, technical analysts generally ignore this information—it is not relevant to their charting schemes.

Components of the Income Statement

The various operating and nonoperating expenses on the income statement are discussed below.

Revenues indicate the firm's total sales during the period (the money that came in).

The **cost of goods sold (COGS)** is the costs of labor, material, and production (including depreciation on assets employed in production) used to create finished goods. Subtracting COGS from revenues shows the gross operating profit or gross margin. This *gross margin* is usually divided by the net sales or revenues and is shown as a percentage, sometimes referred to as the *margin of profit.* Pre-tax margin is determined by subtracting COGS and other operating costs (rent and utilities) from sales to arrive at net operating profit. The resulting figure is earnings before interest and taxes (EBIT).

Interest payments on a corporation's debt are not considered an operating expense. However, interest payments reduce the corporation's taxable income. **Pre-tax income,** the amount of taxable income, is operating income less interest payment expenses.

If dividends are paid to stockholders, they are paid out of net income after taxes have been paid. After dividends have been paid, the remaining income is added to retained earnings and is available to invest in the business.

TEST TOPIC ALERT

Please note the three terms above that we have put in boldface for you. **Revenue** (or sales), **cost of goods sold**, and **pre-tax income** are the three primary components of an income statement.

Think of it simply like this: the income statement shows (1) what came in, (2) what went out, and (3) how much is left (before taxes).

TAKE NOTE

Interest payments reduce a corporation's taxable income, whereas dividend payments to stockholders are paid from after-tax dollars. Because they are taxable as income to stockholders, dividends are taxed twice, whereas interest payments are taxed once as income to the recipient.

Accounting for Depreciation

As mentioned earlier when reviewing the balance sheet, fixed assets are shown at their cost minus accumulated depreciation. For these assets, which wear out over a period of time, tax law requires that the loss of value be deducted over the asset's useful life, longer for some assets and shorter for others (you won't have to know depreciation schedules). On the income statement, the allowable portion for the year is shown as an expense and, for our purposes, will generally be part of COGS. Remember, if the company uses accelerated depreciation, the expenses will be higher in the early years, resulting in lower pre-tax income (and lower income taxes) but higher income later on.

Fiscal Year Accounting

Many business entities prefer to end their accounting year on a date other than December 31 (calendar-year accounting). Any 12-month period used by a business that ends other than on December 31 is known as a fiscal year (the term *fiscal* is generally defined as something that pertains to financial matters). This term will be used many times when referring to required filings by investment advisers.

EXAMPLE

The following table should help you see some of the differences between balance sheet and income statement items.

Balance Sheet	Income Statement
Current liabilities	Revenues
Net worth	Cost of goods sold (COGS)
Retained earnings	Net income
Cash	Interest paid

Accounting Fundamentals

In addition to the information thus far presented, there are two additional accounting concepts you may be required to understand.

Audited vs. Unaudited Financial Statements

Businesses must know their financial position at all times. With today's technologies, it is much easier than only a few decades ago, when all bookkeeping was done manually. It is rare to find a business that does not produce financial information at least monthly, and many do so even more frequently. These financial reports are generally done by in-house staff and, even when done by an outside accounting firm, they are considered unaudited. That is, specific care has not been taken to examine every item. For normal operating purposes, these unaudited statements do the job. However, for formal reporting to the SEC (or other regulators) and to shareholders, an audited report is required. In an audited report, an independent (and independence is critical) auditor, most commonly a representative (or in the case of a large entity, a number of representatives) of a CPA firm, spends many hours poring over the books and records to verify and count everything.

TAKE NOTE

GAAP means *"generally accepted accounting principles."* That is the standard used for audited financial reports.

TEST TOPIC ALERT

Part of the audit is the auditor's opinion. The best is an unqualified opinion. That means the auditor has no qualms about certifying the audit. On the other hand, a qualified opinion means the auditor has some reservations about the accuracy or completeness of the information contained in the report.

Cash vs. Accrual Accounting

Smaller business enterprises tend to use the cash method of accounting, while larger ones base their financial reporting on the accrual method. How do these two methods differ? Primarily, it is the timing of when revenue and expenses are recognized. In the cash method, everything is "as received," while in the accrual it is when "booked." Let's look at an example.

EXAMPLE

ABC Comfort Systems sells home heating and air conditioning systems. They install a system in a home for $3,000 in May and, because they offer "90 days same as cash" terms, they receive the payment in August. Under the cash method, the $3,000 would not be entered on their books until actually received in August. Under the accrual method, the $3,000 would be recorded when the sale took place in May.

Footnotes

Footnotes to the financial statements identify significant financial and management issues that may affect the company's overall performance, such as accounting methods used, extraordinary items, accounting for inventory (FIFO or LIFO), pending litigation, and management philosophy.

Typically, a company separately discloses details about its long-term debt in the footnotes. These disclosures are useful for determining the timing and amount of future cash outflows. The disclosures usually include a discussion of the nature of the liabilities, maturity dates, stated and effective interest rates, call provisions and conversion privileges, restrictions imposed by creditors, assets pledged as security, and the amount of debt maturing in each of the next five years.

Also disclosed in the footnotes would be *off-the-books* financing arrangements such as debt guarantees.

TEST TOPIC ALERT

Footnotes are generally found on the bottom of the financial statements and can be several pages long. Here is an example of how you might be asked about footnotes on your exam:

PRACTICE QUESTION

Potential litigation for patent infringement would appear on a corporation's
A. balance sheet as a deferred asset.
B. footnotes.
C. income statement as an expense.
D. statement of potential litigation.

Answer: B. The footnotes to the financial statements carry information such as potential legal actions, accounting methods used, and off-book debt.

KNOWLEDGE CHECK 7.1

1. A company has filed for an initial public offering for its $10 par common stock. The IPO is priced at $35 per share. Where on the balance sheet is the extra $25 per share recorded?
   A. Capital surplus
   B. Retained earnings
   C. Distributed dividends
   D. Paid-in earnings
2. A corporation calls in $5 million of its outstanding 6% bonds. The call price is 103. The effect on the balance sheet is all of the following **except**
   A. current assets decrease.
   B. current liabilities decrease.
   C. long-term liabilities decrease.
   D. owners' equity decreases.
3. When a corporation's accounting year ends on a date other than December 31, the company is using
   A. a fiscal year.
   B. a non-calendar year.
   C. a Gregorian year.
   D. a lunar year.

LESSON 7.2: CASH FLOW ACCOUNTING

LO 7.d Identify the use of the statement of cash flows.

The cash flow statement reports a business's sources and uses of cash and the beginning and ending values for cash and cash equivalents each year. There are three components generating cash flow:

- operating activities;
- investing activities; and
- financing activities.

TEST TOPIC ALERT

Most financial professionals add revenues and expenses that do not involve cash inflows or outflows (e.g., cost allocations such as depreciation and amortization) back to the company's net income to determine the cash flow. As described previously, the cash flow statement will also reflect money from operations, financing, and investing, but not accounting changes.

Cash Flow from Operating Activities

Operating activities (all transactions and events that normally enter into the determination of operating income) include cash receipts (money coming in) from selling goods or providing services, as well as income from items such as interest and dividends. Operating activities also include cash payments (money going out), such as cost of inventory, payroll, taxes, interest, utilities, and rent. The net amount of cash provided (or used) by operating activities is the key figure on a statement of cash flows. Even though it would seem that interest and dividends would belong in investing activities, the accounting gurus put them here.

EXAMPLE

Sometimes using some numbers makes this concept much easier. If you take a look at the income statement we reviewed a few pages ago, you will see that this company's net income (bottom line, to use the vernacular) was $2,250,000. Among the $6 million in expenses deducted from the total revenues was $500,000 of depreciation. However, the company never "wrote a check" for that money; it is the amount of the original cost that it is allowed to write off as an expense each year as the fixed assets wear out. So, not only does the company have the net income remaining after all expenses and taxes, but it actually had another $500,000 in funds it could use, giving the company a total cash flow of $2,750,000.

Cash Flow from Investing Activities

Investing activities include transactions and events involving the purchase and sale of securities, land, buildings, equipment, and other assets not generally held for resale as a product of the business. It also covers the making and collecting of loans. Investing activities are not classified as operating activities because they have an indirect relationship to the central, ongoing operation of the business (usually the sale of goods or services).

Cash Flow from Financing Activities

All financing activities deal with the flow of cash to or from the business owners (equity financing) and creditors (debt financing). For example, cash proceeds from issuing stock or bonds would be classified under financing activities. Likewise, payments to repurchase stock (Treasury stock) or to retire bonds and the payment of dividends are financing activities as well.

TEST TOPIC ALERT

Cash flow from operations will primarily use items from the income statement, while cash flow from financing activities will use balance sheet items. Make sure you know which one the question is asking about. For example, liquidating an outstanding bond issue (paying off the debt) will have a profound impact on cash flow, and that uses information from the balance sheet (cash for the payoff, and no more debt remaining)

KNOWLEDGE CHECK 7.2

1. All of the following are measurements of cash flow **except**
   A. cash flow from financing activities.
   B. cash flow from investing activities.
   C. cash flow from operating activities.
   D. cash flow from sales activities.

2. Dividends received on investments held by a corporation are part of cash flow from which activities?
   A. Financing
   B. Investing
   C. Operating
   D. Sales

LESSON 7.3: SEC REPORTING

LO 7.e Distinguish between the different forms used in SEC reporting.

As we will learn in the next unit, in many cases, a security must be registered with the Securities and Exchange Commission (SEC) before being offered to the public. The registration rules are found in the Securities Act of 1933. Once registered, publicly traded corporations are required to periodically report to the SEC as specified in the Securities Exchange Act of 1934. One of the best sources of financial information is found in the reports required to be filed with the SEC by publicly traded companies. This information is available online at the SEC's website. The location is at EDGAR, which stands for Electronic Data Gathering, Analysis, and Retrieval of SEC filings. Among those filings, there are generally three that are used by fundamental analysts.

Form 8-K

This form is used to report newsworthy events to the SEC, thereby making them available to the public. Included are items such as change in management, change in the company's name, mergers or acquisitions, bankruptcy filings, and major new product introductions or sale of a product line. A Form 8-K even has to be filed when a member of the board of directors resigns over a disagreement. The 8-K is filed within four business days of the occurrence. This form is used only by domestic issuers; foreign issuers are exempt. Although ADRs are registered with the SEC, they too are exempt because the underlying security is a foreign issue.

TEST TOPIC ALERT

One thing that would not trigger a Form 8-K is the relocation of a wholly owned subsidiary. However, sale of that subsidiary would require a filing and that, like any other Form 8-K filing, must be done within four business days of the event.

Form 10-K

Most domestic public issuers must file an annual report to the SEC on Form 10-K. This report is a comprehensive overview of the company's business and financial condition and includes financial statements that have been audited by an independent accountant. Do not confuse this with the annual report to shareholders, which also contains an audited statement. The Form 10-K will generally contain more detailed financial information than the annual report, while the annual report will have much more detail about the company itself and its future plans. The filing deadlines depend upon the company's public float and are not testable information.

Form 10-Q

Because one year between filings is a long time and a lot can happen quickly, we also have Form 10-Q, which is filed quarterly (*Q* for quarterly). It contains unaudited financial statements, and it must be filed after each of the first three fiscal quarters of the year (no 10-Q is filed at the end of the fourth quarter—that information is taken care of by the filing of the 10-K).

Annual Reports

When it comes to publicly traded companies, in general, all shareholders must receive a copy of the issuer's annual report. For those too lazy to access EDGAR, this is the most detailed information they can get on the company's financial position. Unlike the Form 10-K, this is usually a professionally prepared piece that is just as much used for marketing purposes as it is for providing information. There is usually a welcoming letter from the CEO and/or Chairman of the Board, and it is generally loaded with beautiful pictures of smiling people (employees and customers) and the company's facilities. New plans for products and programs are discussed, and voting proxies are included.

TEST TOPIC ALERT

SEC rules state that a company may provide shareholders with a copy of the Form 10-K instead of sending an annual report.

KNOWLEDGE CHECK 7.3

1. A publicly traded corporation keeps its books on a calendar-year basis. An investor wanting the most up-to-date financial information in late August would view the company's
   A. June 30 Form 8-K.
   B. June 30 Form 10-Q.
   C. December 31 Form 10-K.
   D. July 31 Form 10-Q
2. A member of the LMP Corporation's board of directors has just resigned after a dispute with the board chair. This would be reported to the public on
   A. Form 8-K.
   B. Form 10-K.
   C. Form 10-Q.
   D. Form D.

KNOWLEDGE CHECK ANSWERS

Knowledge Check 7.1

1. **A** Capital surplus is the amount of premium paid by shareholders above par value. It may also be called paid-in capital or paid-in surplus, but it is not paid-in earnings.

   LO 7.a

2. **B** There is no change to current liabilities. Cash is used to pay for the called bonds. That reduces current assets. Those bonds, a long-term liability, are no longer on the books, so the long-term liabilities decrease. Because the company had to pay $5,150,000 to eliminate $5 million in debt, the net worth drops by that extra $150,000.

   LO 7.b

3. **A** Fiscal year accounting refers to any entity ending its accounting year on a date other that December 31. The largest user of a fiscal year is the U.S. government. For accounting purposes, the government's year begins on October 1 and ends September 30.

   LO 7.c

Knowledge Check 7.2

1. **D** Although sales (revenues) are a critical component of cash flow, there is no measurement using that term. Sales (revenues) are included in cash flow from operating activities.

   LO 7.d

2. **C** Even though one would think this would be part of investing activities, the accounting industry puts them into operating activities.

   LO 7.d

Knowledge Check 7.3

1. **B** Form 10-Q is prepared every quarter. Because this company operates on a calendar-year basis, those quarters end in March, June, September, and December. In August, the most recent information would be from the June 30 Form 10-Q.

   LO 7.e

2. **A** Form 8-K is the form used to report newsworthy events to the SEC, thereby making them available to the public. Resignation of a board member over a dispute is considered newsworthy.

   LO 7.e

UNIT 8

Regulation of Securities and Their Issuers

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- › LO 8.a **Identify** instruments that are defined as securities under the Uniform Securities Act.
- › LO 8.b **Identify** those who issue securities.
- › LO 8.c **Recognize** the securities exempt from registration under the Uniform Securities Act and the Securities Act of 1933.
- › LO 8.d **Recall** the exempt transactions under the Uniform Securities Act and the Securities Act of 1933.
- › LO 8.e **Recollect** the procedures for registering nonexempt securities under the Securities Act of 1933.
- › LO 8.f **Recollect** the procedures for registering nonexempt securities under the Uniform Securities Act.
- › LO 8.g **Identify** the methods of state registration of securities, including the antifraud provisions of the Uniform Securities Act.

Your exam will include approximately two questions from the topics covered in Unit 8.

INTRODUCTION

Before we can get started teaching about the rules and regulations, there are a few things we need to know. Because so much of the course deals with laws and regulations, it is necessary to know what laws are involved. When it comes to regulation of securities on the federal level, it will be largely the Securities Act of 1933. On the state level, it will be the Uniform Securities Act. When it comes to the regulation of investment advisers, on the federal level, there is the Investment Advisers Act of 1940. On the state level, it is the Uniform Securities Act (USA). When it comes to broker-dealers and their agents, on the federal level, it is the Securities Exchange Act of 1934 and, once again, on the state level, the USA. This exam is the property of NASAA, the North American Securities Administrators Association, the group of state, provincial, and Mexican regulators. Although the exam will ask about state and federal law, if it doesn't specify, the "default" choice is always state law. Let's investigate that law a bit.

LESSON 8.1: WHAT ARE SECURITIES AND WHO ISSUES THEM?

LO 8.a Identify instruments that are defined as securities under the Uniform Securities Act.

The Uniform Securities Act of 1956 (USA), as amended

The USA is Model State Securities Legislation. With the enactment of numerous state securities laws, commonly referred to as blue-sky laws, the need for uniformity in securities laws among the states arose. In 1956, the original Uniform Securities Act was drafted as model legislation for the separate states to adopt. As model legislation, the USA is not actual legislation; the USA is a template or guide that each state uses in drafting its securities legislation. The securities laws of most states follow the USA very closely and, in many cases, almost exactly.

TAKE NOTE

The term **state** means any of the 50 states; any territory or possession of the United States (such as American Samoa, Guam, and the Virgin Islands); the District of Columbia; and Puerto Rico.

TEST TOPIC ALERT

The exam will test your knowledge of the Uniform Securities Act, not the specifics of your state's securities legislation. The USA is periodically updated to adjust to developments in the securities markets through the passage of Model Rules. You will be tested on the 1956 version of the USA used by the **North American Securities Administrators Association (NASAA),** the advisory body of state securities regulators responsible for the content of the exam. The exam requires that you not only know what the USA says but also are able to apply the law to concrete situations. General knowledge of the law is not enough to pass the exam; you will be asked to apply the law to situations that may arise in the course of business.

Definition: Administrator. Possibly the most used term in the exam is **Administrator.** Who or what is this? Although some states may use other terms to describe this position, the exam will only use the word *Administrator* to refer to the office or agency that has the complete responsibility for administering the securities laws of the state. Therefore, the Administrator has jurisdiction over almost all securities activity that emanates from his state as well as that received in his state. The Administrator has jurisdiction over the registration of securities professionals and securities. She has the power to make rules and issue orders. She can deny, suspend, or revoke registrations. Yes, there are some limitations on the Administrator's powers (and those will be covered in this course), but overall, this is one very powerful person.

There are two other terms that will be covered in great detail in following units, but, in the event you are not familiar with them, we'll define **broker-dealer** and **agent.**

Broker-dealers (BDs) are in the business of buying and selling securities for their customers (investors) and for their own accounts. Agents, commonly referred to as registered representatives or the old-fashioned term, stockbrokers, are the individuals who represent broker-dealers in dealing with customers. The BDs are the entity the agents work for. In Unit 11, you'll get the entire story.

This unit discusses the procedures for the registration of securities as well as their exemptions from registration. For a securities transaction to be lawful under the Uniform Securities Act (USA), the security itself must be registered unless it or the transaction is exempt from registration requirements. In addition, we'll also review some of the SEC's regulations dealing with this subject as found in the Securities Act of 1933.

Perhaps the most important term in the USA is the term *security*. Why is it so important? The reason is simple: the USA applies only to those financial instruments that are securities. The purchase, sale, or issuance of anything that is not a security is not covered by the act. The definition of a security, however, is complex. Over the years, courts have determined case by case what constitutes a security. The U.S. Supreme Court, in the Howey decision, defined the primary characteristics of what constitutes a security by concluding that an investment contract is a security. For an instrument to be a security, the court held, it must constitute (1) an investment of money (2) in a common enterprise, (3) with the expectation of profits, (4) to be derived primarily from the efforts of a person other than the investor. A **common enterprise** means an enterprise in which the fortunes of the investor are interwoven with those of the person offering the investment, a third party, or other investors.

The USA provides a comprehensive list of more than a dozen financial instruments (many of which you've never heard of) that are securities under the act and therefore covered by its provisions. Rather than waste your time with the list (we've included it after the Practice Question), please focus on the six items that are not securities and you'll get any question you are given correct. The following six items are **not** securities under the act:

- An insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed sum of money either in a lump sum or periodically (this is basically any product from a life insurance company that does not use the word "variable")
- Interest in a retirement plan, such as an IRA or 401(k) plan
- Collectibles
- Commodities such as precious metals and grains, including futures and forward contracts
- Condominiums used as a personal residence
- Currency

Unit 8

TEST TOPIC ALERT

The exam will want you to know what is and what is not a security. We suggest that you concentrate on learning the six that are not securities because they are much easier to remember, and you will still be able to answer the questions correctly. Let's try a question so that you can see what we mean.

PRACTICE QUESTION

Which list of instruments below is **not** composed of securities?

A. Stock, treasury stock, rights, warrants, and transferable shares
B. Voting trust certificates and interests in oil and gas drilling programs
C. Commodity futures contracts and fixed payment life insurance contracts
D. Options on securities and interests in multilevel distributorship arrangements

Answer: C. Commodity futures contracts and fixed payment life insurance contracts are included in our list of six items that are not securities.

PRACTICE QUESTION

Which of the following is defined as a security under the Uniform Securities Act?

A. A guaranteed, lump-sum payment to a beneficiary under a modified endowment policy
B. Fixed, guaranteed payments made for life or for a specified period under an annuity contract
C. Commodity futures contracts
D. An investment contract

Answer: D. An investment contract is defined as a security under the Uniform Securities Act. In fact, the term is often used as a synonym for a security. A guaranteed, lump-sum payment to a beneficiary is an endowment policy excluded from the definition of a security. Fixed, guaranteed payments made for life or for a specified period are fixed annuity contracts not defined as securities. Commodity futures contracts and the commodities themselves are not securities. It is much easier to remember what is not a security than what is.

Securities Under the Uniform Securities Act

The USA does not define the term *securities* but provides a comprehensive list of financial instruments that are securities under the act and, therefore, are covered by its provisions. Under the Uniform Securities Act, among the many items included in the definition of **security** are any:

- stock;
- bond;
- debenture;
- evidence of indebtedness, such as a promissory note;
- collateral trust certificate;
- preorganization certificate or subscription;
- investment contract;
- voting trust certificate;
- certificate of deposit for a security (ADRs, not a bank CD);
- certificate of interest or participation in an oil, gas, or mining title or lease, or in payments out of production under such a title or lease;
- put, call, straddle, or other option trading on an exchange or OTC;
- any interest or instrument commonly known as a security; or
- warrant or right to subscribe to or purchase any of the above.

Nonsecurity Investments

Although collectibles, fixed annuities, precious metals, grains, real estate, and currencies can be attractive investments, they are not securities. Because these items are not securities, their sale is not regulated by state securities law. Furthermore, if a registered agent commits fraud in the sale of any of these items, he has not committed a violation of any state securities law. He has violated the antifraud provisions of another act prohibiting fraudulent commercial transactions.

An individual's direct ownership of an automobile is not a security—it is just ownership of a car. However, if that individual makes an investment of money in the stock of an automobile manufacturer with the expectation of making money due to the efforts of the company's management skill, he has purchased a security. In the same manner, if a condominium is purchased in a resort area with the goal of placing it into a rental pool and renting it out most of the year, and it is used only for personal vacation time, the condo is considered a security because there is a profit motive, typically reliant on the efforts of a third party—the rental agent. On the other hand, if the individual has chosen to live in the condominium as a personal residence, it is a home, not a security.

EXAMPLE

Annuities with fixed payouts are not securities, but variable annuities are because they are dependent on the investment performance of securities within the annuity.

LO 8.b Identify those who issue securities.

Issuer

An **issuer** is any person who issues (distributes) or proposes to issue a security. The most common issuers of securities are companies or governments (federal, state, and municipal governments and their agencies and subdivisions).

If an issuer is nonexempt (not exempt from registering its securities) it must generally register its securities in the states where they will be sold under one of the registration methods described in this unit.

TEST TOPIC ALERT

This is very strange wording, but it might well appear on your exam. Under the Uniform Securities Act, with respect to certificates of interest; participation in oil, gas, or mining titles or leases; or in payments out of production under such titles or leases, there is not considered to be any issuer.

Issuer Transaction

An issuer transaction is one in which the proceeds of the sale go to the issuer. All newly issued securities, such as an initial public offering (IPO), are issuer transactions. In other words, when a company raises money by selling (issuing) securities to investors, the proceeds from the sale go to the company itself.

EXAMPLE

State X issues bonds as a way of borrowing money so that the state government can function. The state is the issuer of those bonds. Typically, they will be purchased by a client of a broker-dealer whose account is handled by an agent of the firm. This would be an issuer transaction because the proceeds of the sale of the bonds would go to State X, the issuer.

Nonissuer Transaction

A **nonissuer transaction** is one in which the proceeds of the sales do not go, directly or indirectly, to the entity that originally offered the securities to the public. The most common instance of this is everyday trading on exchanges such as the New York Stock Exchange or Nasdaq. In a nonissuer transaction, the proceeds of the sale go to the investor who sold the shares. Because the shares are not new, we refer to this as *secondary trading*.

EXAMPLE

Using our previous example, if the investor who purchased those State X bonds decided to sell them, she would contact her agent at the brokerage firm where she has an account. The agent would then arrange for a sale to an interested buyer. In this case, because the proceeds of the bond sale would go to the investor, this is a nonissuer transaction, or secondary transaction (like when you sell your old car, it is a second-hand sale: the manufacturer received the money when the product was initially sold [primary] and you receive the money now [secondary]).

Initial or Primary Offering

An issuer transaction involving new securities is called a primary offering. If it is the first time an issuer distributes securities to the public, it is called an initial public offering (IPO). All primary offerings are issuer transactions because the issuer (the company) receives the proceeds from the investor investing in the company.

EXAMPLE

The first time that ABC Shoe Co. issued shares to the public, ABC Shoe engaged in an IPO or an initial primary offering because it received the proceeds from distributing its shares to the public. After ABC Shoe went public, subsequent transactions between investors through agents of broker-dealers were nonissuer (secondary) transactions.

Can an issuer have more than one primary offering? Yes, it happens with mutual funds every day. As you learned in Unit 3, open-end investment companies are constantly issuing new shares. They have a primary every day. However, they, like any other issuer, can only have one IPO. Whenever a corporation wishes to raise additional equity capital, it can issue additional new shares. These shares generally come from the authorized but unissued shares. There are several terms used for these additional primary offerings, such as *follow-on offering* or **additional primary offering (APO)**.

The easiest way to identify a primary offering is to "follow the money." If the funds wind up in the coffers of the issuer, it is probably a primary offering or a primary distribution.

KNOWLEDGE CHECK 8.1

1. Which of the following is included in the Uniform Security Act's definition of a security?
   A. An individual's vested interest in his 401(k) plan
   B. Fixed, guaranteed annuity payments made for life or for a specified period
   C. Commodity futures contracts
   D. A U.S. Treasury bond
2. A primary transaction is
   A. the first transaction between two parties in the over-the-counter market.
   B. a sale between investors of securities traded on the New York Stock Exchange.
   C. a new offering of an issuer sold to investors.
   D. when the proceeds of the sale go to the selling party.

LESSON 8.2: EXEMPT SECURITIES UNDER STATE AND FEDERAL LAW

LO 8.c Recognize the securities exempt from registration under the Uniform Securities Act and the Securities Act of 1933.

Later in this unit we are going to cover the registration of securities. Before doing that, it is important to learn that not all securities must register. Some, primarily because of the nature of the issuer, are granted an exemption from registration. Those are known as exempt securities. Those are the subject of this lesson. In other cases, the nature of the way in which the security is bought or sold results in an exemption from registration. We call those exempt transactions, and they are the subject of the next lesson.

Exemptions from Registration Under the Uniform Securities Act

Under the Uniform Securities Act, the exemptions discussed in this LO refer to an exemption from the act's registration and sales literature filing requirements. In certain situations, the USA exempts both securities and transactions. A security, a transaction, or both can be exempt.

An **exempt security** retains its exemption when initially issued and in subsequent trading. However, justification as an **exempt transaction** must be established before each transaction.

The USA provides for a number of categories of exempt securities and even more categories of exempt transactions. Those securities that are **nonexempt** must register unless sold in exempt transactions. A special category of securities, *federal covered securities* (discussed later in this LO), do not register with the Administrator but may, especially in the case of investment companies, have to file notice with the Administrator. As mentioned above, an exempt security retains its exemption at its initial issue and in subsequent trading.

An exemption for a transaction, on the other hand, must be established with each transaction. Provided it is in the public interest, the state Administrator can deny, suspend, or revoke any securities transaction exemption other than that of a federal covered security. This action may be taken with or without prior notice (summarily).

TAKE NOTE

A security is exempt because of the nature of the issuer, not the purchaser.

Exempt securities under the Uniform Securities Act include the following:

- **U.S. and Canadian government and municipal securities.** These include securities issued, insured, or guaranteed by the United States or Canada, by a state or province, or by their political subdivisions, (states or provinces, cities, counties, etc.).
- **Foreign government securities.** These include securities issued, insured, or guaranteed by a foreign government with which the United States maintains diplomatic relations. However, unlike U.S. or Canadian issues, political subdivisions are not included (unless guaranteed by the sovereign government).
- **Depository institutions.** These include securities that are issued, guaranteed by, or are a direct obligation of a depository institution. The USA divides them into the following categories: (1) any security issued by and representing an interest in or a debt of, or guaranteed by, any bank organized under the laws of the United States, or any bank, savings institution, or trust company organized and supervised under the laws

of any state;* (2) any security issued by and representing an interest in or a debt of, or guaranteed by, any federal savings and loan association, or any building and loan or similar association organized under the laws of any state and authorized to do business in this state; and (3) any security issued or guaranteed by any federal credit union or any credit union, industrial loan association, or similar association organized and supervised under the laws of this state. Please note that for categories (2) and (3), if the institution is not federally chartered, then it must be authorized to do business in the state (under the supervision of a regulator in that state).

- **Insurance company securities.** These include securities issued, insured, or guaranteed by an insurance company authorized to do business in the state. Insurance company securities refer to the stocks or bonds issued by insurance companies, not the variable life policies and variable annuities sold by the companies.
- **Public utility and common carrier securities.** These include any security issued or guaranteed by a public utility or public utility holding company, or an equipment trust certificate issued by a railroad or other common carrier regulated in respect to rates by federal or state authority; or regulated in respect to issuance or guarantee of the security by a governmental authority of the United States, any state, Canada, or any Canadian province.
- **Securities issued by nonprofit organizations.** These include securities issued by religious, educational, fraternal, charitable, social, athletic, reformatory, or trade associations. "Nonprofit" is the key word.
- **Securities of employee benefit plans.** This includes any investment contract issued by an employee stock purchase, savings, pension, or profit-sharing plan.
- **Certain money market instruments.** Commercial paper and banker's acceptances are the two most common examples.

TAKE NOTE

The five items listed with an asterisk (*) are the only cases where an individual representing the issuer in the sale of its securities is excluded from the definition of an agent. This concept will be explained in LO 11.d.

TAKE NOTE

A promissory note (commercial paper) that matures within nine months, is issued in denominations of at least $50,000, and receives one of the three highest ratings by a nationally recognized rating agency is exempt from registration requirements. Please note that this is the only case where a security's rating is part of the registration or exemption under the Uniform Securities Act.

Exemption for Federal Covered Securities

The National Securities Markets Improvement Act of 1996 (NSMIA) brought two significant changes to the industry. The first was the creation of the federal covered security. We'll get to that in a moment. The other part of the law effectively divided the responsibility for regulating investment advisers between the states and the SEC by creating the category of registration known as a federal covered adviser. We'll get into that in the next unit.

Of importance to this unit is the term *federal covered security*, a security that is exempt from registration on the state level. State securities registration requirements were preempted with respect to federal covered securities. However, states may require notice filings, consisting of filing fees and copies of documents filed with the Securities and Exchange Commission (SEC), primarily in the case of registered investment companies (e.g., mutual funds).

The major categories of federal covered securities (as defined in the NSMIA), which therefore cannot be regulated by state securities Administrators (except for violating antifraud provisions), include:

- securities issued by an open-end or closed-end investment company, unit investment trust, or face-amount certificate company that is registered under the Investment Company Act of 1940;
- securities listed on the New York Stock Exchange, the NYSE American LLC (formerly known as the American Stock Exchange [AMEX]), the Nasdaq Stock Market, and (not tested) several other U.S. exchanges. In addition, any security equal in seniority (rights or warrants) or senior to these securities (bonds and preferred stock) is also considered federal covered;
- securities offered pursuant to the provisions of **Rule 506(b)** or **506(c) of Regulation D** under the Securities Act of 1933 (qualifying under the private placement transaction exemption); and
- most securities exempt from registration under the Securities Act of 1933 (you do not have to know the exceptions other than the one we're going to describe below). If the federal government says the security does not have to register, no state can overstep that. Municipal bonds are included in the list of securities exempt from registration under federal (and state) law. However, under the NSMIA, if the municipal issuer is located in the state in which the securities are being offered, that security is not considered a *federal covered security*.

EXAMPLE

A bond issued by the city of Columbus, OH, is a federal covered security everywhere but in the state of Ohio. The effect of this is that no state regulator can enforce any of their rules against the bond. But, in the state of Ohio, even though the security is exempt under Ohio's securities laws, the Administrator could request that the issuer (the city) furnish certain details about the issue. This Columbus, OH, bond is still exempt from registration under both state and federal law, but, in Ohio, it is not known as a federal covered security (everywhere else, it is).

TAKE NOTE

It is important to note that registering a security with the SEC does not automatically make it federal covered. Yes, that is true of investment companies and those securities listed on certain stock exchanges and the Nasdaq Stock Market, but there are tens of thousands of stocks registered with the SEC that trade in the over-the-counter market (e.g., OTC Markets Group), and they are *not* federal covered. Furthermore, a security does not have to be registered with the SEC to be included in the definition of federal covered security. For example, U.S. government and municipal securities are exempt from registration with the SEC and are included in NSMIA's list of federal covered securities.

TAKE NOTE

Although investment company securities such as mutual funds are federal covered securities, the Uniform Securities Act allows states to impose filing fees on them under a process called notice filing, as described in LO 8.g.

PRACTICE QUESTION

Which of the following securities is **not** exempt from the registration and advertising requirements of the Uniform Securities Act?

A. Shares of Commonwealth Edisin, a regulated public utility holding company
B. Securities issued by the nonprofit Carnegee Endowment for Peace
C. Securities issued by a bank that is a member of the Federal Reserve System
D. Variable annuity contracts issued by Metrodential Insurance Company, licensed to do business in the state

Answer: D. Variable annuities (whose performance depends on the securities in a segregated fund) are nonexempt, which means they are covered by the act and have to register. Shares in public utilities, charitable foundations, and banking institutions that are members of the Federal Reserve System are included in our list of exempt securities.

Exempted Securities Under the Securities Act of 1933

The exemptions under federal law are similar to those under state law, but there are some significant differences. As a NASAA exam, the exam will focus on the state laws, but you should be familiar with the federal ones as well.

The Securities Act of 1933 makes it unlawful to sell or deliver a security through any instrument of interstate commerce unless a registration statement is in effect. However, certain securities are exempted from the registration requirements of the act. The following issues qualify as exempted securities:

- Any security issued or guaranteed by the United States, any state, or any political subdivision of a state (all federal government issues and municipal securities are exempted securities). Note that Canadian securities are not included in this exemption (NASAA membership includes Canadian Administrators)
- Any commercial paper that has a maturity at the time of issuance of no more than nine months (270 days), with the stipulation that the proceeds are to be used by the issuer to increase working capital and not for the purchase of fixed assets; there is no minimum denomination or rating requirement similar to that found in the Uniform Securities Act
- Any security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, or charitable purposes and not for pecuniary profit
- Any interest in a railroad equipment trust (for purposes of the law, *interest in a railroad equipment trust* means any interest in an equipment trust, lease, or other similar arrangement entered into, guaranteed by, or for the benefit of a regulated common carrier to finance the acquisition of rolling stock, including motive power)
- Any security issued by a federal or state bank, savings and loan association, building and loan association, or similar institution

TAKE NOTE

The exemption described for banks does not apply to bank holding companies. Most of the large U.S. banks today are owned by holding companies.

Rule 147 Exemption

Any security issued under this rule qualifies as an exempt security under federal law but is not exempt under the Uniform Securities Act and will probably have to register with the state.

This exemption from federal registration applies to any security offered and sold only to persons resident within a single state, where the issuer of such security is a person whose principal place of business is located within such state. *Principal place of business* means the location from which the officers, partners, or managers of the issuer primarily direct, control, and coordinate the activities of the issuer.

The Rule 147 exemption is available only if the entire issue is offered and sold exclusively to residents of a single state. If any sales take place to nonresidents, the entire issue loses its exemption. The purpose of this exemption is to allow issuers to raise money on a local basis, provided the business is operating primarily within that state. The following conditions must be met in order to have a distribution qualify as an intrastate offering exempt from federal registration:

- The securities must be offered or sold exclusively to persons who have their principal residence within the state where the issuer's principal place of business is located.
- For six months from the date of the sale by the issuer to that purchaser, resales of any part of the issue by that person will be made only to persons resident within the same state.
- The issuer must have a "reasonable belief" that the investor is a resident of the state.
- It is required that issuers obtain a written representation from each purchaser as to residency.
- The issuer must place a prominent legend on the certificate disclosing to offerees and investors the limits on resales, among other things.
- A minimum of one of the following conditions must be met:
  - At least 80% of the issuer's gross revenue must be derived from operations within the state.
  - At least 80% of the proceeds of the offering must be used for business purposes within the state.
  - At least 80% of the issuer's assets must be located within the state.
  - A majority of the issuer's employees must be located in the state.

Rule 147A

Rule 147A has the same requirements as the Rule 147 exemption, *except*

- Issuers may be incorporated or organized outside of the state in which they make the offering under Rule 147A, provided their principal place of business is in the state (for example, the corporation could be incorporated in Delaware but have its principal place of business in Idaho); and
- Issuers relying on Rule 147A may make offers available to out-of-state residents such as general solicitation or general advertising on the internet or other means, so long as sales are made only to in-state residents, while Amended Rule 147 requires that issuers make offers and sales only to in-state residents.

EXAMPLE

So, to summarize, here are the most testable changes:

- The "residency" rule for issuers only requires **one** of the three 80% conditions or the fourth—a majority of the employees are located in the state.
- The resale restriction is **six** months from the date of purchase by the investor.

- The rules refer to the term "principal place of business" to mean the location from which the officers, partners, or managers of the issuer primarily direct, control, and coordinate the activities of the issuer. This must always be in the state.
- Only Rule 147A permits an issuer to be incorporated in a state other than the state of residency—e.g., be incorporated in State A and have its principal place of business in State B.
- Only Rule 147A permits an issuer to make offers out of state, but all purchasers are still required to be in-state residents.

PRACTICE QUESTION

Both Rule 147 and Rule 147A require that the issuer meet residency requirements. Meeting which of the following is **not** one of those requirements?

A. At least 80% of the issuer's assets are located in the state.
B. At least 80% of the issuer's gross revenue must be derived from operations within the state.
C. At least 80% of the proceeds of the offering must be used for business purposes within the state.
D. At least 80% of the issuer's employees must be located in the state.

Answer: D. The requirement is that a majority of the issuer's employees are located in the state, not at least 80%.

KNOWLEDGE CHECK 8.2

1. Which of the following securities is *not* exempt from the registration and sales literature filing requirements of the Uniform Securities Act?
   A. Shares of investment companies registered under the Investment Company Act of 1940
   B. Shares sold on the Nasdaq Stock Market
   C. AAA rated promissory notes of $100,000 that mature in 300 days
   D. Bonds issued by Saskatchewan, Canada
2. Four months ago, one of your clients purchased 100 shares of stock that was sold under a Rule 147 exemption. He has just called to inform you that he has sold those shares to his neighbor at a nice profit. Under the provisions of the Rule 147 resale restrictions,
   A. the client had to wait at least 6 months from the date of the last sale by the issuer of any part of the issue.
   B. the resale restrictions now pass to the buyer.
   C. the resale restrictions only apply to residents of another state.
   D. the resale must be made through the broker-dealer who made the original sale.

LESSON 8.3: EXEMPT TRANSACTIONS UNDER STATE AND FEDERAL LAW

LO 8.d Recall the exempt transactions under the Uniform Securities Act and the Securities Act of 1933.

Exempt Transactions Under the Uniform Securities Act

Before a security can be sold in a state, it must be registered unless exempt from registration or traded in an exempt transaction. This section covers exemptions for transactions that take place in a state.

There are many different types of **exempt transactions**. We begin by focusing on those most likely to be on your exam and finish with several others.

- **Isolated nonissuer transactions.** Isolated nonissuer transactions include secondary (nonissuer) transactions that occur infrequently (very few transactions per year; the exact number varies by state). However, these usually do not involve securities professionals. In the same manner that individuals placing a "for sale by owner" sign on their front lawns do not need a real estate license, one individual selling stock to another in a one-on-one transaction is engaging in a transaction exempt from the oversight of the Administrator, because the issuer is not receiving any of the proceeds, and the parties involved are not trading as part of a regular practice.
- **Unsolicited brokerage transactions.** These include transactions initiated by the client, not the agent. This is probably the most common of the exempt transactions. If a client calls a registered agent and requests that the agent buy or sell a security, the transaction is an unsolicited brokerage transaction exempt from state registration. But the Administrator may by rule require that the customer acknowledge upon a specified form that the sale was unsolicited, and that a signed copy of the form be kept by the broker-dealer for a specified period.
- **Underwriter transactions.** These include transactions between an issuer and broker-dealers performing in the capacity of an underwriter (such as a firm commitment underwriting) as well as those between underwriters themselves (as when functioning as members of a selling syndicate).
- **Bankruptcy, guardian, or conservator transactions.** Transactions by an executor, administrator, sheriff, marshal, receiver, guardian, or trustee in *bankruptcy* are exempt transactions. Please note that a custodian under UGMA or UTMA is not included in this list and that the only trustee is one in bankruptcy.
- **Institutional investor transactions.** These are primarily transactions with financial institutions such as banks, insurance companies, and investment companies, and there is no minimum order size used to define these trades.
- **Limited offering transactions.** These include any offering, called a private placement, directed at not more than 10 persons (called *offerees*) other than institutional investors during the previous 12 consecutive months, provided that
  - the seller reasonably believes that all of the noninstitutional buyers are purchasing for investment purposes only,
  - no commissions or other remuneration is paid for soliciting noninstitutional investors, and
  - no general solicitation or advertising is used.

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Unlike federal law, where the private placement rule restricts the number of purchasers, the USA restricts the number of offers that may be made.

The number 10 is the figure that will be tested. But an Administrator may want to reduce it, for example, for uranium stocks or oil royalties, or increase it for a closely held corporation that wants to solicit 20 or 30 friends and relatives of the owners for additional capital. As we continue to learn, the Administrator has a great deal of power.

- **Preorganization certificates.** An offer or sale of a preorganization certificate or subscription is exempt if
  - no commission or other remuneration is paid or given directly or indirectly for soliciting any subscriber,
  - the number of subscribers does not exceed 10, and
  - no payment is made by any subscriber.

  You have probably never heard of a preorganization certificate or subscription, so a little explanation is in order. A new corporation cannot receive a charter unless its documents of incorporation provide evidence that minimum funding is assured. Because the purpose of these preorganization certificates is to enable a new enterprise to obtain the minimum amount of capital required by the corporation law of the state, the USA places a limitation on the number of *subscribers* rather than the number of offerees (as in the private placement exemption above). Hence, there may be a publicly advertised offering of preorganization subscriptions. But there may be *no payment* until effective registration unless another exemption is available. This tool itself simply postpones registration; it does not excuse registration altogether.
- **Transactions with existing security holders.** A transaction made under an offer to existing security holders of the issuer (including persons who are holders of convertible securities, rights, or warrants) is exempt as long as no commission or other form of remuneration is paid directly or indirectly for soliciting that security holder.
- **Nonissuer transactions by pledgees.** A nonissuer transaction executed by a bona fide pledgee (i.e., the one who received the security as collateral for a loan), as long as it was not for the purpose of evading the act, is an exempt transaction. For example, you pledged stock as collateral for a loan and defaulted on your obligation. The lender will sell your stock to try to recoup his loss and, under the USA, this is considered an exempt transaction.

TAKE NOTE

Some students find it helpful to remember that an exempt security is a noun, while an exempt transaction is a verb (hence the word "action").

PRACTICE QUESTION

Which of the following are exempt transactions?

I. A nonissuer transaction with a bank in a Nasdaq Capital Market Security
II. An unsolicited request from an existing client to purchase a nonexempt security
III. The sale of an unregistered security in a private, nonpublicly advertised transaction to 10 noninstitutional purchasers over a period not exceeding 12 months
IV. The sale of unlisted securities by a trustee in bankruptcy

A. I and II
B. I, II, and III
C. I, II, and IV
D. I, II, III, and IV

Answer: C. Choice III is not an exempt transaction because the private placement exemption is limited to 10 offerees, not 10 purchasers. All of the others are included in our list of exempt transactions.

Try to follow this next point because it is a bit tricky. The Administrator may, by rule or order, deny or revoke the registration exemption of:

- any security issued by any person organized and operated not for private profit but exclusively for religious, educational, benevolent, charitable, fraternal, social, athletic, or reformatory purposes, or as a chamber of commerce or trade or professional association (your basic nonprofit exemption); and
- any investment contract issued in connection with an employees' stock purchase, savings, pension, profit-sharing, or similar benefit plan.

Please note that a few pages ago, we gave you a list of nine different exempt securities, from U.S. and Canadian government issues through certain money market instruments. However, the Administrator can only deny exemption to the two specified above. On the other hand, with the exception of those involving federal covered securities, the Administrator may deny any exempt transaction. That means that, for example, just because an agent solicited a transaction with an insurance company of a security that was not federal covered, the Administrator has the power, if he feels it is justified, to consider that transaction nonexempt.

Under the USA, the burden of providing an exemption or an exception from a definition falls upon the person claiming it.

TAKE NOTE

There are only two securities exemptions that the Administrator may revoke, while all exempt transactions, other than in certain federal covered securities, may be revoked.

Before we summarize, let's try a practice question:

PRACTICE QUESTION

Under the Uniform Securities Act, which of the following persons is responsible for proving that a securities issue is exempt from registration?

A. Underwriter
B. The person requesting the exemption
C. State Administrator
D. There is no need to prove eligibility for an exemption.

Answer: B. The burden of proof for claiming eligibility for an exemption falls to the person claiming the exemption. In the event the registration statement was filed by someone other than the issuer (such as selling stockholders or a broker-dealer), that person must prove the claim.

An **exempt transaction** is exempt from the regulatory control of the state Administrator because of the manner in which a sale is made or because of the person to whom the sale is made. A transaction is an action and must be judged by the merits of each instance.

EXAMPLE

An agent can sell a security that is not exempt from registration in the state if the purchaser of the security is a bank or other institutional buyer. Why is that so? Because the sale of securities to certain financial institutions is an exempt transaction (as will be enumerated shortly), the sale can be made without registration. This means that the securities sold in exempt transactions do not have to be registered in the state. If that same nonexempt security was not sold in an exempt transaction, such as to an individual investor, it would have to be registered in the state.

Summary of Exemptions from Registration Under the Uniform Securities Act

Let's start our summary with a key statement from the USA:

"It is unlawful for any person to offer or sell any security in this state unless (1) it is registered under this act or (2) the security or transaction is exempted under this act; or (3) it is a federal covered security."

We must point out that these exemptions apply to the security or transaction only, not to the securities professional. So, if a security is exempt, such as a government security, it can be sold in this state without any registration. But the person who sells it must be properly registered in this state (unless that person qualifies for an exemption). We'll get into this in full detail in Unit 11.

Exempt Transactions Under the Securities Act of 1933

Unlike the USA, there are only two exempt transactions that might be tested, and they are:

- transactions by any person other than an issuer, underwriter, or dealer (basically private transactions between individuals); and
- transactions by an issuer that do not involve a public offering (private placement under Regulation D).

In a major effort aimed at facilitating the capital formation needs of small businesses, the SEC adopted Regulation D, the private placement exempt transaction. Securities offered and sold in compliance with Regulation D are exempt from registration with the SEC and, as was listed earlier, are considered federal covered securities exempt from registration on the state level as well. Our primary concern is with **SEC Rule 506,** a private placement where there is no dollar limit on the amount sold.

The Jumpstart Our Business Startups Act of 2012, or **JOBS Act**, made several important changes to Rule 506 of Regulation D. Rule 506 consists of two sections, 506(b) and 506(c). A company seeking to raise capital through a private placement under Rule 506(b) can sell the offering to an unlimited number of accredited investors (defined below) and up to 35 nonaccredited investors. In addition, no advertising may be done on behalf of the offering.

On the other hand, Section 506(c) permits the offering to be advertised. There are two primary (and interrelated) requirements in order to do this.

- All purchasers are accredited investors, or the issuer reasonably believes that they are accredited investors.
- The issuer takes reasonable steps to verify that all purchasers are accredited investors, which could include reviewing documentation such as W-2s, tax returns, bank and brokerage statements, credit reports, and the like.

An issuer can elect to make a typical Rule 506 offering without general solicitation or advertising under Section 506(b) in order to include up to 35 nonaccredited investors in the offering or to avoid the heightened verification procedures.

The JOBS Act also included a provision that an issuer is disqualified from using Rule 506 under their "bad actor" provisions. Simply put, if the issuer or other relevant persons (such as underwriters, directors, officers, or significant shareholders of the issuer) have been convicted of securities fraud or certain other securities violations, an offering under Rule 506 may not take place.

SEC Rule 501 Accredited Investors

SEC Rule 501 classifies an accredited investor for the purposes of Regulation D into several categories. Investors are considered to be accredited under the rule only if the issuer or any person acting on the issuer's behalf has reasonable grounds to believe, and does believe after reasonable inquiry, that the investors are included in one of the categories in the definition.

The separate categories of accredited investors under Regulation D include:

- a bank, an insurance company, or a registered investment company;
- an employee benefit plan if a bank, an insurance company, or a registered investment adviser makes the investment decisions, or if the plan has total assets in excess of $5 million;
- a charitable organization, corporation, LLC, or partnership with assets exceeding $5 million;
- directors, executive officers, and general partners of the issuer;
- any natural person whose individual net worth, or joint net worth with that person's spouse or spousal equivalent, excluding the net equity in his primary residence, exceeds $1 million at the time of his purchase;
- any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse or spousal equivalent in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;
- entities made up of accredited investors;
- individuals who are qualified as:
  - licensed General Securities Representatives (Series 7),
  - licensed Investment Adviser Representatives (Series 65*), and
  - licensed Private Securities Offerings Representatives (Series 82).
  - Please note that NASAA has stated "a person seeking accredited investor status by passing the Series 65 exam would also need to be licensed as an investment adviser representative in her state and would need to comply with all state-specific licensing requirements (e.g., paying dues, etc.)." So, it is more than just passing the exam. Regardless of the license, one must have met all of the licensing requirements.
- individual investors who are knowledgeable employees of private funds. This would include directors and certain executive officers of the private fund, or of an affiliated person of the private fund that manages the investment activities of the private fund. However, they are only accredited investors for the purpose of investing in offerings by the private fund and other private funds managed by their employer. They cannot use their status as a knowledgeable employee to qualify as an accredited investor to invest in other offerings.

- three categories of investment advisers:
  - those registered with the SEC,
  - those registered in any state, and
  - exempt reporting advisers;
- limited liability companies (LLCs) with assets of more than $5 million; and
- almost any entity with investments of more than $5 million.

The term *accredited investor* applies only to private placements. A favorite phrase of the regulators is "eligibility does not equal suitability." Therefore, just because one meets the financial requirements of an accredited investor does not mean that suitability standards are ignored.

TEST TOPIC ALERT

Can assets in an account or property held jointly with another person who is not the purchaser's spouse be included in determining whether the purchaser satisfies the net worth test in Rule 501? Answer: Yes, assets in an account or property held jointly with a person who is not the purchaser's spouse may be included in the calculation for the net worth test, but only to the extent of his or her percentage ownership of the account or property.

Form D

What is Form D, and when does it have to be filed? Under Rule 503 of Regulation D, an issuer that is issuing securities in reliance on Regulation D must file Form D electronically with the SEC no later than 15 days after the first sale of securities in the offering.

KNOWLEDGE CHECK 8.3

1. All of the following describe exempt transactions **except**
   A. ABC, a broker-dealer, purchases securities from XYZ Corporation as part of an underwriting commitment.
   B. First National Bank sells its entire publicly traded bond portfolio to Amalgamated National Bank.
   C. Amalgamated National Bank sells its publicly traded bond portfolio to ABC Insurance Company.
   D. Joan Smith, an employee of Amalgamated National Bank, buys securities recommended by her agent at ABC Securities Corporation, a registered broker-dealer.
2. As defined in the Uniform Securities Act, each of the following would be considered an exempt transaction **except**
   A. a trustee of a corporation in bankruptcy liquidates securities to satisfy debt holders.
   B. an offer of a securities investment is directed to 10 individuals in the state during a period of 12 consecutive months.
   C. an agent solicits insurance companies to purchase shares of nonexempt securities.
   D. preorganization certificates are subscribed to by nine investors in the state, earning the agent a modest commission.

LESSON 8.4: REGISTRATION OF SECURITIES UNDER FEDERAL LAW

LO 8.e Recollect the procedures for registering nonexempt securities under the Securities Act of 1933.

The **Securities Act of 1933** (also called the **Paper Act**, the **Truth in Securities Act**, and the **Prospectus Act**) regulates the issuing of corporate securities sold to the public. Unless the security or transaction is exempt, the act requires securities issuers to make full disclosure of all material information in their registration materials in order for investors to make fully informed investment decisions.

Just like the rules under state law, if the security is not exempt (a nonexempt security) or the transaction is not exempt (a nonexempt transaction), then the security must be registered with the SEC.

Issuer information must be disclosed to the Securities and Exchange Commission (SEC) in a registration statement and published in a **prospectus**. In addition, the act prohibits fraudulent activity in connection with the sale, underwriting, and distribution of securities. The act provides for both civil and criminal penalties for violations of its provisions.

Even though registration under the Uniform Securities Act (the law that deals with regulation by the states) will be covered directly after this, where appropriate, mention will be made of the similarities and differences between certain federal and state definitions.

Definition: prospectus. A prospectus is any notice, circular, letter, or communication, written or broadcast by radio or television, that offers any security for sale or confirms the sale of a security. A tombstone advertisement (one that simply identifies the security, the price, and the underwriters) is not considered a prospectus nor an offering of the subject security. The term *prospectus* does not include oral communications.

As mentioned earlier, an **issuer** is any person who issues or proposes to issue any security. Most issuers are businesses, and the term *issuer* would also apply to a government entity.

When, in LO 11.d, we describe the exclusion from the definition of agent for an individual who represents the issuer in the sale of its security, we state that this is not the usual method of distributing a new issue, but it is used by small firms who wished to reduce the cost. In almost all cases, securities are distributed by a broker-dealer (or network of BDs) acting as underwriters of the issue. The term *underwriter* is defined as "any person, usually a broker-dealer, who has purchased a security from an issuer with a view to the distribution of the security, or participates or has a direct or indirect participation in that distribution."

TAKE NOTE

The SEC does not approve securities registered with it, does not pass on the investment merit of any security, and never guarantees the accuracy of statements in the registration statement and prospectus.

In its review process, the SEC merely attempts to make certain that all pertinent information is fully disclosed in the registration statement and prospectus by requiring that:

- the issuer file a registration statement with the SEC before securities are offered or sold in interstate commerce;
- a prospectus that meets the requirements of the act be provided to prospective buyers; and
- penalties (civil, criminal, or administrative) be imposed for violations of the act.

The Registration Statement

An issuer must file a *registration statement* with the SEC disclosing material information about the issue. The registration statement must be signed by the principal executive officer (usually designated the CEO), the principal financial officer (usually designated the CFO), and a majority of the board of directors.

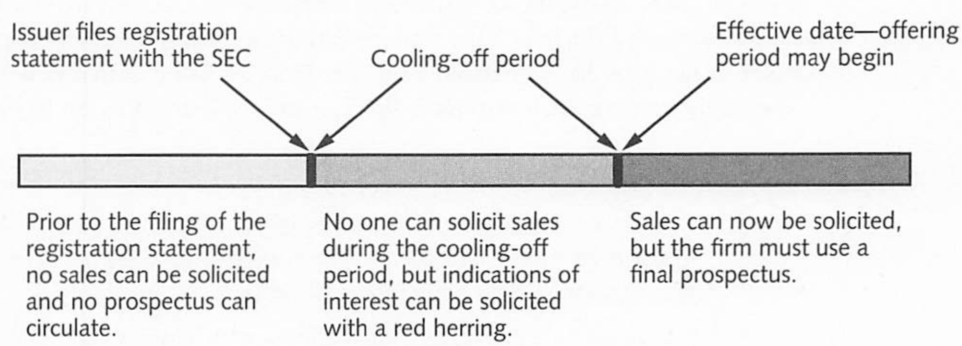
All of the signers are subject to criminal and civil penalties for willful omissions and misstatements of material facts. The information required in the registration statement may be summarized as follows:

- Purpose of issue
- Public offering price (anticipated range)
- Underwriter's commissions or discounts
- Promotion expenses
- Expected use of the net proceeds of the issue to the company
- Balance sheet
- Earnings statements for the last three years
- Names, addresses, and bios of officers, directors, stockholders owning more than 10% of the outstanding stock (i.e., control persons), and underwriters of the issue
- Copy of underwriting agreements
- Copies of articles of incorporation

The Cooling-Off Period

After the issuer files a registration statement with the SEC, a 20-day **cooling-off period** begins. After the issuer (with the underwriter's assistance) files with the SEC for registration of the securities, the cooling-off period begins before the registration becomes effective. The registration can become effective as early as 20 calendar days after the date the SEC has received it. In practice, however, the cooling-off period is seldom the minimum 20 days; the SEC usually takes longer to clear registration statements.

The Three Phases of an Underwriting



The cooling-off period can last several months because of the time it takes to make additions and corrections.

Preliminary (Red Herring) Prospectus

The preliminary prospectus must be made available to any prospective purchaser who expresses interest in the security from the time the issue is filed with the SEC until it becomes publicly available for sale, which is the effective date (the previously described cooling-off period).

A red herring is used to acquaint investors with essential facts concerning the new issue. It is also used to solicit indications of buyer interest. However, it cannot be used:

- as a confirmation of sale;
- in place of a registration statement; or
- to declare the final public offering price.

However, along with stating the expected number of shares to be sold, a bona fide estimate of the price range per share is required to be included.

Under no circumstances may a broker-dealer or one of its agents accept money or orders prior to the effective date. All the agent can do is ask the client for a nonbinding indication of interest as to whether she might be interested in the security once the registration is declared effective.

The term *red herring* was given to the preliminary prospectus because the front page contains the following statement printed in red ink:

"A Registration Statement relating to these securities has been filed with the Securities and Exchange Commission but has not yet become effective. Information contained herein is subject to completion or amendment. These securities may not be sold nor may offers to buy be accepted prior to the time the Registration Statement becomes effective."

No person connected with the offering is allowed to make marks on a preliminary prospectus under any circumstances. They cannot write short summaries or reviews on the preliminary prospectus. The preliminary prospectus must be given to customers without any alterations because, as stated above, information is subject to change.

TAKE NOTE

Two items missing from the preliminary prospectus (red herring) are the public offering price (expected range must be shown) and the effective date.

TEST TOPIC ALERT

During the cooling-off period, underwriters may not:

- take orders; or
- distribute sales literature or advertising material.

However, they may:

- take indications of interest;
- distribute preliminary prospectuses; or
- publish tombstone advertisements to provide information about the potential availability of the securities.

Unit 8

The Final (Effective) Prospectus

A registration statement is normally a very long and complex document for an investor to read. The act requires the preparation of a shorter document called a **prospectus**. The prospectus summarizes the information contained in the registration statement. It must contain all the material facts in the registration statement, but in shorter form. The prospectus must be given to every person who purchases no later than with confirmation of the sale. The purpose of a prospectus is to provide the investor with adequate information to analyze the investment merits of the security. Even if an investor does not intend to read a prospectus, it still must be given to him. It is unlawful for a company to sell securities before the effective date of the registration statement.

Effective Date of the Registration Statement

On the date a registration statement becomes effective, securities may be sold to the public by broker-dealers and their agents. A copy of the final (effective) prospectus must be delivered to each purchaser. This is normally accomplished by including the prospectus along with a confirmation of the trade, although it would certainly be permitted to deliver it earlier. Additional sales literature may be used by the firm as long as the sales literature is preceded or accompanied by a prospectus. Just as with a preliminary prospectus, no markings of any kind may be placed on the prospectus. No areas of special interest may be highlighted or have attention drawn to them by any other method. Money may be accepted by the broker-dealer from customers at this time.

KNOWLEDGE CHECK 8.4

1. Which of the following describe indications of interest secured during the 20-day cooling-off period?
   - I. Binding on the customer
   - II. Nonbinding on the customer
   - III. Binding on the broker-dealer
   - IV. Nonbinding on the broker-dealer
   - A. I and III
   - B. I and IV
   - C. II and III
   - D. II and IV

2. Charlotte is an agent of Gibraltar Securities. Her most active customer told Charlotte that he is thinking about buying 10,000 shares of a retailer's stock for which Gibraltar will be participating in the underwriting syndicate. The SEC release date for the stock is anticipated within 10 business days. What may Charlotte send to the client today?
   - A. The preliminary prospectus and a reprint of a popular advertisement placed by the issuing corporation
   - B. The preliminary prospectus
   - C. An order request
   - D. The final prospectus

LESSON 8.5: REGISTRATION OF SECURITIES UNDER STATE LAW

LO 8.f Recollect the procedures for registering nonexempt securities under the Uniform Securities Act.

State law, under the Uniform Securities Act, requires disclosures similar to those under federal law. Depending on the nature of the issuer and/or the type of transaction, a security may or may not have to register under state and/or federal law. The following is a key statement regarding state law:

Under the Uniform Securities Act, it is unlawful for any person to offer or sell an unregistered security in a state unless

1. it is registered under the act;
2. the security **or** transaction is exempted from registration under the act; or
3. it is a federal covered security.

If the security or transaction is not exempt or is not a federal covered security as defined by the National Securities Markets Improvement Act, it must be registered in the state, or it cannot be lawfully sold in the state.

The first step in the registration procedure is for the issuer or its representative to complete a registration application and file it with the state securities Administrator. The person registering the securities is known as the **registrant**. There are some provisions applicable to all registrations regardless of the method used. The exam will want you to know these well.

Unit 8

Filing the Registration Statement

State Administrators require every issuer to supply the following information on their applications:

- Amount of securities to be issued in the state
- States in which the securities are to be offered, but not the amounts offered in those other states
- Any adverse order or judgment concerning the offering by regulatory authorities, court, or the SEC
- Anticipated effective date
- Anticipated use of the proceeds (why are we raising this money?)

When filing the registration statement with the Administrator, an applicant may include documents that have been filed with the Administrator within the last five years, provided the information is current and accurate. The Administrator may, by rule or order, permit the omission of any information it considers unnecessary.

TEST TOPIC ALERT

Although most registration statements are filed by the issuer, the exam may require you to know that they may also be filed by any selling stockholder, such as an insider making a large block sale, or by a broker-dealer.

Filing Fee

The issuer (or any other person on whose behalf the offering is to be made) must pay a filing fee, as determined by the Administrator, when filing the registration. The filing fees are often based on a percentage of the total offering price.

If the registration is withdrawn or if the Administrator issues a stop order before the registration is effective, the Administrator may retain a portion of the fee and refund the remainder to the applicant.

TAKE NOTE

A **stop order** is used to deny effectiveness to, or suspend or revoke the effectiveness of, any registration statement. This applies only to securities, not professionals such as broker-dealers, agents, investment advisers, and investment adviser representatives.

Ongoing Reports

The Administrator may require the person who filed the registration statement to file reports to keep the information contained in the registration statement current and to inform the Administrator of the progress of the offering.

TEST TOPIC ALERT

These reports cannot be required more often than quarterly.

Special Subscription Form

The Administrator may also require, as a condition of registration, that the issue be sold only on a form specified by the Administrator and that a copy of the form or subscription contract be filed with the Administrator or preserved for up to three years.

LO 8.g Identify the methods of state registration of securities, including the antifraud provisions of the Uniform Securities Act.

State Registration Methods

The USA provides two methods for securities issuers to register their securities in a state, plus a special method for certain federal covered securities. They are:

- notice filing;
- coordination; and
- qualification.

Registration by Notice Filing

As previously mentioned, the National Securities Markets Improvement Act of 1996 (NSMIA) designated certain securities as federal covered and, therefore, removed from the jurisdiction of the state regulatory authorities. Although the states are preempted from requiring registration for federal covered securities, status as a federal covered security is not a preemption of the licensing or antifraud laws. Any person who sells a federal covered security must be licensed as a broker-dealer or agent (unless otherwise exempted) and must also comply with the antifraud provisions of state laws.

The Uniform Securities Act gives the Administrator the authority to require notice filings with respect to federal covered securities, generally investment companies registered with the SEC under the Investment Company Act of 1940. So, what is this notice filing? Primarily, it is an opportunity for the states to collect revenue in the form of filing fees because, unlike with the two actual methods of registration we are going to discuss, the Administrator has limited powers to review any documentation filed with her department. The fees for notice filing are generally lower than for the two forms of registration.

Under the notice filing procedure, state Administrators may require the issuer of certain federal covered securities to file the following documents as a condition for sale of their securities in the state:

- Documents filed along with their registration statements filed with the SEC
- Documents filed as amendments to the initial federal registration statement
- A report as to the value of such securities offered in the state
- Consent to service of process

TEST TOPIC ALERT

Keep in mind the distinction between federal covered securities and SEC-registered securities. As stated earlier, SEC-registered does not mean federal covered. Many are and many aren't, and federal covered also includes those exempt from SEC registration, such as Treasury and municipal securities.

TEST TOPIC ALERT

Before the initial offer of any federal covered security in a state, the Administrator, by rule or order, may require the filing of all documents that are part of a federal registration statement filed with the U.S. Securities and Exchange Commission under the Securities Act of 1933, together with a consent to service of process signed by the issuer. However, unless there is an appearance of fraud, the Administrator does not have the power (because of lack of jurisdiction) to prevent the sale of a federal covered security in his state.

TEST TOPIC ALERT

Even though an issuer of a federal covered security (think about a Fortune 500 company listed on the NYSE) may not have to notice file, that does not mean that the company can make misrepresentations during an offer made in any state. To do so would violate the antifraud provisions of the USA.

Registration by Coordination

The most common form of registration for those securities that are not federal covered (typically securities traded on one of the facilities of the OTC Markets group such as the Pink Market) is coordination. A security may be **registered by coordination** if a registration statement has been filed under the Securities Act of 1933 in connection with the same offering.

In coordinating a federal registration with state registration, issuers must supply the following records in addition to the consent to service of process:

- Copies of the latest form of the prospectus filed under the Securities Act of 1933, if the Administrator requires it
- A copy of articles of incorporation and bylaws, a copy of the underwriting agreement, or a specimen copy of the certificate
- If the Administrator requests, copies of any other information filed by the issuer under the Securities Act of 1933
- Each amendment to the federal prospectus promptly after it is filed with the SEC

Effective Date

Registration by coordination becomes effective at the same time the federal registration becomes effective, provided:

- no stop orders have been issued by the Administrator and no proceedings are pending against the issuer;
- the registration has been on file for at least the minimum number of days specified by the Administrator, a number that currently ranges from 10 to 20 days, depending on the state; and
- a statement of the maximum and minimum offering prices and underwriting discounts have been on file for two business days.

Registration by coordination is by far the most frequently used method and, from a practical standpoint, is the only sensible way to register a multistate offering.

Registration by Qualification

Any security can be **registered by qualification**. Registration by qualification requires a registrant to supply any information required by the state securities Administrator. Securities not eligible for registration by another method must be registered by qualification. In general, securities that will be sold only in one state (intrastate) will be registered by qualification.
To register by qualification, an issuer must supply a consent to service of process and the following information:

- Name, address, form of organization, description of property, and nature of business;
- Name and address of any person owning 10% or more of the outstanding shares of any class of equity security of the issuer;
- Estimated proceeds and the use to which the proceeds will be put;
- Type and amount of securities offered, offering price, and selling and underwriting costs;
- Copy of any prospectus, pamphlet, circular, or sales literature to be used in the offering; and
- A specimen copy of the security's certificate.

The Administrator may require additional information by rule or order. The Administrator may require that a prospectus be sent to purchasers before the sale and that newly established companies register their securities for the first time in a state by qualification.

TAKE NOTE

As we've noted previously, in order to register, even by notice filing, there must be a consent to service of process filed with the Administrator. However, a person (remember the broad definition) who has filed such a consent in connection with a previous registration or notice filing need not file another. A practical effect of this is if you leave the firm you are registering with (you've probably already filed the consent to service of process to get this far) and register with another firm, you do not have to file a new consent—the old one remains on file. Or, if a company decides to raise additional capital by issuing more stock, a new consent is not required.

Effective Date

Unlike coordination, where the effective date is triggered by SEC acceptance of the registration, a registration by qualification becomes effective whenever the state Administrator so orders.

Regardless of the method used, every registration statement is effective for one year from its effective date. One interesting facet of the law is that the registration may continue in effect past the first anniversary if there are still some unsold shares remaining, as long as they are still being offered at the original public offering price by either the issuer or the underwriter.

Although the above rule applies to all methods of registration, as a practical matter, it would rarely apply other than in a security registered by qualification. Those registered by coordination are also obviously registered with the SEC and therefore are sold by the major investment banking houses. Unless the issue is a real dog, it will sell out rather quickly. Even those that are not popular are usually completely subscribed to in a week or two.

On the other hand, what if the issue, regardless of the method of registration, is in very high demand? Is it possible to increase the number of shares in the offering without having to file a new registration statement? Yes. A registration statement may be amended after its effective date so as to increase the securities specified to be offered and sold if two conditions are met:

- The public offering price is not changed from the amount stated in the original registration statement; and
- The underwriters' discounts and commissions are not changed from the respective amounts stated in the original registration statement.

Escrow

As a condition of registration under coordination or qualification, the Administrator may require that a security be placed in escrow if the security is issued:

- within the past three years;
- to a promoter at a price substantially different than the offering price; or
- to any person for a consideration other than cash.

In addition, the Administrator may require that the proceeds from the sale of the registered security in this state be impounded until the issuer receives a specified amount from the sale of the security either in this state or elsewhere. There have been many instances where companies were unable to raise their targeted goal and just took the money and ran. This impound, or escrow, lessens the likelihood that this will happen.

TEST TOPIC ALERT

A registration statement may be amended after its effective date to change the number of shares to be offered and sold if the public offering price and underwriter's discounts and commissions are unchanged.

PRACTICE QUESTIONS

1. KAPCO Dividend Yield Fund, a closed-end investment company registered under the Investment Company Act of 1940, wishes to commence offering its shares in States A, B, C, and D. It could be required to
   A. coordinate its federal registration with each of the four states.
   B. notice file.
   C. register by qualification in each of the states.
   D. do none of these, because investment companies registered under the Investment Company Act of 1940 are federal covered securities and are exempt from registration.

   Answer: B. Although these are federal covered securities and exempt from traditional registration, as a registered investment company, you can expect that it will be required to engage in a notice filing.

2. Registration is effective when ordered by the Administrator in the case of registration by
   A. coordination.
   B. integration.
   C. notice filing.
   D. qualification.

   Answer: D. Registration by qualification is the only registration method where the Administrator sets the effective date. The effective date under registration by coordination is set by the SEC, and notice filing is merely the filing of certain documents by certain federal covered securities.

3. In general, registration statements for securities under the Uniform Securities Act are effective for
   A. a period determined by the Administrator for each issue.
   B. 1 year from the effective date.
   C. 1 year from the date of issue.
   D. 1 year from the previous January 1.

   Answer: B. On the state level, securities registration statements are generally effective for 1 year from the effective date. However, the effective date may be extended for a longer period during which the security is being offered or distributed in a nonexempt transaction by the issuer or other person on whose behalf the offering is being made or by any underwriter who is still offering part of an unsold allotment or subscription taken by him as a participant in the distribution.

Antifraud Provisions of the Uniform Securities Act

Under all regulatory bodies, in order for an action to be fraudulent, it must be committed willfully and knowingly. There is no such thing as "accidental" fraud. Although the SEC has antifraud statues as well, the exam will focus on those of the Uniform Securities Act. The applicability of the antifraud provisions is almost universal. For example, here is a statement about *investment advisers*:

"It is unlawful for any person who receives, directly or indirectly, any consideration from another person for advising the other person as to the value of securities or their purchase or sale, whether

through the issuance of analyses or reports or otherwise, (1) to employ any device, scheme, or artifice to defraud the other person, (2) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon the other person";

and for *broker-dealers*:

"It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly (1) to employ any device, scheme, or artifice to defraud, (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person";

and for *securities*:

"The antifraud provisions apply regardless of whether the security is registered, exempted, or sold in violation of the registration requirements."

What these statements indicate that that no securities professional and no security is exempt from the antifraud rules. But what if the person is excluded from the definition of, say, an investment adviser? Or what if the investment is excluded from the definition of a security? What then?

The distinction between exemptions and exceptions (or exclusions) from definitions is important in view of the fact that an exempt security is not exempt from the antifraud provisions of the Uniform Securities Act.

As we covered earlier in this unit, the typical life insurance policy or fixed annuity is not a security and is not covered under the antifraud statutes of the Uniform Securities Act. On the other hand, we know that securities issued by insurance companies are exempted from registration under the conditions of the act. Even though these securities are exempt from registration and the filing of advertising and sales literature with the Administrator, they are still subject to the antifraud provisions. Therefore, one could be charged with fraudulent behavior in the sale of stock in an insurance company (or any other exempt security).

In the next unit, we will learn about investment advisers, including those who are excluded from the definition. As an example, one of the exclusions applies to engineers whose advice is incidental to their profession. Could that engineer ever be charged with violating the antifraud provisions regarding investment advice? Yes! Just because a person is not an investment adviser doesn't mean that fraudulent advice can be given. Using the same logic, a federal covered investment adviser, although not registered in any state, can be charged by the state Administrator when there is an alleged violation of the antifraud provisions of the USA.

Is there ever a time when the antifraud provisions do not apply? Yes. They do not apply to an investment that is excluded from the definition of a security. An example of this would be a rare coin dealer who falsifies the dates on coins sold to a client. That certainly is fraud, but it doesn't come under the USA's antifraud provisions because rare coins are not securities. Another example is the sale of a fixed annuity—it is not a security, so the antifraud provisions of the Uniform Securities Act do not apply. Of course, the state insurance department would have something to say about any fraudulent activity with insurance products, but if they were not securities, the USA provisions don't apply.

KNOWLEDGE CHECK 8.5

1. A registration statement for an offering to be made in a state could be filed by all of the following **except**
   A. the issuer.
   B. an institution holding a large block of the shares.
   C. a broker-dealer.
   D. the state Administrator.

2. In general, registration statements for securities under the Uniform Securities Act are effective for
   A. a period determined by the Administrator for each issue.
   B. 1 year from the effective date.
   C. 1 year from the date of issue.
   D. 1 year from the previous January 1.

KNOWLEDGE CHECK ANSWERS

Knowledge Check 8.1

1. **D** Any bond, regardless of the nature of the issuer, is considered a security. The physical commodity and futures contracts on commodities are included in the list of nonsecurity investments. Retirement plans and fixed annuities are not securities.

   LO 8.a

2. **C** A primary transaction is a new offering of securities by an issuer sold to investors. The key is that the proceeds of the sale go to the issuer. Transactions between two investors in the over-the-counter market are called secondary transactions (the market between investors). A sale between investors of securities traded on the New York Stock Exchange is another example of a secondary transaction. In both of those cases, the proceeds of the sale go to the selling party, but that party is not the issuer.

   LO 8.b

Knowledge Check 8.2

1. **C** In order to be exempt, promissory notes cannot have a maturity beyond 270 days. Registered investment companies (think *mutual funds*) are federal covered securities, as are shares of companies listed on the Nasdaq Stock Market. Any security issued by a state or Canadian province (and their subdivisions) is an exempt security.

   LO 8.c

2. **C** Although the rule has a 6-month resale restriction, that only applies to sales made to residents of other states. It is not a problem if you re-sell in a much shorter time to your neighbor.

   LO 8.c

Knowledge Check 8.3

1. **D** The purchase of securities from a broker-dealer by an employee of a bank is a nonexempt transaction—it is the sale of a security by a broker-dealer to a member of the public and is therefore not exempt. Transactions between broker-dealers and issuers as part of an underwriting commitment; transactions between banks; and transactions between banks and insurance companies are exempt because they are transactions between financial institutions. Exempt transactions are most often identified by whom the transaction is with rather than what type of security is involved.

   LO 8.d

2. **D** The nine investors are within the required ten but, in order for a preorganization certificate to be an exempt transaction, there can be no payment of funds or commissions. Transactions by fiduciaries, such as a trustee in bankruptcy (the only trustee who qualifies) and transactions with institutions, such as insurance companies, are exempt. The private placement exemption applies as long as there are no more than ten offers to individual (retail) purchasers within 12 consecutive months.

   LO 8.d

Knowledge Check 8.4

1. **D** Indications of interest are not binding on either party.

   LO 8.e

2. **B** Because a security is in registration until released by the SEC for public sale, only the unadulterated prospectus may be sent to parties indicating interest in purchasing the stock. Orders may not be accepted for a security while in registration. Because the final prospectus is indeed an offering document, it may not be presented until the SEC has released the security for public sale (made the security effective).

   LO 8.e

Knowledge Check 8.5

1. **D** The Administrator receives the filing but does not make it.

   LO 8.f

2. **B** Securities registration statements are effective for 1 year from the effective date. The date of issue is when the actual shares are issued. That is usually a short time after the effective date.

   LO 8.g

UNIT 9

Regulation of Investment Advisers Including State-Registered and Federal Covered Advisers

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- › LO 9.a **Define** *investment adviser*, including the impact of SEC Release IA-1092 on the definition of investment advisers and their activities.
- › LO 9.b **Identify** exclusions and exemptions under the Investment Advisers Act of 1940 and the Uniform Securities Act.
- › LO 9.c **Identify** the exempt reporting adviser and private fund adviser exemptions.
- › LO 9.d **Recall** the effects of the Dodd-Frank Act on the investment adviser registration process.
- › LO 9.e **Identify** the registration process for an investment adviser, including the use of the Form ADV.
- › LO 9.f **Recognize** the financial requirements to register as an investment adviser.
- › LO 9.g **Recall** the investment adviser books and recordkeeping requirements under state and federal law.
- › LO 9.h **Recognize** that investment adviser representatives must be adequately supervised.

Your exam will include approximately six questions from the topics covered in Unit 9.

INTRODUCTION

State securities Administrators regulate persons engaged in securities transactions that occur in their states similarly to the way they regulate the securities involved in those transactions.

Investment advisers are defined by federal and state securities laws. A person that performs the functions of an investment adviser, as the term is defined in the Uniform Securities Act or the Investment Advisers Act of 1940 and more fully described in SEC Release IA-1092, is by definition an investment adviser. Investment advisers must conduct business within the regulatory framework prescribed in federal and state securities laws. Investment advisers are represented by individuals known as investment adviser representatives (IARs). This exam qualifies you for that role. There is more information about IARs in Unit 10.

LESSON 9.1: WHO IS AN INVESTMENT ADVISER?

LO 9.a Define *investment adviser,* including the impact of SEC Release IA-1092 on the definition of investment advisers and their activities.

The definition of investment adviser (IA) is virtually identical under state law (the Uniform Securities Act) and federal law (the Investment Advisers Act of 1940). Here is how it is worded in the Uniform Securities Act:

"*Investment adviser means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities.*"

Definition: person. As defined in the Uniform Securities Act, "'Person' means an individual (a natural person) a corporation, a partnership, an association, a joint-stock company, a trust where the interests of the beneficiaries are evidenced by a security, an unincorporated organization, a government, or a political subdivision of a government." For test purposes, it is easiest to remember the three nonpersons. They are (1) a minor, (2) a deceased individual, and (3) an individual declared mentally incompetent by the courts.

PRACTICE QUESTION

A person is basically anyone that can open an account. The test would be looking for you to choose an answer to a question such as this:

Which of the following is included in the definition of a person?

A. A minor
B. The National Hockey League
C. A deceased person
D. A person whom the courts have declared to be mentally incompetent

Answer: B. Odd to think of the NHL as a person, but they would be included in the USA's definition. That is why such questions are much easier if you just remember the three nonpersons.

The definition of investment adviser is sometimes referred to as the "three prong test." That is, as long as the person involved:

1. gives advice to others on securities;
2. does so as part of a regular business activity; and
3. receives compensation for performing this activity.

Let's examine each of those.

Giving Advice to Others on Securities

Persons will meet the first prong of the test if they provide advice to others about specific securities, such as stocks, bonds, mutual funds, or limited partnerships, as well how to allocate assets among a group of securities. Even indirect advice can be included. Examples of this could be:

- "Why should you invest in securities as compared to nonsecurities investments, such as insured bank CDs or rental property?" or
- "Here is our view on future stock market trends."

The advice can be in written or oral form; that is, it can be part of a printed (or online) report or advice given on a phone call. The regulators, both state and federal, have stated that advice on many other types of investments is **not** advice about securities. Some of the specifically mentioned nonsecurities investments include:

- commodities;
- collectibles, such as coins or stamps;
- precious metals, such as gold and silver; and
- real estate.

TAKE NOTE

The list of what is a security and what is not a security was covered in detail in Unit 8, LO 1.a.

PRACTICE QUESTION

A person giving advice on which of the following investments would be deemed to be giving advice on securities?

A. Gold
B. Common stock
C. Rental real estate
D. Rare stamps

Answer: B. Common stock is a security; the others are considered nonsecurities.

In the Business of Providing Advice

A person is in the business of providing advice and meets the second prong defining one as an investment adviser if he:

- gives advice on a regular basis such that it constitutes a business activity conducted with some regularity. Although the frequency of the activity is a factor, it is not the only determinant in whether one is giving advice. Furthermore, providing advice does not have to be the person's principal activity; and
- advertises investment advisory services and presents himself to the public as an investment adviser or as one who provides investment advice.

Compensation

A person who receives any economic benefit as a result of providing investment advice meets the third prong. Compensation includes advisory fees, commissions, or other types of fees relating to the service rendered and can be directly or indirectly paid.

EXAMPLE

When a person designs a comprehensive financial plan for an individual but does not charge a fee for that design, electing to be compensated solely through commissions received on the sale of insurance policies sold as part of the plan, that is considered compensation. Even though that compensation is indirect, it meets the release's definition of compensation for investment advice.

Investment Counsel

One of the terms that may appear on the exam is **investment counsel.** Questions dealing with this topic require the student to know that there are two criteria specified in the Investment Advisers Act of 1940 that must be met in order to use the term to describe the nature of the IA's business. They are as follows:

- *The IA's principal business must be giving investment advice.* This basically excludes financial planners and others for whom investment advice is only a part of what they do.
- *The IA must provide investment supervisory services.* This one is a bit harder for most to understand, so here are some details as issued by the SEC:

Continuous and Regular Supervisory or Management Services.

General Criteria. You provide continuous and regular supervisory or management services with respect to an account *if: (a) you have discretionary authority over and provide ongoing supervisory or management services with respect to the account; or (b) you do not have discretionary authority over the account, but you have ongoing responsibility to select or make recommendations, based upon the needs of the client, as to specific securities or other investments the account may purchase or sell and, if such recommendations are accepted by the client, you are responsible for arranging or effecting the purchase or sale.*

You do not provide continuous and regular supervisory or management services for an account if you: (a) provide market timing recommendations (i.e., to buy or sell), but have no ongoing management responsibilities; (b) provide only impersonal investment advice (e.g., market newsletters); (c) make an initial asset allocation, without continuous and regular monitoring and reallocation; or (d) provide advice on an intermittent or periodic basis (such as upon client request, in response to a market event), or on a specific date (e.g., the account is reviewed and adjusted quarterly)." [1]

PRACTICE QUESTION

Which of the following investment advisers would be permitted to use the term *investment counsel*?

A. A Certified Financial Planner (CFP®), offering a wide range of services to her clients, including tax planning, estate planning, and insurance planning, as well as investment advice
B. A professional providing a market timing service with an annual subscription fee of $495 (this service attempts to maximize profits by suggesting entry and exit points for over 100 listed stocks)
C. A firm whose exclusive business is placing their client's assets into model portfolios which are monitored on a daily basis
D. All of these

Answer: C. In order to use the term *investment counsel*, two criteria must be met—the principal business must be giving investment advice, and the adviser must provide investment supervisory services. Running model portfolios for clients with daily monitoring would meet both requirements. The financial planner is not principally in the business of offering investment advice, because she describes her service as offering a wide range of services, of which advice is only one part. The exam frequently uses that wording to indicate that advice is not the principal activity. While the market timing publisher's principal business activity may be offering advice, nothing about the description indicates that individual client accounts are being monitored.

[1] Appendix B Form ADV: Instructions for Part 1A

SEC Release IA-1092

As a result of the proliferation of persons offering investment advice in the 1980s, Congress directed the SEC to define the activities that would subject a person to the 1940 Investment Advisers Act. The SEC did so in SEC Release IA-1092 in October of 1987.

SEC Release IA-1092 interprets the definition of investment adviser under the Investment Advisers Act of 1940 to include financial planners, pension consultants, and others who offer investment advice as part of their financial practices. Much of the Release was a repetition of existing law, such as the "three prongs." The biggest impact was the expansion of the definition. Let's look at those who are directly affected.

Financial Planners

Financial planners who make recommendations regarding a person's financial resources or perform analyses that concern securities are investment advisers if such services are performed as part of a business and for compensation. Under this interpretation, the SEC holds that there is no such thing *as a comprehensive financial plan that does not involve securities.*

Pension Consultants

Consultants who advise employee benefit plans on how to fund their plans with securities are also considered investment advisers by the SEC. In addition, the SEC considers pension consultants who advise employee benefit plans on the selection, performance, and retention of investment managers to be investment advisers.

Sports and Entertainment Representatives

Persons who provide financially related services to entertainers and athletes that include advice related to investing, tax planning, budgeting, and money management are also investment advisers. As earnings for these celebrities continue to climb, more and more of them use personal managers to handle all of their finances, and those individuals or firms are generally going to be considered investment advisers.

TAKE NOTE

A sports agent who secures a favorable contract for a football player and receives a commission of 10% of the player's salary is not necessarily an investment adviser. However, if the sports agent advises the football player to invest his money in specific securities, the agent is then in the business of offering investment advice and would then be subject to the Investment Advisers Act of 1940 or the Uniform Securities Act.

KNOWLEDGE CHECK 9.1

1. Under SEC Release IA-1092, which of the following is *most likely* to meet the definition of an investment adviser?
   A. A person who sells long-term care insurance
   B. A person who advises businesses on the best locations for their stores
   C. A person who assists pension plans in the selection of portfolio managers
   D. A person who manages portfolios of investment grade coins
2. Under the Uniform Securities Act, the term *person* would *not* refer to which of the following?
   A. A deceased individual
   B. A subdivision of a government
   C. An unincorporated amateur athletic club
   D. A nonprofit, charitable corporation

LESSON 9.2: WHO IS NOT AN INVESTMENT ADVISER?

LO 9.b Identify exclusions and exemptions under the Investment Advisers Act of 1940 and the Uniform Securities Act.

Because terminology is critical to jurisdiction, it is important to know the difference between excluded from a definition and exempt from a provision.

Exclusion means excluded from, or not included in, a definition. For example, if a person is excluded from the definition of an investment adviser, that person is not subject to provisions of state or federal law that refer to investment advisers.

There are a number of exclusions from the investment adviser definition available to persons who might well satisfy all three prongs of the definition but, because of the provisions of the law, are specifically not defined as investment advisers. An excluded person is not subject to any provisions of the Investment Advisers Act or the Uniform Securities Act (other than antifraud statutes).

Exemption means not being subject to the registration provisions of the acts even though that person meets the definition. For example, a person defined as an investment adviser can be exempt from state registration requirements as an investment adviser because that person enjoys an exemption from state registration under the Uniform Securities Act. An example we'll cover shortly is the case of an investment adviser with no place of business in the state whose only clients in the state are institutions.

Definition: federal covered investment adviser. The National Securities Markets Improvements Act of 1996 (discussed in LO 9.d) created the term *federal covered investment adviser.* These are investment advisers who are solely under federal jurisdiction and are specifically excluded from the definition of investment adviser in the Uniform Securities Act. Because they are not defined as investment advisers under state law, they do not register on the state level.

A significant portion of the law (and the exam) deals with those who either are excluded from the definition or are investment advisers but exempt from registering as such. Let's begin with those who are excluded from the definition.

Exclusions

Although the definition of an investment adviser is broad, certain exclusions apply. Under state law (the Uniform Securities Act), there are seven primary exclusions from the definition of an investment adviser.

1. Any bank and bank holding company, savings institution, or trust company is excluded. This exclusion is generally limited to U.S. banks and bank holding companies. The exclusion is unavailable to credit unions and investment adviser subsidiaries of banks or bank holding companies.

   Definition: bank holding company. A holding company is organized to invest in and manage other corporations. Control can occur through the ownership of 50% or more of the voting rights or through the exercise of a dominant influence. It is sometimes referred to as the parent organization. A bank holding company is a holding company whose primary asset is a commercial bank. Most of the large U.S. banks today are owned by holding companies.

2. Any lawyer, accountant, teacher, or engineer whose advice is solely incidental to the practice of their profession is excluded. This exclusion is not available to any of these who have established a separate advisory business. Also, the exclusion would not be available to any of these who hold themselves out as offering investment advice. We like to refer to this as the L.A.T.E. exclusion.

EXAMPLE

When referring to the L.A.T.E. exclusion, it is important to understand the meaning of *incidental*. A lawyer advising clients to carefully invest a settlement from a legal case is not giving investment advice unless charging a separate fee for helping set up the portfolio. An accountant is not giving investment advice when suggesting to a wealthy client that investing in tax-exempt municipal bonds might be a wise idea unless charging a separate fee to help select the bonds.

3. Any broker-dealer whose performance of such services is solely incidental to the conduct of its business as a broker-dealer and who receives no special compensation (such as when offering wrap fee programs) is excluded. The exclusion also applies to registered representatives (agents) of broker-dealers.

   Definition: wrap fee program. Any advisory program under which a specified fee or fees not based directly upon transactions in a client's account is charged for investment advisory services (which may include portfolio management or advice concerning the selection of other investment advisers) and the execution of client transactions. The exclusion from the definition of investment adviser available under both state and federal law to broker-dealers is not in effect for those offering wrap fee programs. The exam may ask about these programs this way:

   Which two of the following are services provided in a wrap fee program? The correct choice would be investment advisory and brokerage execution (transactions) for a single "wrapped" fee. Don't choose financial planning and recommendations.

TAKE NOTE

Special compensation for investment advice is compensation to the broker-dealer or salesperson in excess of that which they would be paid for providing a brokerage or dealer service alone. Consequently, *special compensation* exists where there is a clearly definable charge for investment advice.

4. Publishers may qualify for an exclusion from the definition, but they must meet certain criteria. Excluded from the definition of investment adviser would be a "publisher of any bona fide newspaper, news magazine, or business or financial publication of general and regular circulation."[2] To qualify for this exclusion, the publication must be (1) of a general and impersonal nature, in that the advice provided is not adapted to any specific portfolio or any client's particular needs; (2) bona fide, or genuine, in that it contains disinterested commentary and analysis as opposed to promotional material; and (3) of general and regular circulation, in that it is not timed to specific market activity or events affecting, or having the ability to affect, the securities industry. For example, newspapers of general circulation would be eligible for the exclusion.

TEST TOPIC ALERT

An investment newsletter is being published for a subscription fee. Rather than being published on a regular basis (weekly, monthly, quarterly, and so forth), issues are released in response to market events. How do the laws view this publisher? If the publication is issued from time to time in response to episodic market events, the exclusion is lost.

5. Certain individuals who are employed by investment advisers—*investment adviser representatives* (described in detail in Unit 10, LO 10.a)
6. Any person who is a federal covered adviser is excluded from the definition.
7. Any other person the Administrator specifies is excluded.

The exclusions under federal law (the Investment Advisers Act of 1940) are almost the same, except for the final three above. Instead, the federal act excludes:

"Any person whose advice, analyses, or reports are related only to securities that are direct obligations of, or obligations guaranteed by, the United States, or by certain U.S. government-sponsored corporations designated by the Secretary of the Treasury (e.g., FNMA, GNMA) is excluded."

TAKE NOTE

For purposes of the exclusion, under both state and federal law, the term *bank* does not include a savings and loan association or a foreign bank, but it does include a savings institution.

Because understanding these exclusions is so important, let's look at an example:

PRACTICE QUESTION

The Uniform Securities Act excludes certain persons from the definition of an investment adviser if their performance of advisory services is solely incidental to their professions. This exclusion would apply to all of the following **except**

A. an accountant.
B. an economist.
C. an electrical engineer.
D. a college professor teaching a course on economics.

Answer: B. As long as the activity is incidental to the professional practice, and no separate fee for the advice is charged, the act specifically excludes accountants, lawyers, any professional engineer (aeronautical, civil, mechanical, or other), and teachers. Economists are not included in this listing (most economists are not teachers).

[2] Section 202(a)(11)D) of the Investment Advisers Act of 1940.

Exemptions

When it comes to exemptions, state and federal laws have established rules whereby a person, although meeting the definition of an investment adviser, is not required to register as such. That person is considered to be exempt from registration. Because the state and federal exemptions are not as similar as the exclusions, let's take them separately starting with the exemptions available under the Investment Advisers Act of 1940 (federal law).

Federal Law Exemptions

The Investment Advisers Act of 1940 exempts the following persons who, even though defined as investment advisers, are exempt from the registration requirements of the act.

Intrastate advisers (only within one state). Investment advisers, other than an investment adviser who acts as an investment adviser to any private fund (defined at LO 3.d and again in LO 9.c), whose clients are residents of the state in which the adviser has its principal office and only place of business and who do not give advice dealing with securities listed on any national exchange (e.g., New York Stock Exchange), are exempt. For example, an adviser would be exempted under this provision if all of its clients were Georgia residents, its only places of business were in Georgia, and it did not give advice on securities listed on any national exchange.

Advisers to insurance companies. Advisers whose only clients are insurance companies are exempt.

TEST TOPIC ALERT

Please be careful on this one—the exam frequently asks if the exemption applies when the only clients are banks. As we'll learn shortly, that exemption applies under state law, but not under federal law.

State Law Exemptions

In the same manner as the federal law, the Uniform Securities Act exempts from registration certain persons who, although they fall within the definition of an investment adviser, do not have to register as such in the state.

Investment advisers exempt from registration with the state Administrator are those who have **no place of business in the state** but are registered in another state, provided their only clients in the state are:

- broker-dealers registered under the act;
- other investment advisers;
- institutional investors;
- existing clients who are not residents but are temporarily in the state;
- limited to five or fewer clients, other than those listed above, resident in the state during the preceding 12 months (called the de minimis exemption); or
- any others the Administrator exempts by rule or order.

Definition: institution. The term *institution* would include banks, trust companies, savings and loan associations, insurance companies, investment companies (e.g., mutual funds), employee benefit plans with assets of not less than one million dollars ($1,000,000), and governmental agencies or instrumentalities. Institutions are included in the term *person*, defined previously. The act generally affords less protection to institutional investors owing to their supposed greater investment sophistication.

Definition: retail client. As you can tell by now, terminology is very important on this exam. A few questions use the term *retail client* instead of *noninstitutional client.* Look for it and remember that retail clients need far more protection than institutional ones. If the question refers to an individual, including a trust or an estate, that will always be a retail client.

TAKE NOTE

This exemption applies to investment advisers who are registered in at least one state but have clients in another state where the investment adviser (IA) does not maintain a place of business.

TEST TOPIC ALERT

One of the bullet points above grants an exemption to those investment advisers who have no place of business in the state but are licensed in a state where they have a place of business and offer and sell securities in the state only with persons in the state who are existing customers and who are not residents of the state but are just there temporarily. This is sometimes referred to as the *snowbird exemption* because it is frequently used to deal with existing clients who winter in warmer climates. There is no time limit to define *temporary* (some people spend 3–4 months staying warm) but if the client should change legal residence to that state, the investment adviser has 30 days to register in that state or discontinue doing business with that client (unless qualifying for the de minimis exemption). It is similar to the common experience of moving from one state to another. When you do that, you generally have 30 days to get new license tags for your car and a new driver's license.

TEST TOPIC ALERT

Because these exemptions all apply when the investment adviser does not have a place of business in the state it is relevant to understand that an investment adviser or one of its representatives who advertises to the public, in any way, the availability of meeting with prospective clients in a hotel, country club, seminar, or any other location in the state is considered to have a place of business in the state. However, an investment adviser or one of its representatives who contacts existing clients who happen to be in the state and notifies them that he will be passing through the state and will be available to meet with them in his hotel room, is not considered to have a place of business in the state because the announcement is being made only to existing clients and not to the public.

EXAMPLE

An investment adviser registered in State A, with no business locations in any other state, has, over the preceding 12 months, directed investment advice to five individual investors residing in State B. Is the investment adviser required to register in State B?

The answer is no! Registration is not required because the investment adviser does not have a place of business in State B and directs business to five or fewer individual residents of the state during the previous 12 months. If the firm had a place of business in State B, registration would be required in that state even if it had only one client. Also, registration would be required if business had been transacted with six or more individual residents (retail clients) of State B during the previous 12 months.

What if the IA gave investment advice to six banks, six insurance companies, and six other investment advisers instead of the individuals? Again, the answer would be no registration. As long as the investment adviser has no place of business in the state and limits its clientele to institutions, broker-dealers, large employee benefit plans, or other investment advisers, it qualifies for this exemption.

LO 9.c Identify the exempt reporting adviser and private fund adviser exemptions.

We've just listed a number of exemptions under federal and state law. Here is another one that applies to both, with only a slight difference between them.

Private Fund Advisers

We introduced you to private funds in Unit 3 of this course. Here, we'll go into a bit more of the legal details. Title IV of the Dodd-Frank Act of 2010, known as the Private Fund Investment Advisers Registration Act of 2010, contains a comprehensive overhaul of the registration process for investment advisers. The bill provided for the following new exemptions from registration under the Advisers Act:

- An exemption for advisers solely to private funds—this exemption applies as long as that investment adviser's total assets under management (AUM) in the United States, without regard to the number or type of private funds, is less than $150 million (the private fund adviser exemption)
- An exemption for certain non-U.S. advisers with no place of business in the United States and minimal assets under management (less than $25 million) attributable to U.S. clients and investors (the foreign private adviser exemption)
- An exemption for advisers solely to venture capital funds (the venture capital fund exception)

TEST TOPIC ALERT

Recall that at LO 3.e we mentioned that hedge fund managers generally register with the SEC even though the funds do not.

Unit 9

Definition of a Private Fund

As previously covered in Unit 3, Section 402 of the Dodd-Frank Act defines a private fund as "an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940, but for Section 3(c)(1) or 3(c)(7) of that Act."

In more straightforward terms, a 3(c)(1) issuer is one whose outstanding securities are beneficially owned by not more than 100 persons, and which is not making and does not presently propose to make a public offering of its securities. With no more than 100 shareholders and no public offering, the term *private fund* seems quite logical. For this exemption, the only status requirement for shareholders is that they are accredited investors.

A 3(c)(7) issuer is one whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers (at least $5 million in investments for individuals and generally $25 million in investments for business entities), and who is not making and does not at that time propose to make, a public offering of such securities. In this case, the lack of a public offering is logically private, and the fact that the invested wealth requirement limits the potential universe of investors is a factor as well. Unlike the 3(c)(1) issuer, there is no statutory limit to the number of investors.

The point is, regardless of how it's defined, if one is an adviser solely to private funds, it is possible to qualify for an exemption from registration with the SEC.

As described previously, there is an exemption from registration for certain private funds and venture capital funds. However, even though exempt from registration, if designated as an exempt reporting advisor (ERA), they are required to complete and electronically file reports using the IARD system on certain items set forth in Form ADV, which will be made publicly available on the SEC's website.

TAKE NOTE

There is a special reporting form for certain private fund advisers. This is an easy one to remember because it is Form PF (Private Fund). Which advisers are required to file Form PF?

Any person registered with the SEC as an investment adviser who manages one or more private funds and had at least $150 million in private fund assets under management as of the last day of its most recently completed fiscal year is required to file Form PF.

Well, what about state law? Their Model Rule closely parallels the federal exemption, with two differences.

Private Fund Adviser Exemption Under State Law

NASAA's Model Rule for the Registration Exemption for Investment Advisers to Private Funds is almost identical to the federal exemption described previously. Here are the two differences that might be testable.

If qualifying for the exemption as a 3(c)(1) issuer (no more than 100 investors), NASAA's Model Rule requires that all investors be qualified clients.

A qualified client is a person that:

- has at least $1.1 million in assets under management with the investment adviser immediately after entering into the advisory contract (AUM test); or
- has a net worth (in the case of a natural person client, together with assets held jointly with a spouse) that the investment adviser reasonably believes is in excess of $2.2 million immediately prior to entering into the advisory contract (net worth test).

As a reminder, the value of a natural person's primary residence must not be included in net worth.

- Remember, "value of primary residence" means the fair market value of a person's primary residence, minus the amount of debt secured by the property up to its fair market value (net equity). Note that "qualified" for NASAA is significantly less than "qualified" under federal law.
- Neither the private fund adviser nor any of its advisory affiliates are subject to the "bad actor" provisions. Those provisions disqualify anyone who has certain criminal convictions (generally felonies), certain SEC disciplinary orders, or suspension or expulsion from membership in a self-regulatory organization such as FINRA.

Exemption for Foreign Private Advisers

A foreign private adviser is defined in the Dodd-Frank Act as any investment adviser that:

- has no place of business in the United States;
- has, in total, fewer than 15 clients and investors in the United States in private funds advised by the adviser;
- has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the adviser of less than $25 million; and
- does not hold itself out to the public in the United States as an investment adviser or act as an investment adviser to an investment company registered under the Investment Company Act of 1940.

Exemption for Investment Advisers to Venture Capital Funds

The rules define a venture capital fund as a private fund that:

- has limited leverage;
- does not, except in certain limited circumstances, offer its investors redemption rights or other similar liquidity rights;
- represents itself as a venture capital fund to investors; and
- is not registered under the Investment Company Act of 1940.

What really are venture capital funds? What is venture capital? You are probably familiar with the term *start-up company*. At one point in time, well-known firms like Google, Facebook, and Netflix were "young" and in need of additional capital to expand and grow. Venture capitalists are investors who are willing to take a chance on a new "venture," recognizing that there is a high potential for loss as well as potential for gain that can, in some cases, be very high. A venture capital fund is a pooled investment where venture capitalists invest their money and pay an adviser to select opportunities meeting their objectives. If the conditions listed above are met, that investment adviser is exempt from registration under federal (and state) law.

Here is a helpful summary chart.

	Private Fund Adviser	Venture Capital Fund Adviser
Maximum assets under management:	$150 million	Unlimited
Permitted clients:	Private funds only	Private funds only
Permitted investment strategies:	Any	Venture capital only
Required to register with the SEC?	No	No

Please note that these exemptions are granted on the basis of whom you advise, not on what types of securities are the subject of your advice. Note also that **exclusion** means exclusion from a definition, whereas **exemption** means not subject to registration. All of the cases mentioned here involve investment advisers; it's just that they qualify for an exemption from registration under federal law.

PRACTICE QUESTION

Who of the following would not seek an exemption from registration under the Investment Advisers Act of 1940?

A. A person whose only advisory clients are insurance companies
B. A person whose only offices are in a single state, whose only clients are residents of that state, and who does not render advice on securities traded on a national exchange
C. A person who only gives advice to venture capital funds
D. An accountant whose advice is incidental to her accounting business and for which no separate fee is charged

Answer: D. This is tricky (as is the exam). The accountant is excluded from the definition. Therefore, there is no reason for her to look for an exemption. Anyone who is excluded is automatically exempt from registration. The other three choices meet the definition of investment advisers and qualify for one of the exemptions described above.

KNOWLEDGE CHECK 9.2

1. A state-registered investment adviser would *not* qualify for the de minimis exemption if, over a 12-month period, it had
   A. five retail clients.
   B. five or fewer retail clients.
   C. fewer than six retail clients.
   D. six or fewer retail clients.
2. Section 402 of the Dodd-Frank Act defines a private fund as "an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940, but for Section 3(c)(1) or 3(c)(7) of that Act." Section 3(c)(1) places a limit on beneficial ownership of shares to not more than
   A. 10 persons.
   B. 35 persons.
   C. 100 persons.
   D. 500 persons.

LESSON 9.3: REGISTERING AS AN INVESTMENT ADVISER

LO 9.d Recall the effects of the Dodd-Frank Act on the investment adviser registration process.

Registration Requirements for Investment Advisers

At this point, we know who is an investment adviser, who is excluded from the definition, and who, although defined as an investment adviser, is exempt from registration. If the person is not excluded and not exempt, then registration is required. In 1996, a major change to the registration requirements took place with the passage of the National Securities Markets Improvement Act (NSMIA). Up until that time, investment advisers registered with both the federal agency (the SEC) and the appropriate states. However, the NSMIA bifurcated (split in two) those requirements by declaring that investment advisers would register with the SEC or the state(s), but not both. They did this by creating a new definition: *federal covered investment adviser,* which is sometimes just referred to as a covered adviser on the exam.

Federal Covered Investment Adviser

What makes someone a federal covered investment adviser? In most cases, they are larger firms and are registered with the SEC. Here are the three most tested categories:

- Those registered with the SEC because they are eligible ($100 million in assets under management) or required to register with the SEC because they meet the minimum threshold of assets under management (currently $110 million)
- Those under contract to manage an investment company registered under the Investment Company Act of 1940—e.g., a mutual fund, regardless of the amount of assets under management
- Those not registered with the SEC because they are excluded from the definition of an investment adviser by the Investment Advisers Act of 1940 (the most tested example of this case is the investment adviser whose advice is limited solely to securities issued by the U.S. government or one of its agencies)

TAKE NOTE

Because so much of this exam deals with interpreting the laws, it is sometimes necessary to review some legal concepts with you. For example, if a person is excluded from the definition of investment adviser under the Investment Advisers Act of 1940, the states, under the NSMIA, cannot define such person as an investment adviser because federal law excludes that person from the definition. In other words, if the separate states could define those persons who were excluded from the federal definition as investment advisers, the federal law would have no meaning.

TAKE NOTE

In 2012, the SEC came out with a new metric—Regulatory Assets Under Management (RAUM). Is this simply a new name for AUM? No, it is a somewhat different measurement and can be more or less than the investment adviser's AUM. Although that is the number determining SEC eligibility, we have never heard of "RAUM" appearing on the exam. We use "AUM" in our text and QBank questions and will continue to do so unless students tell us that NASAA has decided to use "RAUM."

Dodd-Frank and Assets Under Management

As stated previously, the NSMIA eliminated state registration requirements for federal covered advisers, largely based upon assets under management (AUM). Dodd-Frank has created three thresholds: one for the large adviser, one for the mid-size adviser, and, logically, one for the small adviser. Let's examine each of these—their requirements and their exceptions, if any.

Large Investment Advisers

Large advisers, those advisers with at least $100 million or more in assets under management, are eligible for SEC registration; once AUM reaches $110 million, registration with the SEC is mandatory. Unless covered by one of the exemptions mentioned previously, all large IAs must register with the SEC. State registration is not required because the federal law preempts state registration.

Small Investment Advisers

This category includes advisers with assets under management of less than $25 million. Unless the investment adviser is an adviser to an investment company registered under the Investment Company Act of 1940, registration with the SEC is prohibited and, unless exempted under state rules, registration with the state is required. However, if the adviser were required to register in 15 or more states, the prohibition would be lifted and registration with the SEC would be permitted instead.

Mid-Size Advisers

This category includes those with AUM of at least $25 million but not $100 million. Generally, these advisers are prohibited from SEC registration and must register with the state. However, there are more extensive exceptions than exist with the small advisers. Just as with any other category, those who are advisers to investment companies registered under the Investment Company Act of 1940 register with the SEC. That is true regardless of their size.

There are several other ways for a mid-size firm to qualify for SEC registration. A mid-size adviser is not prohibited from registering with the SEC:

- if the adviser is not required to be registered as an investment adviser with the securities Administrator of the state in which it maintains its principal office and place of business;
- if registered, the adviser would not be subject to examination as an investment adviser by that securities Administrator;
- if the adviser is required to register in 15 or more states; or
- the adviser elects to take advantage of the buffer (described following).

TAKE NOTE

The law (and often the exam) phrases things in a negative context. As stated above, we have listed four cases where a mid-size investment adviser is not prohibited from registration with the SEC. Put into simple language, that means they are eligible to register with the SEC (if they desire) but not required to do so.

Other Exceptions Under Dodd-Frank

The SEC is permitted to grant exceptions to advisers from the prohibition on Commission registration, including small and mid-size advisers, if the application of the prohibition from registration would be "unfair, a burden on interstate commerce, or otherwise inconsistent with the purposes" of the act. Under this authority, they have adopted several exemptions from the prohibition on registration, including:

- pension consultants providing advisory services to employee benefit plans having at least $200 million of assets who may register with the SEC (even though the consultant does not itself have those assets under management). The SEC picked that number to ensure that, in order to register with the SEC, if desired, the consultant's activities are "significant enough to have an effect on national markets";
- those mid-size advisers with at least $100 million but less than $110 million in AUM who elect to register with the SEC rather than the state(s) (this buffer will be described below);
- investment advisers expecting to be eligible for SEC registration within 120 days of filing the application for registration on Form ADV; and
- internet advisers.

The $10 Million and $20 Million Buffers

The numbers work like this: A state-registered adviser, once it has assets under management of at least $100 million (subject to certain exceptions previously mentioned, everyone needs at least $100 million to initiate registration with the SEC), may choose to remain state-registered or may register with the SEC. Once AUM reach $110 million, registration with the SEC is mandatory—they can no longer stay state-registered. That is the $10 million buffer.

The SEC recognized that market conditions (or obtaining or losing clients) can cause AUM to fluctuate, so they established a $20 million buffer to keep advisers from having to switch back and forth. Once registered with the SEC, an investment adviser need not withdraw its SEC registration unless it has less than $90 million in assets under management. Having become SEC registered, the IA can remain so as long as AUM remains, at or above the $90 million level. Likewise, those investment advisers registered at the state level can choose to remain there until they reach the $110 million level. This buffer is designed to avoid the expense and hassle involved in potentially annual changes to where the investment adviser is registered.

Time for Measuring AUM

These numbers are based on the AUM reported on the IA's annual updating amendment. The effect of this is that a federal covered adviser's AUM could drop below $90 million during the year without triggering the need to change to state registration, just as long as the annual update showed at least the minimum $90 million required. Of course, the same would be true of a state-registered IA whose AUM peaked above $110 million during the year but then fell at the time of the update. If, at the time of filing the annual updating amendment to the Form ADV by an SEC registered IA, the reported AUM is less than $90 million, it is necessary for the investment adviser to withdraw its SEC registration and register with the appropriate state(s) within 180 days. On the other hand, if a state-registered adviser's reported AUM exceeds $110 million, registration with the SEC must take place within 90 days.

TAKE NOTE

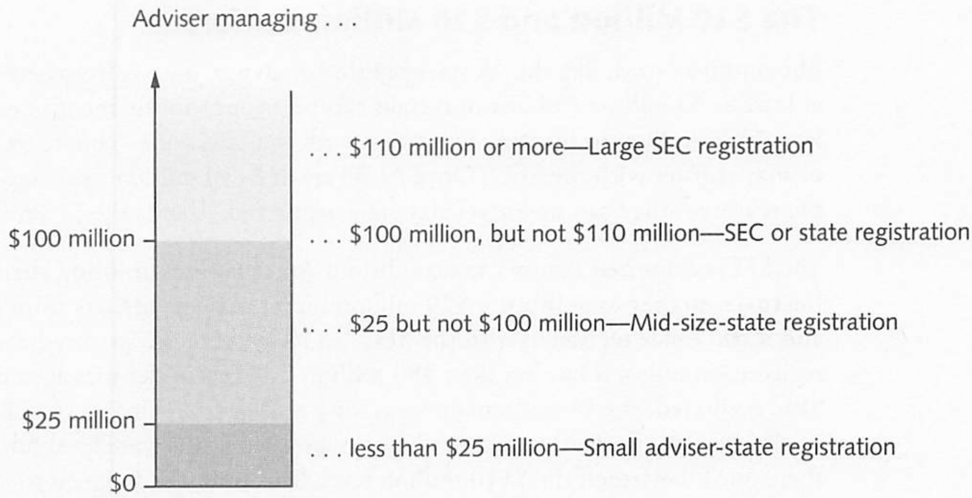
The buffer works because the measurement is made only once per year—at the time of the filing of the firm's annual updating amendment.

Remember these three relevant times:

1. When a state-registered IA reports AUM at $110 million or more on the annual updating amendment, the IA must withdraw from the states and register with the SEC within 90 days.
2. When a new investment adviser files for registration, if that IA believes that it will have at least $100 million in AUM within the first 120 days, it is eligible to register with the SEC, even if their AUM is way below that on "day 1." This is very common when a large BD decides to open an IA and knows that they'll have billions of dollars in a short time.
3. When an SEC registered IA reports less than $90 million in AUM on the annual updating amendment, the IA must withdraw its registration with the SEC and register in the appropriate states within 180 days. Why is the time allowed in #3 twice as long as in #1? Because it takes much less time to register with one agency, the SEC, than to register potentially with a number of states.

TAKE NOTE

As a general rule, the SEC or federal rules involve bigger numbers than the state rules—that is, large investment advisers must register with the SEC, whereas small investment advisers must register with the state(s).



TEST TOPIC ALERT

An investment adviser registered under state law whose assets reach $110 million under management has 90 days to register with the SEC. A federal covered investment adviser whose assets under management fall below $90 million no longer qualifies for SEC registration and has 180 days to register with the state(s).

LO 9.e Identify the registration process for an investment adviser, including the use of the Form ADV.

How does registration take place? With only a few differences, the procedures for registering as an investment adviser are the same, whether registering with the SEC or with the states. Those differences will be pointed out as we go along.

Investment Adviser Registration Process

To register with the state securities Administrator, a person must:

- submit an application;
- provide a consent to service of process;
- pay filing fees;
- post a bond (if required by the Administrator); and
- take and pass an examination if required by the Administrator. The examination may be written, oral, or both.

Registration is accomplished using *FormADV. Form ADV consists of* Part 1A and Part 1B, and Part 2A and Part 2B. Investment advisers use Form ADV to:

- register with the Securities and Exchange Commission;
- register with one or more state securities authorities; or
- amend those registrations.

Filing in almost all cases is done through the IARD. The Investment Adviser Registration Depository (IARD) is an electronic filing system that facilitates investment adviser registration, regulatory review, and the public disclosure information of investment adviser firms.

Form ADV

Form ADV contains four parts. Part 1A asks a number of questions about the investment adviser, its business practices, the persons who own and control the firm, and if the firm is involved in any other activities such as being a broker-dealer. All advisers registering with the SEC or any of the state securities authorities must complete and file Part 1A.

Part 1A also contains several supplemental schedules. These include:

- Schedule A, which asks for information about the direct owners and executive officers (control persons); and
- Disclosure Reporting Pages (or DRPs), which are schedules that ask for details about disciplinary events involving the adviser or advisory affiliates.

Part 1B asks additional questions required by state securities authorities. Investment advisers applying for registration with or who are already registered with the SEC do not have to complete Part 1B.

Part 2A requires advisers to create narrative **brochures** containing information about the advisory firm. The requirements in Part 2A apply to all investment advisers registered with or applying for registration with the SEC or the states.

Part 2B requires advisers to create **brochure supplements** containing information about certain supervised persons. The requirements in Part 2B apply to all investment advisers registered with or applying for registration with the SEC or the states.

It may help you remember that the **A** in Part **2A** tells us that that part is for the **Adviser** and the **B** in Part 2 is about the **Bodies** (the people) who work there.

We will cover the brochures and brochure supplements in greater detail later in Unit 13.

TEST TOPIC ALERT

Control means the power, directly or indirectly, to direct the management or policies of an investment adviser, whether through ownership of securities, by contract, or otherwise. Under the Investment Advisers Act of 1940 as well as NASAA's Model Rule, each of the firm's officers, partners, or directors exercising executive responsibility (or persons having similar status or functions) is presumed to control the firm.

A person is presumed to control an IA organized as a corporation if the person directly or indirectly has the right to vote 25% or more of a class of the corporation's voting securities; a person is presumed to control one that is a partnership if the person has the right to receive upon dissolution, or has contributed, 25% or more of the capital of the partnership.

Please note that this is a different percentage from the definition of control person under the Securities Exchange Act of 1934, where having more than 10% of the voting power makes one a control person. Remember that a control person is defined three different ways: the Exchange Act requires more than 10%, the Investment Company Act (Unit 3) requires more than 25%, and the Advisers Act and the USA require 25% or more.

The application for registration as an investment adviser is on Form ADV.

Part 1 contains information about the IA, including:

- location of principal office;
- location of books and records (if not at the principal office);
- form of business organization (sole proprietorship, partnership, corporation, LLC, etc.);
- method of business;
- other business activities (broker-dealer, registered representative [agent] of a BD);
- maintaining custody of customer assets or exercising discretion;
- details relating to all control persons (officers, directors, partners, etc.);
- disciplinary history; and
- for state-registered IAs, states in which the IA intends to register or is already registered.

TAKE NOTE

Should any of the above information change, prompt notification must be given to the appropriate regulator.

Part 2A is known as the investment adviser's brochure and tends to focus on customer related information, such as:

- compensation arrangements (fees, commissions, hourly charge);
- types of clients (individuals, institutions, pension plans);
- type of investments (equities, corporate debt, municipal securities, U.S. Treasuries, investment companies);
- types of strategies employed (buy and hold, value, growth);
- methods of analysis used (technical, fundamental);
- educational and business background of those who render advice; and
- an audited balance sheet if a federal covered or state-registered adviser requires or solicits *substantial* prepayment of fees (defined shortly) or if a state-registered adviser maintains custody (discussed in Unit 14).

The brochure is arranged in a narrative form using plain English.

Part 2B requires advisers to create brochure supplements containing information about certain supervised persons. Together, Part 2A and Part 2B are delivered to the client as described later in this unit.

State-registered advisers file *both* Part 1 and Part 2 with the Administrator of each state in which they are registering.

PRACTICE QUESTION

If a prospective client wanted to know what type of investment strategies are employed by an investment adviser, the information would be found in the adviser's

A. Form ADV Part 1A.
B. Form ADV Part 1B.
C. Form ADV Part 2A.
D. Form ADV Part 2B.

Answer: C. Form ADV Part 2A contains information of most use to clients, such as the type of strategies employed by the adviser. Part 1A contains information needed by the regulators; Part 1B is only for state-registered IAs; Part 2B contains information dealing with those individuals in the firm who manage accounts.

TEST TOPIC ALERT

Although there are no minimum educational or experience requirements, there is a specific area on Form ADV Part 2B where state-registered advisers must identify each of the principal executive officers and management persons and describe their formal education and business background. If this information has been supplied elsewhere in Form ADV, it is not necessary to repeat it in response to this question.

Updating Form ADV

Formal renewal of the investment adviser's registration is through the filing of the annual updating amendment. Form ADV must be updated each year by filing an annual updating amendment within 90 days after the end of the adviser's fiscal year. This annual updating amendment is used to update the responses to all items on the ADV. Of critical importance is the verification of assets under management (AUM) ensuring that the adviser is eligible to continue being registered with the SEC. One of the requirements relating to the brochure described in Part 2 is that submission must be made of a summary of material changes either in the brochure (cover page or the page immediately thereafter) or as an exhibit to the brochure.

Amendments for Material Changes

In addition to the annual updating amendment, the IA must amend Form ADV by filing additional amendments if information relating to any of the following changes or becomes inaccurate in any way:

- Change of the registrant's name
- Change in the principal business location
- Change in the location of books and records, if they are kept somewhere other than at the principal location
- Change to the contact person preparing the form
- Change in organizational structure, such as from partnership to corporation
- Inaccuracy of information provided in the brochure
- Change to any of the questions regarding disciplinary actions
- Change in policy regarding custody of the customer funds and/or securities

Fees

In addition to the initial registration, there is a requirement for annual renewal. There are fees for the initial filing and renewals. If an investment adviser changes its form of business organization (e.g., from a sole proprietorship to a corporation), an amended ADV, but no fees, would be required.

TEST TOPIC ALERT

Under both federal and state law, a **successor firm** registers by filing a new application (ADV Parts 1 and 2) and, in the case of the SEC, paying the appropriate fee or, under the USA, without paying an additional fee. Please note the difference—one case involves a fee while the other does not.

Notice Filing

While on the topic of fees, it is important to recognize what happened to state revenues after the passage of the NSMIA. Prior to that time, investment advisers registered on both levels, and that meant, in many cases, registering with 20, 30, or more states with each state collecting a nice fee. When state lobbyists realized that the NSMIA, by excluding federal covered advisers from the definition, meant that those advisers would no longer have to register, they implored Congress to put some condition into the act that would help recover some of that lost revenue. That is how notice filing came about.

Instead of registering with the state(s), covered advisers pay state filing fees and give notice to the Administrator. The procedure followed is called **notice filing**. As part of the notice filing, the Administrator can require a federal covered adviser to file a copy of whatever has been filed with the SEC and, of course, pay a filing fee.

If a federal covered adviser only deals with institutions, other IAs, other BDs, and so forth, notice filing is not required. This is a similar concept to the USA not requiring registration of state-registered advisers who have no place of business in the state and deal with this same group of clients. We have not heard of this ever being asked on the exam, but you never know what NASAA has up their sleeve.

Provide a Consent to Service of Process

New applicants for registration must provide the Administrator of every state in which they intend to register with a **consent to service of process**. The consent to service of process appoints the Administrator as the applicant's attorney to receive and process noncriminal securities-related complaints against the applicant. Under the consent to service of process, all legal documents (e.g., subpoenas or warrants) received by the Administrator have the same legal effect as if they had been served personally on the applicant.

TAKE NOTE

The consent to service of process is submitted with the initial application and remains in force permanently. It does not need to be supplied with each renewal of a registration.

Effective Date of Registration and Renewals

Assuming there are no irregularities in the application, registration with the SEC takes effect on the 45th day after filing of a complete application and, as with all securities professionals, at noon of the 30th day in the case of state-registered investment advisers.

TEST TOPIC ALERT

One of the most common questions asked on the exam is the renewal date for the state registration of investment advisers (and the other securities professionals—investment adviser representatives, broker-dealers, and agents). That renewal date is December 31. One of the tricks the exam likes to play is asking about a person who registers in November. When does that registration come up for renewal? Well, even if it is only a month or so later, every registration of a securities professional comes up for renewal on the NEXT December 31, so your first year is always a short one.

TEST TOPIC ALERT

Although withdrawal of registration normally takes 30 days, the Administrator has the power to shorten that period, in effect permitting a rush order.

TEST TOPIC ALERT

Although successful completion of the Series 65 examination may satisfy a portion of the requirements of a particular state, it does not convey the right to transact business prior to being granted a license or registration by that state.

TEST TOPIC ALERT

While registration as an IAR is pending, the individual may not take part in any activity that would require registration. Clerical work (filing customer records) or assisting internally with research would be permitted.

Just as the exam may ask about registering, it may ask about leaving the business.

Form ADV-W

If an adviser no longer desires to engage in the business, application to withdraw registration is accomplished by filing **Form ADV-W**. Form ADV-W must be filed in order to withdraw the registration voluntarily.

Should there be any legal proceedings in progress, the withdrawal will be held up until resolution of the issue. Otherwise, each Form ADV-W filed by an SEC registered adviser is effective upon acceptance by the IARD. However, the investment adviser's registration will continue for a period of 60 days after acceptance solely for the purpose of commencing a proceeding against the firm. In the case of a state-registered adviser, withdrawal is effective 30 days after filing, but the Administrator retains jurisdiction over the former registrant for a period of one year.

In Unit 12, we'll discuss the conditions under which a registration may be canceled by the Administrator.

Exempt Reporting Advisers (ERAs)

As described previously, there is an exemption from registration for certain private funds and venture capital funds. However, even though exempt from registration, if designated as exempt reporting advisers (ERAs), they are required to complete and electronically file reports using the Investment Adviser Registration Depository (IARD) system on certain amended items set forth in Form ADV Part 1, which will be made publicly available on the SEC's website.

TEST TOPIC ALERT

Exempt reporting advisers (ERAs) file Form ADV Part 1 (they don't answer all of the questions) but do not have to prepare a Form ADV Part 2.

KNOWLEDGE CHECK 9.3

1. In the absence of any other possible exemption, registration with the SEC would be prohibited for which of the following investment advisers?
   A. A pension consultant managing $150 million
   B. The investment adviser under contract to an open-end investment company with $18 million in assets
   C. An investment adviser whose assets under management are $103 million
   D. An investment adviser who would be required to register in 17 states
2. In which of the following cases is it necessary to submit a new Form ADV rather than an amended one?
   A. A successor firm
   B. A change to the location of the firm's principal office
   C. A change in the structure of the firm from a partnership to a corporation
   D. The firm changes its fee structure

LESSON 9.4: FINANCIAL AND RECORDKEEPING REQUIREMENTS FOR INVESTMENT ADVISERS

LO 9.f Recognize the financial requirements to register as an investment adviser.

Under the Investment Advisers Act of 1940, there are no specific financial requirements, such as a minimum net worth. However, as we will see, there are financial disclosures that must be made to clients under certain conditions.

Investment Adviser Financial Requirements

Under the Uniform Securities Act, the Administrator may, by rule or order, establish minimum financial requirements for an investment adviser registered in the state. We will begin with some requirements that apply to both federal covered and state-registered investment advisers.

Substantial Prepayment of Fees

Both state and federal law offer extra protection to those clients of investment advisers who have made substantial advance payment of fees for services to be rendered in the future. The term used is *substantial prepayment of fees*. In the case of a federal covered adviser, it is considered substantial if the IA collects prepayments of *l* $1,200 per client, six months or *more* in advance. Under the USA, it is *more than* **$500,** and again, six months or *more* in advance.

TEST TOPIC ALERT

Under the USA, when an investment adviser accepts prepayments of fees of *more* than $500 for a contract period of six months or more, it is known as a substantial prepayment. However, under the Investment Advisers Act of 1940, it does not become a substantial prepayment until it exceeds $1,200.

PRACTICE QUESTION

Which of the following would NASAA consider to be a substantial prepayment of fees?

A. $500 covering the next six months
B. $800 covering the entire contract year
C. $800 covering the next calendar quarter
D. $5,000 covering the next month

Answer: B. NASAA (state law) defines a substantial prepayment of fees to be **more** than $500, six or more months in advance. While $800 and $5,000 are certainly more than $500, they cover a shorter period than six months.

Disclosure of Financial Impairment

Any investment adviser that has discretionary authority or custody of client funds or securities, or requires or solicits *substantial prepayment of fees, must disclose* any financial condition that is reasonably likely to impair its ability to meet contractual commitments to its clients. As an example, the SEC has indicated that disclosure may be required of any arbitration award "sufficiently large that payment of it would create such a financial condition."

Here is the way it is stated in Form ADV Part 2:

If you have discretionary authority or custody of client funds or securities, or you require or solicit prepayment of more than $1,200 in fees per client, six months or more in advance, you must disclose any financial condition that is reasonably likely to impair your ability to meet contractual commitments to clients.

TEST TOPIC ALERT

The Administrator may require an adviser who has *custody* of client funds or securities or has *discretion* over a client's account to post a surety bond or maintain a minimum net worth. The requirement is higher for custody than for discretion. Typically, the net worth required of investment advisers with discretionary authority is $10,000, and that for those taking custody, whether or not they are exercising discretion, is $35,000. If the adviser is using a surety bond instead, the requirement in either case is $35,000. An adviser who does not exercise discretion and does not maintain custody but does accept prepayment of fees of more than $500, six or more months in advance, must maintain a positive net worth at all times.

Definition: surety bond. A surety bond is usually issued by an insurance company (the surety) who guarantees payment of a specified sum to an injured party (either the client or the Administrator) when the securities professional causes damages by her actions or fails to perform.

TEST TOPIC ALERT

Because the Uniform Securities Act is only a template, some states have higher net worth or bonding requirements. The exam may want you to know that if a state-registered IA meets the net worth or surety bonding requirements of the state where its principal office is located, that is sufficient in any other state in which it may be registered.

Definition: principal office. We've used this term several times, and it is an important one to know. Both state and federal law define this as "the executive office of the investment adviser from which the officers, partners, or managers of the investment adviser direct, control, and coordinate the activities of the investment adviser."

PRACTICE QUESTION

Mammon Money Managers (MMM) has its principal office in State A and is also registered in States B, C, and D. MMM exercises discretion in client accounts. As a result, MMM would have to meet the net worth or bonding requirements of

A. the SEC.
B. State A.
C. the state with the highest requirement.
D. each state.

Answer: B. A state-registered investment adviser need only meet the financial requirements of the state in which its principal office is located. SEC requirements are meaningless here because this is a state-registered firm.

TEST TOPIC ALERT

One of the effects of the NSMIA is to limit the powers of an Administrator over a federal covered adviser. Section 222 of the Investment Advisers Act of 1940 states that when it comes to federal covered advisers, any financial or bonding requirements, as well as rules relating to recordkeeping, are solely under federal jurisdiction.

TEST TOPIC ALERT

The proper term to use when referring to the financial requirements of an investment adviser is *net worth*, while for broker-dealers it is *net capital*. However, we have heard from a number of students that NASAA might be using net capital where they should be using net worth in questions about IAs. So, if you want to get the question right, answer it the way they give it to you. You will see several examples of this in our practice questions.

Failure to Maintain Minimum Net Worth

The USA specifies the action to be taken by a registered investment adviser whose net worth falls below the required minimum. By the close of business on the next business day, the adviser must notify the Administrator that the investment adviser's net worth is less than the minimum required. After sending that notice, the adviser must file a financial report with the Administrator by the close of business on the next business day. One more item that must be included in the report is the number of client accounts. When the adviser's net worth is below the minimum requirement, the adviser must obtain a bond in an amount of the net worth deficiency rounded up to the nearest $5,000.

EXAMPLE

A state-registered investment adviser discovers on *Monday* that its net worth is below the minimum requirement. No later than the close of business on *Tuesday*, notice must be sent to the Administrator of the state in which the investment adviser has its principal office. Then, no later than the close of business on *Wednesday*, the investment adviser must file a detailed report with the Administrator of its financial condition. Included in the report must be a statement as to the number of client accounts.

EXAMPLE

An investment adviser who maintains custody of customer funds and securities discovers that its net worth is only $23,000. Even though the adviser only needs a net worth of $35,000, this would require immediate surety bonding in the amount of $15,000 because it must be rounded up to the nearest $5,000.

Computing Net Worth

At Unit 7, LO 7.a, we learned about computing net worth from a corporate balance sheet. For NASAA purposes, the term *net worth* is the excess of assets over liabilities (assets minus liabilities). However, NASAA does not permit the investment adviser to include the following as assets: Goodwill and all other assets of an intangible nature, home, home furnishings, automobile(s), and any other personal items not readily marketable in the case of an individual; advances or loans to stockholders and officers in the case of a corporation; and advances or loans to partners in the case of a partnership. However, furniture used in the office, such as a sofa in the reception room or bookcases in the company research library, are considered assets for the purpose of the computation.

LO 9.g Recall the investment adviser books and recordkeeping requirements under state and federal law.

Books and Records

Once registered, there are a number of post-registration activities required, such as recordkeeping, annual filings, and other reports. The Uniform Securities Act virtually duplicates the first 12 items of the recordkeeping requirements of the Investment Advisers Act of 1940 listed below.

The Investment Advisers Act requires every adviser (other than ones specifically exempted from registration) to make, keep, and preserve such records, and for such periods as the SEC may prescribe as necessary or appropriate in the public interest or for the protection of investors. By rule, the SEC has set forth various recordkeeping requirements for investment advisers. Moreover, the act makes it unlawful for any person to willfully make any untrue statement of a material fact in any report filed with the SEC or to willfully omit to state in a report any material fact required to be stated therein.

The SEC and the states require investment advisers to maintain the following books and records:

- A journal, including cash receipts and disbursement records
- General and auxiliary ledgers reflecting asset, liability, reserve, capital, income, and expense accounts

- A memorandum of each order given by the adviser for the purchase or sale of any security, or any instruction received by the adviser from the client concerning the purchase, sale, receipt, or delivery of a security, and of any modification or cancellation of any such order or instruction
- All checkbooks, bank statements, canceled checks, and cash reconciliations
- All bills or statements (or copies thereof) paid or unpaid
- All trial balances, financial statements, and internal audit working papers
- Originals of all written communications received and copies of all written communications sent by the adviser related to any recommendation or advice given or proposed to be given; any receipt, disbursement, or delivery of funds or securities; or the placing or execution of any order to purchase or sell any security (provided, however, that if the investment adviser sends any notice, circular, or other advertisement offering any report, analysis, publication, or other investment advisory service to more than 10 persons, the investment adviser shall not be required to keep a record of the names and addresses of the persons to whom it was sent; except that if the notice, circular, or advertisement is distributed to persons named on any list, the investment adviser shall retain with the copy of the notice, circular, or advertisement a memorandum describing the list and its source)
- A record of all accounts in which the adviser is vested with any discretionary power with respect to the funds, securities, or transactions of any client
- All powers of attorney and other evidence of the granting of any discretionary authority by any client to the adviser, or copies thereof
- All written agreements (or copies thereof) entered into by the adviser with a client or otherwise relating to its investment advisory business
- A file containing a copy of each notice, circular, advertisement, newspaper article, investment letter, bulletin, or other communication, including by electronic media (email), that the investment adviser circulates or distributes, directly or indirectly, to two or more persons (other than persons connected with the investment adviser); if the item, including communications by electronic media, recommends the purchase or sale of a specific security and does not state the reasons for the recommendation, the adviser must prepare a memorandum indicating the reasons for that recommendation
- A file containing a copy of all written communications received or sent regarding any litigation involving the investment adviser or any investment adviser representative or employee, and regarding any written customer or client complaint
- A file containing a copy of each document that pertains to the registrant or its investment adviser representatives; the file should contain, but is not limited to, all applications, amendments, renewal filings, and correspondence
- With certain exceptions, a record of all securities transactions in which an investment adviser or any advisory representative has, or by reason of such transaction acquires, any direct or beneficial ownership

In practice, the recordkeeping rule has served as a deterrent to the practice of scalping because it requires all advisory representatives to report all of their security transactions to their affiliated advisory firms on a regular basis; these reports are subject to SEC examination. **Scalping** is the practice whereby an investment adviser, before the dissemination of a securities recommendation, trades on the anticipated short-run market activity that may result from the recommendation.

Time Period for Maintenance of Records

The Investment Advisers Act of 1940, as well as the NASAA Model Rule on Investment Adviser Recordkeeping, requires that an investment adviser's books and records be maintained in a readily accessible place for five years. The five-year period will run from the end of the fiscal year during which the last entry was made on the record. During the first two years of the five-year period, the rule requires that the records be maintained in the principal office of the adviser. After this initial two-year period, the records may be preserved in electronic or microfilm format or any other form of data storage in compliance with the act. Even though the recordkeeping requirements are almost identical, it is important to remember for the test that federal covered advisers only comply with the SEC's requirements, while state-registered advisers need only meet the requirements of the state where their principal office is located.

Under both federal and state requirements, partnership articles and any amendments thereto, articles of incorporation, charters, minute books, and stock certificate books of the investment adviser and of any predecessor must be maintained in the principal office of the investment adviser and preserved until at least three years after termination of the enterprise.

TEST TOPIC ALERT

A few pages ago, we gave you a Test Topic Alert that emphasized that as long as state-registered investment advisers meet the net worth or surety bond requirements of their home state, that is sufficient for any state in which they are registered. The same is true regarding recordkeeping requirements, and the proof is in the following statement copied from Form ADV:

2. State-Registered Investment Adviser Affidavit

If you are subject to state regulation, by signing this Form ADV, you represent that you are in compliance with the registration requirements of the state in which you maintain your principal place of business and are in compliance with the bonding, capital, and recordkeeping requirements of that state.

Storage Requirements

The records required may be maintained and preserved for the required time by an investment adviser on:

- paper or hard copy form, as those records are kept in their original form;
- micrographic media, including microfilm, microfiche, or any similar medium; or
- electronic storage media, including any digital (computer disk) storage medium or system as long as the investment adviser establishes and maintains procedures
  - to maintain and preserve the records so as to reasonably safeguard them from loss, alteration, or destruction,
  - to limit access to the records to properly authorized personnel and the Administrator, and
  - to reasonably ensure that any reproduction of a nonelectronic original record on electronic storage media is complete, true, and legible when retrieved.

In all cases, the investment adviser must arrange and index the records in a way that permits easy location, access, and retrieval of any particular record and provide the Administrator with the means to access, view, and print the records.

PRACTICE QUESTION

Under the Investment Advisers Act of 1940, all of the following are true regarding adviser recordkeeping **except**

A. the IA must keep records of transactions made for its own account as well as the account of investment adviser representatives to lessen the likelihood of scalping.
B. computer-generated records may be stored in that format.
C. client account records must be maintained, including a list of recommendations made.
D. records must be maintained for a period of two years from the end of the fiscal year in which the last entry was made.

Answer: D. This is the exception, because the records must be kept for five years. Nothing in the question asked about the two-year requirement in the office. The five-year requirement is that records be easily accessible whether in the office or not.

TEST TOPIC ALERT

You will need to remember that the record retention requirement for investment advisers is five years from the end of the year in which the record was originally generated.

LO 9.h Recognize that investment adviser representatives must be adequately supervised.

Each registered investment adviser must adopt and implement written policies and procedures designed to prevent violation of the federal and state securities laws, review those policies and procedures **annually** for their adequacy and the effectiveness of their implementation, and designate a **chief compliance officer** (CCO) to be responsible for administering the policies and procedures. An adviser's chief compliance officer should be competent and knowledgeable regarding the Advisers Act and the USA and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm. Thus, the compliance officer should have a position of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures. In fact, the CCO's identity must be disclosed on Form ADV.

In keeping with the times, one of the areas that must be covered in these written procedures deals with physical security and cybersecurity. An investment adviser must establish, implement, update, and enforce written physical security and cybersecurity policies and procedures reasonably designed to ensure the confidentiality, integrity, and availability of physical and electronic records and information. The policies and procedures must be tailored to the investment adviser's business model, taking into account the size of the firm, type(s) of services provided, and the number of locations of the investment adviser. We'll have more to say about this topic in Unit 14.

The role of the CCO is particularly important when it comes to ensuring supervision of those individuals referred to as "supervised persons." Failure to supervise can lead to suspension or revocation of the investment adviser's registration.

Definition: supervised person. A supervised person is any of the IA's officers, partners, directors (or other persons occupying a similar status or performing similar functions), or employees, or any other person who provides investment advice on the investment adviser's behalf and is subject to its supervision or control. The most common example is the investment adviser representative (defined in Unit 10).

Although many supervised persons fall within the definition of "investment adviser" (they meet the three-prong test), the SEC and the states do not require those individuals to register as investment advisers with the regulators. Instead, the advisory firm must register. The adviser's registration covers its employees *and* other persons under its control, provided that their advisory activities are undertaken on the investment adviser's behalf. In most cases, these individuals must register as investment adviser representatives and come under the adviser's supervisory jurisdiction.

This is particularly true in the case of financial planners who have elected to operate as independent contractors, not employees of investment advisory firms. Regardless, they are required to be registered as investment adviser representatives of the firm and must be placed under the same level of supervisory scrutiny as employees. Their business cards may contain the name of their separate planning entity but must also disclose the name of the entity registered as the investment adviser.

Do not confuse this with a similar term defined in the Advisers Act: *person associated with an investment adviser*. A person associated with an investment adviser is "any partner, officer, or director of such investment adviser (or any person performing similar functions), or any person directly or indirectly controlling or controlled by such investment adviser, including any employee of such investment adviser, except that for persons associated with an investment adviser whose functions are clerical or ministerial shall not be included in the meaning of such term."

What is the difference? *Supervised person* includes **every** employee under the supervision of the investment adviser, while *associated person* excludes clerical and administrative employees.

KNOWLEDGE CHECK 9.4

1. An investment adviser registered in State G is obligated to maintain certain books and records as specified by the Uniform Securities Act. Which of the following statements regarding adviser recordkeeping is *not* true?
   A. Records originally created on computer may be stored in electronic media.
   B. Records are subject to surprise audits by the State G Administrator.
   C. Written records may be reduced to microfilm.
   D. Records must be kept for six years.
2. Defalcator Investment Advisers (DIA) is registered in States A, K, and R. Disclosure of financial impairment is required in all of the following circumstances **except**
   A. DIA maintains custody of customer funds and securities.
   B. DIA requires a quarterly prepayment of fees in the amount of $800.
   C. DIA requires an annual prepayment of fees in the amount of $600.
   D. DIA exercises discretion over customer advisory accounts.
3. Amir is the proprietor of Best Financial Planning, Inc. (BFPI). He is licensed as an investment adviser representative with Fortune Awaits You (FAY), an investment adviser registered in several states. Supervision over Amir's advisory activity is the responsibility of
   A. Amir personally as the sole proprietor of BFPI.
   B. BFPI.
   C. FAY.
   D. the Administrator of the state in which BFPI maintains its principal office.

KNOWLEDGE CHECK ANSWERS

Knowledge Check 9.1

1. **C** This is the role of a pension consultant. Unless the insurance has a securities aspect, selling it would not be considered investment advice. Real estate and coins are not securities.

   LO 9.a

2. **A** There are three specific "nonpersons" on this exam. They are (1) a deceased individual, (2) an individual declared mentally incompetent, and (3) a minor. A person can be almost any entity, including a corporation, a partnership, an unincorporated association, a subdivision of a government, a trust that issues shares of ownership (such as a unit investment trust), or a natural person (an individual).

   LO 9.a

Knowledge Check 9.2

1. **D** Because the maximum is five retail clients in a 12-month period, the choice with *six* clients or fewer is over the limit. Notice that "fewer than six" and "five or fewer" mean the same thing.

   LO 9.b

2. **C** Section 3(c)(1) limits the number of investors to a maximum of 100. Section 3(c)(7) does not have a numerical limit on investors, but it does have more stringent financial requirements.

   LO 9.c

Knowledge Check 9.3

1. **A** Dodd-Frank removed the prohibition against registering with the SEC for those who would otherwise be required to register in 15 or more states. It does the same for pension consultants advising more than $200 million, not $150 million. With AUM between $100 million and just under $110 million, an IA can choose to register with the SEC or the states. Any investment adviser under contract to an investment company registered under the Investment Company Act of 1940 is considered a federal covered IA and must register with the SEC.

   LO 9.d

2. **A** In almost every instance, changes require the filing of an amended ADV. When the change is material, the filing is done promptly. In other cases, it is done within 90 days of the end of the adviser's fiscal year. When there is a successor firm, it is treated as a new entity requiring a new Form ADV Part 1 and Part 2.

   LO 9.e

Knowledge Check 9.4

1. **D** Records of an investment adviser must be maintained for five years. Records are subject to surprise audits by the state Administrator, written records may be reduced to microfilm, and records originally created on a company's computer may be stored in electronic media.

   LO 9.g

2. **B** Disclosure of financial impairment is necessary whenever the IA exercises discretion or maintains custody. A substantial prepayment of fees will also trigger the disclosure. For state-registered IAs, that is more than $500, six or more months in advance. Although the $800 prepayment is certainly more than $500, it is for three months, not six months or more.

   LO 9.f

3. **C** As is the case with many independent financial planners, they have their own planning business but are licensed with a separate investment advisory firm. That firm is where the responsibility lies for the actions of any of their IARs.

   LO 9.h