

HOW THE SEC'S PROPOSED RULE MAY AFFECT INTERNET INVESTMENT ADVISERS

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The Securities and Exchange Commission staff has proposed a rule under the Investment Advisers Act of 1940 (Advisers Act) that would exempt certain investment advisers operating through the Internet. "Exemption for Certain Investment Advisers Operating Through the Internet," Release No. IA-2028; File No. S7-10-02. The proposed Rule 203A-2(f) would expand the list of those entities that may register with the SEC, thus pre-empting state regulation to include any adviser that "conducts substantially all of its advisory business through an interactive website on the Internet." See Letter to Jonathan G. Katz, Secretary, SEC, from Joseph Borg, President, North American Securities Administrators Association Inc., dated June 6 (NASAA Letter). The proposed rule, however, has stirred up some controversy in certain quarters of the investment management industry.

Advisers Act

The Advisers Act defines an "investment adviser" in § 202(a)(11) generally to include any person (including a natural person or entity) who (1) for compensation (2) is engaged in the business (3) of providing advice to others or issuing reports or analyses regarding securities. Therefore, to fall within the definition of investment adviser, a person must satisfy each of these three elements of the definition. Over the years, these definitional elements have been broadly construed by courts and the SEC, the federal agency with primary jurisdiction over investment advisers. There are, however, exclusions from the definition of investment adviser that may apply to banks and bank holding companies; lawyers, accountants, engineers and teachers; and broker-dealers and registered representatives. See Advisers Act, § 202(a)(11)(A)-(F) and § 202(b). In addition, there are exemptions from registration for the following: intrastate advisers; advisers to insurance companies only, private investment advisers, foreign advisers offering services to U.S. clients, and entities registered under other regulatory regimes such as broker-dealers, commodity trading advisers, insurance companies and commodity pool operators. See Advisers Act, § 203(b) and § 203A. Furthermore, the passage of the National Securities Markets Improvement Act of 1996 (NSMIA) provided some more amendments to the Advisers Act.

NSMIA

NSMIA basically bifurcated the regulatory regime between the federal government and the states. Since investment advisers having a place of business within a state usually must register also with that state, all

but the smallest investment advisers historically have been required to register at both the federal and state levels. According to Title III of NSMIA, which added § 203A to the Advisers Act, an investment adviser that is required to be regulated in the state in which it maintains its principal office and place of business is neither required nor permitted to register under the Advisers Act unless it (i) has assets under management of \$25 million or more (or such higher amount as the SEC may determine), or (2) is an adviser to a registered investment company (commonly referred to as a “mutual fund”).

Therefore, SEC-registered advisers and their “supervised persons”¹ are generally exempted from state registration, and a nationwide de minimis exemption, based on a minimum number of clients in any state, is created. It should be noted, however, that despite NSMIA, the states still retained the power to impose fees and antifraud jurisdiction over SEC-registered advisers. However, NSMIA allowed the SEC, by rule or regulation, to permit the registration with the SEC if state registration would present burdens on the investment adviser. One of the goals that the proposed rule seeks is to reduce the administrative and regulatory burdens to which an Internet investment adviser would be subjected, since it would have to register in each state where it conducted its investment advisory business. The SEC posits that this would be a tremendous burden, since Internet investment advisers do not engage in the same type of business model as a traditional investment adviser; however, the state securities agencies disagree with this assessment, as described below.

Proposed Rule

Under NSMIA, the SEC may permit investment advisers to be regulated at the federal level, even if they do not meet the \$25 million-assets-under-management test, if the prohibition on SEC registration would be “unfair,” a burden on interstate commerce or otherwise inconsistent with the purposes of § 203A of the Advisers Act. See Letter to Jonathan G. Katz, Secretary, SEC, from Rasha Elganzouri, Counsel, Investment Counsel Association of America, dated June 6 (ICAA Letter). Advisers Act, § 203A(c).

With the proposed rule, the SEC is seeking to allow Internet investment advisers to register with the SEC when many of them do not meet the \$25 million assets-under-management test.² Proposed Rule 203A-2(f) would exempt an investment adviser from the prohibition on SEC regulation if the investment adviser conducts substantially all its advisory business through an interactive web site on the Internet. The phrase “substantially all” is defined to mean that at least 90 percent of the investment adviser’s clients obtain investment advice exclusively through the interactive web site. An “interactive web site” is defined as a web site in which computer-based models or algorithms provide investment advice to clients based on information that each client supplies to the site. This is intended to exclude those investment advisers that simply have an Internet web site for marketing or client-servicing purposes from registering with the SEC. In practice, clients visiting these web sites would answer online questions about their finances, investment objectives, investment time horizon, risk tolerance and investment restrictions.

In addition, the interactive web site may be reached at any time by persons residing in any state or outside the United States. Internet investment advisers have no physical presence in a particular community or state, and clients of these advisers have little or no direct contact with the adviser or its personnel and obtain the adviser’s services only through a web site.

The Debate

One provision of the proposed rule that is generating controversy is the “substantially all” test. The Investment Counsel Association of America (ICAA) has recommended that the 90 percent limitation be even more narrowly construed to apply to “an identifiable class of clients that, in return for compensation, received tailored investment advice based on personal information supplied to the adviser through an interactive website.” ICAA Letter at 5. This recommendation seeks to prevent Internet investment advisers from factoring in anonymous users of their interactive web sites into the 90 percent client calculation. Moreover, “a requirement that an Internet adviser provide advice to an identifiable set of clients is consistent with the adviser’s fiduciary duty to know the customer and provide suitable investment advice.” *Id.* Indeed, according to the ICAA, there may be some situations in which direct contact with the investor and the investment adviser is warranted to fulfill suitability obligations under the Advisers Act; therefore, “[i]n such circumstances, the Internet adviser cannot factor these clients in the [90] percent limitation required under the proposed rule.” *Id.*

The North American Securities Administrators Association Inc. (NASAA) has taken the position that “anything less than 100 percent is unlikely to discourage unscrupulous advisers from modifying their business models with the objective of avoiding state regulation.” NASAA Letter at 4. Therefore, according to NASAA, “‘substantially all’ should mean that 100 percent of an adviser’s clients obtain their advice exclusively through the website, with a de minimis safe harbor in urgent situations initiated by a client, such as a technology breakdown.” *Id.*

In addition, the proposed rule does not account for investment advice provided through such devices as e-mail communications, instant messaging and telephone communications, in the “exclusively through interactive web site” prong of the exemption that could potentially leave room for abuse. *Id.* NASAA also disagrees with the cost benefit analysis in the proposed rule, and that “the cost of compliance with state requirements is unsubstantiated, the costs of registering in states is extrapolated beyond logical bounds, and no consideration was given to investor protection benefits flowing from state regulation.” *Id.* at 3. Finally, NASAA indicates that the SEC is ignoring an existing rule under the Advisers Act where an Internet investment adviser is expecting to qualify for SEC registration within 120 days and may register with the SEC without having to register in any state. See 17 C.F.R. 275.203A-2(d). Therefore, according to NASAA, if an Internet investment “adviser determines that it would be obligated to register in at least 30 states, it could take advantage of an existing preemption.” NASAA Letter at 3.

In light of the comments that the SEC staff has received to date, it is possible that the staff will attempt to close any potential loopholes, as illustrated in the “substantially all” test, that may encourage Internet investment advisers to avoid their fiduciary obligations to clients. In addition, the staff may seek to strike a balance with the state securities agencies, represented by NASAA, so that the most efficient regulatory scheme for Internet investment advisers may be devised. Clearly, the needs of the state securities agencies in promoting investor protection in their respective states must be weighed against the potential burdens for Internet investment advisers to register in all 50 states when they have no physical presence there and do not exercise discretionary authority and continuous supervision over assets.

As the SEC staff reviews comments on the proposed rule, it will be important for the commission to take into account the concerns of those in the investment management industry. One of the paramount concerns is that the proposed rule does not become an area of abuse so that Internet investment advisers

use the exemption to avoid their fiduciary duties, including suitability, that are implicit under the Advisers Act.

(1) The term “supervised person” means any partner, officer, director (or other person occupying a similar status or performing similar functions) or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser. A state, however, may license, register or otherwise qualify any investment adviser representative who “has a place of business located within that state.”

(2) Investment advisers exclusively using interactive web sites generally do not exercise discretionary or continuous supervision over assets.