Commentary: States' Rights Embodied in the Securities Laws

By Stephen J Nelson; The Nelson Law Firm, LLC

Originally Published in *Traders Magazine* on December 8, 2010

http://www.tradersmagazine.com/news/securities-law-states-rights-106801-1.html

Incoming House Majority Leader Eric Cantor stirred up a fair amount of controversy lately by speaking in favor of, or at least not dismissing out of hand, a plan by the Virginia legislature to amend the U.S. Constitution to provide that a two-thirds vote of the states could overturn any duly enacted federal law. Virginia's proposal is reminiscent of the "nullification doctrine" advanced by Senator John C. Calhoun of South Carolina in the 1820s.

Most lawyers, and I am no exception, are fascinated by Constitutional law issues. Unfortunately, the issues raised by the nullification doctrine were not resolved in court. South Carolina did, in fact, vote to "nullify" the Tariff Act of 1928, eventually causing Congress in 1832 to authorize President Jackson to take military action against the State. Cooler heads prevailed before bullets started to fly, rendering military action at that time unnecessary. However, the doctrine remained popular in Southern circles and was only finally put to rest by the Civil War. The unfortunate reality is that, rather than providing an opportunity for interesting legal employment, fundamental Constitutional issues have a nasty way of being resolved by bloodshed.

The thrust of the nullification doctrine, in either its ancient or its latest regurgitated form, is to grant more power to the States, as compared to the federal government. In recent years, federal securities laws have tended to move in the opposite direction. The trend has been to put more responsibility for fighting fraudulent practices involving securities in the hands of the states. Interestingly, the states don't seem eager to have this power.

Most recently, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) removes from Securities and Exchange Commission (SEC) registration any investment adviser that manages less than $100 million in assets, provided that the adviser is regulated by its home State. This move continues the trend that began with The National Securities Markets Improvements Act of 1996 (NSMIA), which removed investment advisers of less than $25 million in assets completely from the SEC registration scheme. On November 19, 2010, the SEC proposed new rules that would implement the investment adviser registration division of labor enacted by Dodd-Frank.

Under the new rules, (1) if an investment adviser has assets under management between \$25 million and \$100 million *and* (2) the State in which the investment adviser maintains its principal office and place of business requires it to register *and* (3) the adviser is subject to examination by the state securities commissioner (or similar official), then the adviser must register with the State and is prohibited from registering with the SEC. Unless all three elements are satisfied, the investment adviser is required to register with the SEC.

It is worth noting that Dodd-Frank differs from NSMIA in the way it deals with the dividing line between Federal and State authority. Under NSMIA, investment advisers managing less than \$25 million in assets are exempt from SEC registration, whether or not their home State actually chooses to regulate them. As it happens, every State except Wyoming has a registration scheme for investment advisers. However, state registration laws also contain many exemptions, so many registered advisers with assets under \$25 million are completely exempt from registration anywhere. Advisers with assets greater than \$25 million may also be exempt under State registration statutes, but Dodd-Frank would then require them to register with the SEC. Most States have adopted some version of the Uniform State Securities Act (1956), which exempts from registration investment advisers whose clients are limited to institutional clients or employee benefit plans with assets greater than one million dollars. Some states define institutional clients quite broadly. Advisers who qualify for one of those state exemptions would have to register with the SEC.

In addition, to qualify for federal exemption, Dodd-Frank requires not only that a State register an investment adviser, but also that the investment adviser be subject to an examination program. According to a comment submitted by the North American Securities Administrators Association (NAASA), 47 states maintain an examination program for investment advisers that includes routine examinations. 89% of routine examinations are performed on a one to six year exam schedule.

However, there are some notable absences when it comes to investment adviser examinations. New York, for example, does not have an examination program, so unless it establishes a new program, New York advisers with assets between \$25 and \$100 million will remain subject to SEC registration. New Mexico has one person who is responsible for all things investment adviser, and doesn't welcome the addition of a substantial number of new customers. Connecticut has loudly objected to the new rules, on the grounds that increasing its regulatory responsibility would impose a significant burden on its already stretched resources. State programs are being abolished and curtailed everywhere due to budgetary concerns. Notwithstanding NAASA's optimistic comment to the SEC, taking responsibility for a large number of investment advisers is unlikely to be met with applause by any State's legislators, including Virginia's.

The SEC, for its part, does not intend to determine whether any State's investment adviser examination program is adequate or effective. Instead, the SEC will simply ask the State in writing whether or not it has an examination program that would satisfy Dodd-Frank. If it responds affirmatively, the case is closed. Offloading a substantial number of registrants into inadequately funded or ineffectual state programs seems like a recipe for fraud; but any state that objects to the influx of new registrants need only eliminate its examination program! That will keep out the new state registrants, but will allow the under-$25-million advisers to remain free from examination oversight.

The SEC's new rules do provide a helpful uniform way to calculate the amount of assets under management.

U.S. securities laws have always been a shared responsibility of Federal and State governments. The reason for this is primarily historical. The States were plagued with episodes of securities fraud in the 1920s and enacted "blue sky" laws to protect their citizens. These laws became the basis of the Securities Act of 1933. The only exception, and a very important one, is the Securities Exchange Act of 1934, which is exclusively a matter of Federal jurisdiction. The markets belong entirely to the SEC.

Dodd-Frank's division of authority dovetails nicely with European regulation. The recent Alternative Investment Fund Manager Directive generally would provide European-wide regulation for investment advisers who manage more than 100 million Euros in assets, while leaving all others in the hands of national regulation.

The fact is that national and state governments are happy to collect registration fees from investment advisers. Examination programs, on the other hand, are expensive. Smaller advisers present particularly difficult examination issues because they often lack the resources to employ dedicated compliance personnel and maintain expensive compliance programs. This lack of resources renders the work of State examiners tedious, time-consuming and frustrating. For the same reason, it is difficult to assess industry fees sufficient to maintain examination programs for this sector. State Securities Commissions suffer chronic underfunding issues.

It is also difficult to argue that Dodd-Frank's division of labor is a devolution of local issues to local authorities. The Investment Advisers Act already contains an exemption for advisers whose clients are located only in one State. The fact is that in this era of globalization, many investment advisers with offices in say, Connecticut, largely serve investors in other states. Visits from clients are rare events. As a result, decisions about where to locate an investment advisory office tend to be dictated by the convenience of an adviser's portfolio managers, rather than the location of its clients. This means that a State's scarce investor protection resources will often be allocated to protecting another State's investors.

Entire libraries have been devoted to the concepts of federalism and the related nullification and States' rights theories that underpin our Constitutional system. I doubt very much that anyone thinks a valid reason for the system is to skim the cream into the Federal system and relegate the expensive small problems to State authorities.

In principle, authority should be a triumvirate with obligations and funding. So would the State of Virginia, in a delightful twist of irony, "nullify" that portion of Dodd-Frank that expands the authority of the States to regulate investment advisers?