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## REGULATORY MONITOR

### SEC Update

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#### SEC Proposes Amendments to the Internet Adviser Exemption

**O**n July 26, 2023, the Securities and Exchange Commission (SEC) unanimously proposed to amend Rule 203A-2(e) (Internet Adviser Exemption) under the Investment Advisers Act of 1940 (the Advisers Act).<sup>1</sup> The Internet Adviser Exemption is an exemption from the general prohibition against small- or mid-sized investment advisers registering with the SEC instead of registering with one or more state securities regulators. The proposed amendments to the rule (Proposed Amendments) are intended to modernize the rule to reflect the broader evolution in technology and the marketplace since the rule initially was adopted in 2002 and to align current practices in the investment advisory industry more closely with the narrow exemption that was intended to reflect Congress' allocation of responsibility for regulating investment advisers between the SEC and the states.

#### Background

The National Securities Markets Improvement Act of 1996 amended the Advisers Act to divide the responsibility for regulating investment advisers between the SEC and the states.<sup>2</sup> The states generally were given the primary responsibility for regulating smaller advisory firms, while the SEC was given primary responsibility for regulating larger advisers. Congress further refined the allocation of regulatory

responsibility in 2010 in the Dodd-Frank Wall Street Reform and Consumer Protection Act.<sup>3</sup> The Dodd-Frank Act, among other things, amended Section 203A of the Advisers Act to give the states' primary responsibility for regulating mid-sized advisers, that is, investment advisers having between \$25 million and \$100 million of assets under management, with certain exceptions. The SEC set the registration threshold higher in 2011 by giving certain investment advisers the choice whether to register with the SEC or with the state(s) if they have at least \$100 million, but less than \$110 million, in assets under management.<sup>4</sup>

As a result, under Section 203A of the Advisers Act and Rule 203A-1 thereunder, an investment adviser is required to register with the SEC if it (a) has \$110 million or more of assets under management; (b) has \$25 million or more of assets under management and has its principal office and place of business in a state where it is exempt from registration or a state that requires registration but does not subject investment advisers to examination (currently, only New York State fits this description); (c) advises registered investment companies or business development companies; (d) is a foreign investment adviser with aggregate assets under management of \$25 million or more attributable to fifteen or more US clients or US investors in private funds managed by the adviser; or (e) is otherwise permitted to register with the SEC by rule or order.<sup>5</sup> Other investment

advisers are prohibited from registering with the SEC and must register with any state securities authority(ies) with jurisdiction over them.<sup>6</sup>

### The Internet Adviser Exemption

The Internet Adviser Exemption is one of several exemptions that the SEC has adopted by rule that permits investment advisers to register with the Commission even though the advisers do not meet the eligibility requirements for federal registration. These exemptions are set out in Rule 203A-2 under the Advisers Act. Current Rule 203A-2(e) provides that the Section 203A(a) prohibition on registering with the SEC will not apply to any investment adviser that (a) provides investment advice “to all of its clients exclusively through an interactive website,” except that it may provide advice to fewer than fifteen clients during a 12-month period by other means (referred to as the “de minimis exception”); (b) maintains certain records demonstrating that it provides investment advice to its clients exclusively through an interactive website as provided in the rule; and (c) does not control, is not controlled by, and is not under common control with, another investment adviser that registers with the SEC solely in reliance on its affiliation with the internet adviser.<sup>7</sup>

The Internet Adviser Exemption was intended to create a narrow exemption from the prohibition on SEC registration for certain advisers that, unlike state-registered advisers, have no local presence and whose advisory activities are not limited to one or a few states, and that also typically do not manage the assets of their clients or advise a registered investment company, and thus do not meet the statutory thresholds for registration with the Commission.<sup>8</sup> As the SEC stated in adopting it, absent the Internet Adviser Exemption, internet investment advisers would likely incur the burden of having to register in multiple states and later having to withdraw those registrations if they become eligible for SEC registration under another exemption.<sup>9</sup>

### The Proposed Amendments

In proposing the amendments, the SEC explained that it is seeking to modernize the Internet Adviser Exemption’s conditions to account for the evolution in technology and the investment advisory industry since the adoption of the rule over twenty years ago.<sup>10</sup> The Proposing Release notes that, as compared to twenty years ago, the use of technology is now central to how many investment advisers provide their products and services to clients and that the SEC has observed an increase in the number of advisers seeking to rely on the Internet Adviser Exemption, and not always appropriately.<sup>11</sup> The SEC also explained that the Internet Adviser Exemption was intended to be a narrow exemption focused on entities that are in the business of exclusively providing investment advice through an interactive website, but that the SEC Exam Staff has observed numerous compliance deficiencies by advisers relying on the Internet Adviser Exemption, including reliance upon the exemption by advisers that are ineligible to do so.<sup>12</sup>

#### Operational Interactive Website

The Proposed Amendments to the Internet Adviser Exemption would replace the term “interactive website” with a new defined term, “operational interactive website.”<sup>13</sup> Thus, the rule would require an investment adviser relying on the Internet Adviser Exemption to have “at all times” an “operational interactive website.” The term “operational interactive website” would be defined as “a website or mobile application through which the investment adviser provides digital investment advisory services on an ongoing basis to more than one client (except during temporary technological outages of a de minimis duration).”<sup>14</sup>

The new definition would incorporate a number of changes to the Internet Adviser Exemption. These changes include (1) an express requirement that the internet-based services be provided to clients on an ongoing basis (that is, the requirement to provide an operational interactive website would apply to an

adviser at all times during which the adviser relies on the Internet Adviser Exemption to be registered with the SEC),<sup>15</sup> with a provision for temporary outages, (2) permitting investment advice to be provided through the use of mobile applications, and (3) the requirement that the service must be provided to more than one client (discussed in more detail, below).

### Digital Investment Advisory Service

The definition of “operational interactive website” also refers to the investment adviser providing “digital investment advisory services” through the operational interactive website. “Digital investment advisory service” would be defined as “investment advice to clients that is generated by the operational interactive website’s software-based models, algorithms, or applications based on personal information each client supplies through the operational interactive website.”<sup>16</sup> The SEC explained that the definition is similar to the current requirement, except that it expressly allows advisers to provide investment advice generated by software-based algorithms in addition to software-based models or applications.<sup>17</sup>

The SEC further explained that its intent is to require that investment advice provided by an internet adviser through its website or mobile application must be generated by software-based models, algorithms or applications based on personal information provided by the client.<sup>18</sup> In other words, an internet adviser’s personnel would not be permitted to generate, modify, or otherwise provide clients specific investment advice through the operational interactive website or otherwise.<sup>19</sup> The SEC emphasized that “human-directed client-specific investment advice, delivered through electronic means, would not be eligible activity under the Investment Adviser Exemption. The use of the internet or other electronic media to communicate with clients is not, alone, a sufficient basis for an adviser to rely on the exemption.”<sup>20</sup> One question not addressed in detail by the SEC

is the interaction between this restriction and Rule 3a-4 under the Investment Company Act of 1940, which provides a safe harbor from the definition of investment company (and registration under the Securities Act of 1933) for discretionary investment advisory programs that, among other things, make personnel of the manager of a client’s account who are knowledgeable about the account and its management reasonably available to the client for consultation.

### More Than One Client

As noted above, the proposed definition of “operational interactive website” would require that an internet investment adviser must provide digital investment advisory services through its website or application on an ongoing basis to “more than one client.” The SEC explained that in its view, advisers with no clients or only one client are more akin to local businesses that can be effectively regulated by a state, rather than the SEC.<sup>21</sup>

### De Minimis Provision

The Proposed Amendments would eliminate the exception in the current Internet Adviser Exemption that permits internet investment advisers to provide investment advice to clients by means other than their interactive websites, provided it is limited to fewer than 15 such clients during any 12-month period. If adopted, any investment adviser relying on the Internet Adviser Exemption would be required to provide investment advice to all of its clients exclusively through an operational interactive website.

The SEC explained that the de minimis provision was included in the original rule so that an adviser would not lose its ability to rely on the exemption if it provided advice to a small number of clients other than through an interactive website.<sup>22</sup> The SEC stated that it “preliminarily believes” that there is not the same need for this provision now.<sup>23</sup> The SEC also noted that advisers that do have non-internet clients may be able to rely on other

provisions to register federally, and therefore be less likely to lose their ability to remain SEC-registered. The SEC also cited advances in technology, allowing internet businesses to better control what states they operate in, and changes to the multi-state exemption enacted since 2002 as supporting this proposed change, as internet advisers are now better able to control the number of states in which they would be required to register.<sup>24</sup>

### Form ADV

Finally, the Proposed Amendments would amend Form ADV to require investment advisers that rely on the Internet Adviser Exemption to make affirmative representations as to their eligibility to rely on that rule.

### Request for Comment

The SEC sought comment on: (i) all aspects of the Proposed Amendments relating to the requirements for internet investment advisers to have an operational interactive website and related amendments to Form ADV; and (ii) the proposed elimination of the de minimis exception in the Internet Adviser Exemption. Comments on the Proposed Amendments were due by October 2, 2023.

### Conclusion

The Proposed Amendments are intended to reinforce the narrow scope of the Internet Adviser Exemption as envisioned by the SEC, and also clarify the application of the exemption to interactive technologies as their use has evolved since 2002. Investment advisers that currently rely on the Internet Adviser Exemption should review the proposal carefully to determine what effect it would have on their ability to continue being federally registered and, if not, any state registration requirements that may be applicable.

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### NOTES

- <sup>1</sup> *Exemption for Certain Investment Advisers Operating Through the Internet*, Advisers Act Release No. 6354 (July 26, 2023) (Proposing Release), available at: <chrome-extension://efaidnbmnmnibpcajpcglclefndmkaj/https://www.sec.gov/files/rules/proposed/2023/ia-6354.pdf>.
- <sup>2</sup> National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).
- <sup>3</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
- <sup>4</sup> Rule 203A-1(a)(1) under the Advisers Act. This rule also requires an adviser to withdraw its SEC registration and switch to state registration if its assets under management fall below \$90 million.
- <sup>5</sup> Section 203A(a)(1) of the Advisers Act [15 U.S.C. § 80b-3a(a)(1)].
- <sup>6</sup> *See Rules Implementing Amendments to the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 3221 (Jun. 22, 2011), at n. 16.
- <sup>7</sup> Rule 203A-2(b) permits an investment adviser that controls, is controlled by or under common control with, another SEC-registered investment adviser to register with the SEC.
- <sup>8</sup> *Exemption for Certain Investment Advisers Operating Through the Internet*, Advisers Act Release No. 2091 (Dec. 12, 2002) (2002 Adopting Release), at nn. 6–8 and accompanying text.
- <sup>9</sup> 2002 Adopting Release at text accompanying n.8 and § IV.B.
- <sup>10</sup> Proposing Release at 5.
- <sup>11</sup> Proposing Release at 10.
- <sup>12</sup> Proposing Release at 11–12; *see* Risk Alert, Observations from Examinations of Advisers that Provide Electronic Investment Advice, Securities and Exchange Commission Division of Examinations (Nov. 9, 2021), available at <https://www.sec.gov/files/exams-eia-risk-alert.pdf>.

<sup>13</sup> See proposed Rule 203A-2(e)(1)(i).  
<sup>14</sup> Proposed Rule 203A-2(e)(2).  
<sup>15</sup> Proposing Release at 17-18.  
<sup>16</sup> Proposed Rule 203A-2(e)(2).  
<sup>17</sup> Proposing Release at 20.  
<sup>18</sup> Proposing Release at 21.

<sup>19</sup> *Id.*  
<sup>20</sup> *Id.*  
<sup>21</sup> Proposing Release at 18-19.  
<sup>22</sup> Proposing Release at 26.  
<sup>23</sup> *Id.*  
<sup>24</sup> Proposing Release at 27.

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