The LeGaye Law Firm, PC

Investment Adviser Registration And Regulatory Overview

Daniel E. LeGaye
6/28/2010

Investment Adviser Registration and Regulatory Overview

Table of Contents

Investment Adviser Registration
And
Regulatory Overview

Introduction

Companies and individuals who provide investment advice to others are generally subject to regulation by federal and or state securities regulators. Therefore, before providing financial advice to anyone, prospective advisers must determine whether registration is required, and if so, what type of registration is appropriate. Where registration is required, it is critical to understand the regulatory requirements related to that registration as well as the on-going regulatory obligations, as the regulatory environment is complex and the ramifications of non-compliance are significant.

This discussion does not purport to address all aspects of the advisory industry or all regulatory requirements affecting an Investment Adviser, as such, it is important to note that this discussion is a summary of key issues we believe material, and is provided for discussion purposes only. The matters affecting the registration and on-going operations of an Investment Adviser are complex and this discussion is not a substitute for engaging legal counsel or any other specialized professionals to discuss all of the facts regarding your proposed activities and individual situation.

Investment Adviser Registration Overview

IA & IAR's

An Investment Adviser ("IA") and/or an Investment Adviser Representative ("IAR") is generally described as any entity or person who, for compensation, engages in the business of advising others, either directly as to the value of securities, or as to the advisability of investing in, purchasing, or selling securities. IA's and IAR's are generally required by most states to register or become licensed. To confuse the situation, some states use the term "register" and others use the term "license". For our purposes here, both terms have the same meaning.

The IA firm holds the investment adviser registration. The IAR is an individual who performs services on behalf of the IA, and the IA holds his or her registration. Some states include within the definition of an IAR a person (often called a solicitor) who regularly refers customers to an IA and who receives compensation for those referrals. Other states may have modified licensing requirements for solicitors.

Characteristics of IA

There are three essential elements which characterize an IA. They are:

- The IA and or IAR provide advice or analysis on securities either by making direct or indirect recommendations to clients, or by providing research or opinions on securities or securities markets.
- The IA and IAR receive any form of compensation for the advice provided.
- The IA and IAR engage in a regular business of providing advice on securities.

State and Federal Registration

Once it has been determined that your activities possess the characteristics requiring registration, you will then need to determine whether your activities will be subject to state registration and or federal registration. The decision to register or become licensed with either state or federal securities regulators is generally based upon the following analysis.

State Registration

State registration is generally applicable where the prospective IA:

- Anticipates having less than $25,000,000 in assets under management in the first 180 days of its registration.
- Provides only financial planning or other services that do not involve regular and ongoing management of clients' securities.

- Acts as a solicitor only, by soliciting clients on behalf of other advisers, while providing no advice themselves.

To further complicate the regulatory framework, each state has its own securities statutes and regulations governing the operation and registration of Investment Advisers. However, most states have a deminimus exemption for advisers having only a few clients in the state, but these exemptions vary from state to state. Therefore, it is important to look at each states regulations as to their deminimus exemption. The exemption can be impacted by whether there are actual offices in the respective state, and some states count solicitations toward that minimum.

Federal Covered Advisers

Federal registration is generally applicable where the prospective IA:

- Has or will have $25,000,000 or more in client assets within the first 180 days of registration, and those assets are under regular and ongoing management.
- Is an adviser to investment companies under the Investment Company Act of 1940.
- Is providing services in 30 or more states.

Federally registered advisers are primarily subject to the Investment Advisers Act of 1940 (the "Advisers Act"), which is enforced by the Securities and Exchange Commission ("SEC"). However, a federally registered Investment Adviser must notice file with all states where they have a place of business in the state, or have six or more clients in that state in a twelve-month period, regardless of place of business.

IA Registration Process

Primarily either the SEC or the states regulate IAs. However, while both groups of regulators maintain jurisdiction over certain aspects of the advisory activities of advisers, the registration process is centered around the primary regulator, i.e. federal or state. Thus, state IAs register or are

licensed with the respective states in which they are required to register, and a federally covered IA would register with the SEC.

Form ADV

The main document in the registration of an IA is the Form ADV. You should review the Form ADV to gain a preliminary understanding of the information needed. The Form ADV consists of two parts and is approximately 73 pages in length. The Form ADV generally contains substantial information on the structure of the business contemplated, the persons providing the advisory advice and disclosures related to conflicts of interest. As such, the government's estimate of 9 hours to complete the form may be optimistic.

ADV Part 1

The ADV Part I sets forth information about an adviser's business, the persons who own or control the adviser, and whether the adviser or certain of its personnel have been sanctioned for violating the securities laws or other laws. ADV Part I is available in electronic format and is both filed and amended through Investment Adviser Registration Depository ("IARD").

ADV Part II

The ADV Part II is a written disclosure statement (or a written brochure) that provides information about business practices, fees, and conflicts of interest the adviser may have with its clients, and is required to be delivered to prospective clients. ADV Part II is completed in paper format at this time, as the IARD is not prepared to accept an electronic filing of ADV Part II. It is important to review rule 204-3 of the Advisers Act regarding your legal obligations to:

- Deliver a copy of ADV Part II (or a brochure containing comparable information) to prospective clients, and
- Offer annually a copy of ADV Part II (or brochure containing comparable information) to all current customers.
- You do not send your ADV Part II to the SEC as a part of the registration process; however, you should check with state securities

authorities to determine what their filing requirements are for the ADV Part II.

IARD

All advisers must now register with the SEC and their states electronically through the IARD, a secure Internet based data system. Setting up an IARD Account is the first step in the registration process. Once an adviser establishes an IARD account, the adviser can access Form ADV (Part 1) on IARD, complete this part of Form ADV, and submit it electronically through IARD to the SEC. Part II of Form ADV is completed in paper form as discussed below.

Federal Registration Process

Generally, the SEC has 45 days after receipt of the last amendment to the Form ADV filed with the SEC to declare an applicant's registration effective. Upon being declared effective, the SEC will mail an Effective Order to the IA, and an IA can also check on IARD for the registration status.

To the extent the SEC does not approve the registration within 45 days; the SEC institutes an administrative proceeding to determine whether the application should be denied. This administrative action must be completed within one hundred twenty (120) days after filing the application, although the SEC can obtain a ninety (90) days extension, and an order either granting or denying registration must then be issued. Grounds for denial exist if the SEC finds that an applicant cannot satisfy any of the requirements of Section 203 of the Advisers Act, or if an existing registration for that applicant would be subject to revocation or suspension under Section 203.

The application process for registration with the SEC is generally made by:

- Filing a complete Form ADV electronically with the SEC through IARD, and filing notice with the states in which one wants to offer services.
- Filing a Form U-4 application for each IAR who will provide services on behalf of the IA.

- Remitting all required fees for the IA and the IAR.

A notice filing for a federal covered adviser is usually made by:

- Filing a complete copy of its Form ADV as filed with the SEC.
- Filing a Form U-4 application for each IAR who will provide services on behalf of the Investment Adviser.
- Payment of any required notice-filing fees.

State Registration Process

All states except Wyoming, the District of Columbia and Puerto Rico have a registration or licensing requirement for IA. As such, the process for state registered advisers varies from state to state, but is generally quite similar to the SEC process. With that said, depending on the state, they may require:

- A passing score on a competency examination for each individual acting as an IAR.
- Payment of a fee for processing the applications.
- Certain disclosures to the securities agency and or the public.
- Registration of branch offices of the adviser.
- A bond or minimum net capital.
- Audited financial statements.

As a part of their requirements for registration, several states require audited financial statements to be submitted together with the Firm's initial application. Generally, audited financial statements are not required, unless the IA either has custody of customer funds or securities; or requires a fee to be paid at least six months in advance of $500 or more. Otherwise, financial audits are not generally required for IA registrations.

Capital Requirements

Generally, there are no capital requirements for an IA. However, to the extent an IA has a negative net worth, regulators have taken the position that the IA was insolvent, and such should disclose that fact to its customers on its FORM ADV. Certain states do have capital requirements, and in those states, it will be necessary for the prospective IA to comply with the states' capital adequacy guidelines as set out in their respective statutes. In general, the amount of capital required will depend upon whether the prospective IA intends to maintain custody of customer funds or securities, has discretionary control of customer's accounts or requires the payment of $500 or more, at least six months in advance from rendering of services.

Surety Bond Requirements

To the extent a Surety Bond is required by any state jurisdiction, the IA may incur additional start up costs and registration delays. Some states may require surety bond coverage depending upon whether the IA will have discretionary control over client accounts, maintain custody of customer funds and or securities, or charge a fee of $500 or more at least six months in advance.

IAR Registration

Qualification examinations remain a confusing area for the industry with respect to IAR registrations. While the SEC does not currently have qualification examination requirements for IARs, when you look at the individual state rules and regulations, the requirements vary drastically. Additionally, unlike the brokerage registration, securities licensed individuals who become affiliated with an IA do not actually register their securities licenses with the IA. Accordingly, individuals who register their licenses through an IA, and who wish to maintain their licenses for FINRA purposes, will need to affiliate with a qualified broker-dealer within two years of their termination from their prior broker-dealer. Otherwise, their licenses will expire for FINRA purposes, although they will remain valid for investment advisory registration purposes.

The following is a general breakdown of the examinations that may be required to be met by the individuals involved with the IA, based upon state registration requirements:

- Series 65: Investment Adviser Examination
- Series 7: General Securities Representatives Exam
- Series 66: Investment Advisory Representative Exam
- Qualify for a waiver of same by obtaining one of the following professional designations:
    - Certified Financial Planner (CFP);
    - Chartered Financial Consultant (ChFC);
    - Personal Financial Specialist (PFS);
    - Chartered Financial Analyst (CFA);
    - Chartered Investment Counselor (CIC); or
    - Any other designation recognized by the particular jurisdiction.

Ongoing Compliance Issues

IAs Are Fiduciaries

The anti-fraud provisions of the Advisers Act and most state laws impose a duty on Investment Advisers to act as fiduciaries in dealings with their clients. Thus, as an IA, you are a "fiduciary" to your advisory clients, which means you owe your clients a duty of undivided loyalty and utmost good faith. This fundamental obligation to act in the best interests of your clients and to provide investment advice in your clients' best interests is the foundation of regulatory compliance for an IA.

This means the IA must hold the client's interest above its own in all matters and to the extent possible, conflicts of interest should be avoided at all costs. With that said, some conflicts will inevitably occur, such as a person

being licensed as a securities agent as well as an adviser. In these instances, the adviser must focus on describing those conflicts and how the adviser will maintain impartiality in its recommendations to clients clearly and accurately. In any event, SEC has said that an adviser has a duty to:

- Make reasonable investment recommendations independent of outside influences.
- Select broker-dealers based on their ability to provide the best execution of trades for accounts where the adviser has authority to select the broker-dealer.
- Make recommendations based on a reasonable inquiry into a client's investment objectives, financial situation and other factors.
- Always place the client interests ahead of the IAs.

The review of the disclosures is generally done in hindsight by a regulatory examiner, who will view perceived conflicts from the point of view of the customer and inquire the following:

- Was the disclosure or lack of disclosure a factor in the client's decision to use an IA's services or ratify an IA's recommendations?
- Was the customer misled?
- Was the customer placed at a disadvantage or taken unfair advantage of because of the conflict and the IA's compliance with disclosure requirements?

The burden of proof lies with the IA, and departure from this fiduciary standard may constitute “fraud” upon clients pursuant to the Advisers Act and state securities laws.

Compliance Program and Written Procedures

IAs are required to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Advisers Act and or the state laws governing their advisory activities. The program should provide for an annual review of those policies and procedures to determine

their adequacy and the effectiveness of their implementation. Each IA must also designate a chief compliance officer ("CCO") to be responsible for administering the policies and procedures for the respective IA.

The policies and procedures are not required to contain specific elements, but should address the IAs individual operations and identify conflicts and other compliance factors that create risks related to the respective IA, and then design policies and procedures that address those risks. Notwithstanding that, the policies and procedures of an IA should, at a minimum, address the following issues to the extent that they are relevant to its business:

- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, the disclosures to clients, and applicable regulatory restrictions.
- The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements.
- Proprietary trading by the IA and the personal trading activities of your supervised persons.
- Safeguarding of client assets from conversion or inappropriate use by firm personnel.
- The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction.
- Safeguards for the privacy protection of client records and information.
- Trading practices, including procedures which satisfy the best execution obligation (i.e. seeking the best price for a security in the marketplace as well as ensuring that, in executing client transactions, clients do not incur unnecessary brokerage costs and charges), use of client brokerage to obtain research and other services (referred to as "soft dollar arrangements"), and allocate aggregated or batch trades among clients.

- Marketing advisory services, including the use of solicitors.
- Processes to value client holdings and assess fees based on those valuations.
- The implementation of a business continuity plan.
- Prevent the misuse of material non-public information (under Section 204A of the Advisers Act). These policies and procedures must encompass your activities and those of your supervised persons.

Code of Ethics

As an IA, you are required to adopt a Code of Ethics, which govern their employees and enforce certain insider trading procedures. Your Code of Ethics should set forth the standards of business conduct expected of the firms' "supervised persons" (i.e., your employees, officers, directors and other people which you are required to supervise), and it must address personal securities trading by these people.

As with the written procedures, the IA is not required to adopt a particular standard of business ethics, but rather, the standard chosen should reflect the IAs fiduciary obligations to its advisory clients, and the fiduciary obligations of the people supervised by the IA. In order to prevent unlawful trading and promote ethical conduct by advisory employees, an advisers' Codes of Ethics should include certain provisions relating to personal securities trading by advisory personnel. The Code of Ethics must include the following requirements:

- "Access persons" must report their personal securities transactions to the Chief Compliance Officer ("CCO") or to another designated person each quarter. "Access persons" are any of the IA firms supervised persons who have access to non-public information regarding client transactions or holdings, make securities recommendations to clients or have access to such recommendations, and, for most IAs, this definition includes all officers, directors and partners.

- The access persons must submit a complete report of the securities that they hold at the time they first become an access person, and then at least once each year after that. The Code of Ethics must also require that access persons obtain the IAs approval prior to investing in initial public offerings or private placements or other limited offerings, including pooled investment vehicles (except if the firm has only one access person).
- The CCO or other person designated in addition to the CCO must review these personal securities transaction reports.
- The supervised persons must promptly report violations of the Code of Ethics (i.e., including federal securities laws) to the CCO or to other persons you designate (provided the CCO also receives a report on such issues). A record of these breaches must also be maintained.
- Each of the persons supervised must be supplied with a copy of the firms Code of Ethics (and any amendments that are subsequently make to it), and the IA must obtain a written acknowledgement from the supervised person that he or she has received it.
- The Code of Ethics must be described in the Form ADV, Part II for the IA, and the IA must provide a copy to their advisory clients, if they request it.

Written Disclosure Statement

An IA is required to provide their advisory clients and prospective clients with a written disclosure document. IAs may comply with this requirement either by providing advisory clients and prospective clients with Part II of its Form ADV, or with another document that contains, at a minimum, the information that is required to be disclosed in Form ADV, Part II. While an IA has great leeway in tailoring their disclosures, the following reflects a few of the issues that should be addressed in the Form ADV Part II:

- What kinds are services are available
- Who is providing those services

- What fees and other expenses will the client be subject to and are they negotiable
- Is the adviser being compensated from other sources
- Is the adviser affiliated with another adviser, a broker-dealer or an issuer of securities
- Can a client implement a financial plan anywhere or do they only get to keep the plan if you implement it through the adviser
- What other potential conflicts of interest exist that might affect the adviser's recommendations

Other situations, which require disclosures of other conflicts, might include, but are not limited to:

- The IA or its employees are also acting as a broker-dealer and or a securities agent.
- The IA or IAR is receiving transaction-based compensation, including 12b-1 or other marketing fees, related to securities recommended to its clients.
- The IA or IAR receives any type of compensation from any source for soliciting or referring clients to another adviser or a broker-dealer.
- Hidden fees in the form of undisclosed service charges, wrap fees or expenses reimbursed by other parties.

Since the Form ADV Part II should clearly spell out the details of the advisory relationship and other business interests of the adviser for clients and prospective clients, the written disclosure document should be delivered to prospective clients at least 48 hours before entering into an advisory contract. If it is delivered at the time the client enters into the contract, the client should be given five business days after entering into the advisory contract to terminate the contract without penalty. Additionally, under certain conditions, firms may comply with the delivery requirements through electronic media.

Ongoing Operational Issues

Annual ADV Filing

IA's are required to file an annual update of Form ADV Part IA of your registration form through the IARD. This annual amendment to your Form ADV Part I must be filed within 90 days after the end of the IAs fiscal year. The primary information reported on the Form ADV Part I on an annual basis is the assets under management. It is critical to accurately report the amount of assets under management on Form ADV, Part 1A, Item 5F(2). Advisers who have less than $25 million of assets under management and who are not otherwise eligible to maintain their registration with the SEC will be required to withdraw their federally covered registration, and register directly with the respective states where they have customers. Finally, it is generally deemed a violation of the anti-fraud provisions of the Advisers Act to overstate the assets under contract and or the types of customers that the IA represents.

As with ADV Part I, you must update Part II annually within 90 days of the end of your fiscal year and whenever it becomes materially inaccurate. With respect to ADV Part II, amendments are not required to file it through IARD at this time. Rather, it is considered to be 'filed' with the SEC when you update the form and place a copy in your files.

Annual Attestation of Code of Ethics

On an annual basis, the IA must provide a copy of its Code of Ethics, and any amendments that were subsequently made to it, to the persons supervised by the IA. The firm must also obtain a written acknowledgement from the supervised person that he or she has received it.

Annual Offer of the Written Disclosure Statement

Each year, you must also deliver or offer (in writing) to deliver a disclosure document to each client, without charge. To this end, IA firms are also required to maintain a copy of each disclosure document, and each amendment or revision to it, that was given or sent to clients or prospective

clients. In addition, the IA should maintain a record reflecting the dates on which such disclosure was given or offered to be given to any client or prospective client who subsequently became a client.

Client Contracts

IA client contracts must include some specific provisions. Whether written or oral, the contracts must communicate that the IA may not assign the advisory services provided to a client to any other person without the prior consent of the client. Additionally, regulators have represented that an IA should not enter into contracts with clients that contain terms or clauses commonly referred to as a "hedge clause", except with certain sophisticated clients. This is based upon the belief of the regulators that such clauses or provisions are likely to lead other clients to believe that they have waived their rights of legal action, whether under the federal securities laws or common law. Additionally, it is recommended to include language addressing the receipt of the IAs privacy policy, business continuity plan and certain anti-money laundering language.

Form ADV Amendments

In addition to making annual filings of the Form ADV Part I and Part II, IA's must promptly file an amendment to their Form ADV whenever certain information contained in the Form ADV becomes inaccurate. The Form ADV filing requirements are contained in Rule 204-1 of the Advisers Act and in the instructions to the Form. Since inaccurate, misleading and or omitted Form ADV disclosures are the most frequently cited findings from regulatory exams, it is critical to focus on maintaining a complete and current Form ADV.

Recordkeeping

An IA is generally required to maintain and keep current the records listed below. However, it will also be necessary to check with the home state regulator, as additional recordkeeping requirements may be required by the home state of the adviser. Finally, an IA must maintain all corporate and

client records for a minimum period of three years, two of which must be in a readily accessible location.

Records Required of All Advisers

The following records are generally required of all IAs:

- Receipts and Disbursements Journals
- General Ledger
- Order Memoranda
- Bank Records
- Bills and Statements
- Financial Statements
- Written communications and agreements (including electronic transmissions)
- List of discretionary accounts
- Advertising
- Personal transactions of IARs and supervisors
- Client records
- Powers granted by clients
- Disclosure statements
- Solicitors' disclosure statements
- Performance claims
- Customer information forms and suitability information
- Written Supervisory Procedures

Records Additionally Required of Advisers with Custody

The following records are generally required of all IAs who maintain or have custody of client assets:

- Journals of securities transactions and movements
- Separate client ledgers
- Copies of confirmations
- Record by security showing each client's interest and location thereof

Records Additionally Required of Advisers Managing Client Accounts

The following records are generally required of all IAs who manage client accounts:

- Client purchases and sales history
- Current client securities position

These records are required to be maintained in an easily accessible place for a period of five years from the end of the fiscal year during which the last entry was made and, for the first two years, the records must be maintained in the adviser's principal office.

Reporting – Form 13F

IA's may also be subject to other reporting obligations, for example, an IA that exercises investment discretion and or that shares investment discretion with others over certain equity securities, which have a fair market value taken together of $100 million or more, must file a Form 13F each quarter that discloses these holdings. "Discretionary authority" means that you have the authority to decide which securities to purchase, sell, and/or retain for your clients.

Other Regulatory Considerations

Advertising of Advisory Services

To protect investors, the SEC and various states prohibits certain types of advertising practices by advisers. An “advertisement” generally includes any communication addressed to more than one person that offers any investment advisory service with regard to securities. An advertisement could include both a written publication (such as a website, newsletter or marketing brochure) as well as oral communications (such as an announcement made on radio or television).

Advertising must not be false or misleading and must not contain any untrue statement of a material fact. Advertising, like all statements made to advisory clients and prospective clients, is subject to the general prohibition on fraud. Specifically prohibited are:

- Testimonials
- The use of past specific recommendations that were profitable, unless the adviser includes a list of all recommendations made during the past year.
- A representation that any graph, chart, or formula can in and of itself be used to determine which securities to buy or sell.
- Advertisements stating that any report, analysis, or service is free, unless it really is free.

IAs should disclose all material facts necessary to avoid any unwarranted inference where they advertise past performance. For example, SEC staff has indicated that it may view performance data to be misleading if it:

- Does not disclose prominently that the results portrayed relate only to a select group of the adviser’s clients, the basis on which the selection was made, and the effect of this practice on the results portrayed, if material.

- Does not disclose the effect of material market or economic conditions on the results portrayed (e.g., an advertisement stating that the accounts of the adviser's clients appreciated in value 25% without disclosing that the market generally appreciated 40% during the same period).
- Does not reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that accounts would have or actually paid.
- Does not disclose whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings.
- Suggests or makes claims about the potential for profit without also disclosing the possibility of loss.
- Compares model or actual results to an index without disclosing all material facts relevant to the comparison (e.g., an advertisement that compares model results to an index without disclosing that the volatility of the index is materially different from that of the model portfolio).
- Does not disclose any material conditions, objectives, or investment strategies used to obtain the results portrayed (e.g., the model portfolio contains equity stocks that are managed with a view towards capital appreciation).

Finally, an IA may not imply that the SEC or another agency has sponsored, recommended or approved the respective IA based upon its registration and a firm should not use the term "Registered Investment Adviser" to imply that as a registered adviser, you have a level of professional competence, education or special training.

Best Price and Execution

As a fiduciary, IA's are required to act in the best interests of their advisory clients, and to seek to obtain the best price and execution for their securities transactions. The term "best execution," means seeking the best price for a

security in the marketplace as well as ensuring that, in executing client transactions, clients do not incur unnecessary brokerage costs and charges. The IA is not obligated to get the lowest possible commission cost, but rather, it should determine whether the transaction represents the best qualitative execution for the advisory clients. In addition, whenever trading may create a conflicting interest between the IA and its clients, the IA has an obligation, before engaging in the activity, to obtain informed consent from the clients, after providing full and fair disclosure of all material facts.

The industry practice of aggregate or "bunch" orders on behalf of two or more client accounts has been held to be a solution to best execution issues that arise from timing of the execution between client accounts. However, regulators have held the purpose of the bunching has to be done for the purpose of achieving best execution, and that no client is systematically advantaged or disadvantaged by the bunching. In the alternative, to the extent an IA decides not to aggregate orders for client accounts, it is necessary to disclose to the clients the potential consequences of not aggregating orders.

It is important seek to obtain the best price and execution when you enter into transactions for clients on a "principal" or "agency cross" basis. If the IA has acted as a principal for its own account by buying securities from, or selling securities to, a client, the adviser must disclose the arrangement and the conflicts of interest in this practice, in writing, and also obtain client consent for each transaction prior to the time that the trade settles.

Client Solicitation for Compensation

Requirements for Investment Advisers that Pay Others to Solicit New Clients

An IA may pay cash compensation to others to seek out new clients on their behalf, commonly called "solicitors" or "finders," if they meet certain conditions that are set forth under Rule 206(4)-3 of the Advisers Act:

- The solicitor is not subject to certain disciplinary actions.
- The fee is paid pursuant to a written agreement to which the IA is a party and, subject to certain exceptions, the agreement must:

- describe the solicitor's activities and compensation arrangement;
- require that the solicitor perform the duties assigned to it and in compliance with the Advisers Act;
- require the solicitor to provide clients with a current copy of the IAs disclosure document; and,
- if seeking clients for personalized advisory services, require the solicitor to provide clients with a separate written disclosure document containing specific information.

- The IA receives from the solicited client, prior to, or at the time the IA enters into an agreement, a signed and dated notice confirming that he or she was provided with the IAs disclosure document and, if required, the solicitor's disclosure document.
- You have a reasonable basis for believing that the solicitor has complied with the terms of your agreement.

While there is not a requirement at the federal level for the solicitor to be a registered Investment Adviser, certain states have specific requirements that anyone receiving a portion of an advisory fee, must be registered in their jurisdiction. As a result, it is recommended to confirm local law prior to entering into a solicitor agreement with a non-registered entity.

Custody

Most IAs do not maintain custody of their client's funds; a brokerage firm typically acts as a custodian and holds client funds and securities. However, if an IA does have direct or indirect access to client funds or securities, the IA is deemed to have custody of client funds and is subject to additional regulatory scrutiny. In these situations, securities regulators will want to see how IA's handle those assets by reviewing the following:

- Has the adviser complied with the rules relating to safeguarding client assets in the adviser's custody?
- Does the Form ADV reflect that the adviser has custody?

- Are these assets maintained in segregated accounts?
- Does the adviser maintain the required records of client assets in its custody?
- Does the client get an itemized statement at least every three months showing the assets in the adviser's custody and the activity in the account?
- Has an independent accountant conducted at a surprise audit of client assets least annually?

Additionally, if the IA has discretionary authority over the client's account, is there any evidence of excessive trading, self-dealing, preferential treatment, unsuitable recommendations, unauthorized transactions or incomplete disclosure?

Disclosure of Certain Financial and Disciplinary Information

Federally covered IAs and IARs may be required to disclose certain financial and disciplinary information pursuant to Rule 206(4)-4 of the Advisers Act. These requirements are described below.

- Registered advisers that have custody or discretionary authority over client funds or securities, or that require prepayment six months or more in advance of more than $500 in advisory fees, must promptly disclose to clients and any prospective clients any financial conditions that are reasonably likely to impair their ability to meet their contractual commitments to their clients.
- All IAs must also promptly disclose any legal or disciplinary events that would be material to a client's or a prospective client's evaluation of the adviser's integrity or its ability to meet its commitments to clients (regardless of whether the adviser has custody or requires prepayment of fees). The types of legal and disciplinary events that may be material include:
    - Criminal or civil actions, where the adviser or a management person of the adviser was convicted, pleaded guilty or "no

contest," or was subject to certain disciplinary actions with respect to conduct involving investment-related businesses, statutes, regulations, or activities; fraud, false statements, or omissions; wrongful taking of property; or bribery, forgery, counterfeiting, or extortion.

- Administrative proceedings before the SEC, other federal regulatory agencies, or any state agency where the adviser's or a management person's activities were found to have caused an investment-related business to lose its authorization to do business, or where such person was involved in a violation of an investment-related statute or regulation and was the subject of specific disciplinary actions taken by the agency.
- Self-regulatory organization (SRO) proceedings in which the adviser or a management person was found to have caused an investment-related business to loose its authorization to do business; or was found to have been involved in a violation of the SRO's rules and was the subject of specific disciplinary actions taken by the organization.

Other General Disclosure Issues

Regulatory examiners will look for disclosure-related items not only in the Form ADV disclosure document, but also in any material describing the adviser's business that a client or potential client might see. This can include:

- Advertising
- Contracts
- Web sites
- Print, radio and TV ads
- Bulk mailings
- Fee schedules

- Seminar materials
- Portfolio reviews

Proxy Voting of Clients' Securities

If an IA has voting authority over proxies for clients' securities, it must adopt policies and procedures reasonably designed to ensure that the firm votes proxies in the best interests of clients; discloses information to clients about those policies and procedures; and describes to clients how they may obtain information about how the firm has voted their proxies.

IAs must also retain certain records if they vote proxies on behalf of your clients. To that end, the firm must keep:

- The proxy voting policies and procedures.
- The proxy statements received regarding the client's securities; however, the rule does provide some alternative arrangements.
- Records of the votes cast on behalf of clients.
- Records of client requests for proxy voting information.
- Any documents that are prepared that were material to making a decision as to how to vote or that memorialized the basis for the ultimate decision.

Regulatory Exams

IA firms are subject to periodic, sometimes unannounced, audits and regulatory exams by securities regulators. The purpose of these audits are generally to protect investors by determining whether IAs are complying with the law, adhering to the disclosures that they have provided to their clients, and maintaining appropriate compliance programs to ensure compliance with the law. When examined, the IA is required to provide examiners with access to all requested advisory records that are maintained, although under certain conditions, documents may remain private under the attorney-client privilege. A historical review of both SEC and state regulators

has generally revealed that the primary regulatory problems noted in regulatory exams are:

- Form ADV disclosures
- Poorly maintained books and records
- Poorly maintained financial records
- Custody issues
- Advertising and performance representations

Conclusion

While less rule driven than the broker-dealer industry, there are substantial regulatory pitfalls related to the registration and operations of an investment advisory firm. As a result, participating in the Investment Adviser industry requires attention to detail and knowledge of the various regulator's laws, rules and regulations. The information presented in this discussion are provided for informational purposes by The LeGaye Law Firm, PC, and is not intended a substitute for professional legal advice. No attorney-client relationship is intended or implied through the information provided herein, or by an inquiry directed to the firm unless the inquiry or contact results in the firm being engaged pursuant to an explicit agreement with a client. You should consult your lawyer to obtain legal information and recommendations specific to determine the exact requirements for you or your firm.