# Interactive Brokers

***presents***

# Starting out as a Registered Investment Advisor

## The Basics of Registered Investment Advisors' Compliance Obligations


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Webinar begins @ 4:00 pm EST

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# Overview

- Starting and registering your own advisory firm offers many benefits, including independence and the ability to control the advisory services your clients receive.

- This increased freedom and control brings additional responsibilities, including making sure you comply with applicable state and federal rules.  Most investment advisors need to register with the SEC or their state, make a series of regulatory filings and meet ongoing compliance and regulatory requirements.  We summarize these compliance obligations in this webinar.

- This webinar provides an overview of key compliance areas that advisors must address.  For the most part, we focus on the federal and SEC rules, which also have been adopted by many states.  But we highlight key areas where state rules may differ from federal and SEC rules.

- *Please keep in mind that the contents of this presentation have been prepared for educational and informational purposes only, and should not be construed as legal or compliance advice.*

# Options for Starting Out as an Advisor

- If you are starting out as an advisor, there are several ways to service your clients and be independent of a broker.

- You can form your own advisory firm, giving you independence concerning how to run your business and service your clients.

- If you would enjoy the freedom and control of acting as an independent advisor but do not want to assume the compliance obligations associated with setting up and registering your own advisor, you could join an existing advisory firm.

  – This will provide the benefit of an established compliance and management structure, and help you avoid the challenges of building your own infrastructure.

# IB Tools to Help New Advisors

- IB has resources available to help new advisors and registered reps considering the advisor model.

- IB's platform offers many benefits to advisors choosing the IB platform, such as best execution, a way to manage client accounts from one master account, a variety of automatic billing arrangements, and a wide range of trading tools and portfolio modeling tools. These advantages are discussed on the IB website interactivebrokers.com/ria and in a previous webinar interactivebrokers.com/independentpdf.

- IB recently added an RIA Compliance Center section of our website that advisors may find useful :
  - A series of "Spotlights" providing a detailed overview of key compliance topics facing advisors;
  - A transition guide outlining major legal and compliance considerations in moving to an advisory firm model;
  - Links to regulatory websites and resources;
  - A list of third-party compliance and other service providers, many of whom have agreed to provide discounts to advisors trading on the IB platform; and
  - A tool advisors may use to ask basic compliance and registration-related questions.

- Advisors can also find third-party compliance firms through the IB Investors' Marketplace.

- IB is planning a new Marketplace in the IB Investors' Marketplace to help small or new advisors connect with existing advisors with a fully developed compliance structure looking to grow their firms.
  – This new Marketplace will be available in the Professional Advisor area on interactivebrokers.com/marketplace.

# Ways Advisors Can Meet Their Compliance Obligations

- New advisors may choose to conduct compliance-related work in-house (possibly with some assistance from their custodian) or turn to third parties for help.  Advisors may look to:

  – Legal counsel (especially for researching registration requirements and help with regulatory filings);
  – Third-party compliance services, like *RIA in a Box*, which offer a variety of registration and compliance service packages;
  – Regulatory compliance software products and automation tools;
  – Industry trade associations, like the Investment Adviser Association, which offers compliance libraries, guides, and newsletters to its members; and
  – Compliance professional forums or blogs.

- In light of the cost and effort of complying with these requirements, some advisors may decide to join existing advisors instead of setting up their own shop.  IB is planning an additional marketplace on its Investors' Marketplace site that will allow potential advisors to connect with existing advisory firms.

# Registering an Advisory Firm:

## <u>Basic Federal Registration Requirements</u>

- Typically an advisory firm must register with the Securities and Exchange Commission ("SEC") if it has $100 million or more in assets under management ("AUM").
- Firms with AUM between $25 and $100 million, which are generally required to register with the states in which they are located, may need to register with the SEC in certain circumstances:
  - Firms in states that do not regulate or examine advisors (New York, Minnesota, and Wyoming) must register with the SEC if they have $25 million or more AUM.
  - Firms required to be registered in 15 or more states may register with the SEC instead.
- Advisory firms with certain types of clients generally do not need to register:
  - Advisors whose only clients are private funds and have less than $150 million AUM do not need to register, although they may need to make certain regulatory filings with the SEC and their states;
  - Advisors to venture capital firms are also exempt from registration; and
  - Family office advisors are not deemed "investment advisers" so they do not need to register.
- <u>Advisors must compute their AUM annually to make sure they comply with these thresholds.</u>
  - The SEC has built in cushions on either side of these thresholds so SEC-registered advisors whose AUM temporarily falls less than $10 million below the $100 million threshold do not have to register with a state instead and state-registered advisors whose AUM rises only temporarily $10 million or less above the $100 million threshold do not need to register with the SEC.

# Registering an Advisory Firm:

## Basic State Registration Requirements

- Most states require advisors with a place of business in the state to register there, regardless of the AUM or number of clients the advisor has. A few states allow in-state advisors to have 5 (or even 15) local clients before requiring registration.
- Firms with AUM between $25 and $100 million – generally referred to as “mid-sized advisors” – and advisors with less than $25 million AUM – so-called “small advisors” – may still need to register with the state(s) in which they do business but do not have an office or place of business if they have more than a certain number of clients (typically 5).
  - Please keep in mind that registering in your state may not be enough if you do business in other states. Most states apply these rules to advisors located in the state as well as out-of-state advisors who have or solicit clients from the state. (Some states allow out-of-state advisors to have more clients than in-state advisors before they must get registered.)
  - Some states require advisors with *any* clients from the state to get registered.

- *Each state has its own registration requirements that it enforces independently and you should research the rules of each state in which you do business.*

- *Additional information on registration requirements is available in our two registration-related spotlights: Registration Requirements and Filings for Investment Advisors and Their Employees and State Registration Requirements for Small Investment Advisors.*

# Registering an Advisory Firm:

## The Private Fund Exemption

- Investment advisors who only manage hedge funds and other “private” funds are considered “investment advisers” but are exempt from registration if they fall into these categories:
  - U.S. advisors that act as investment advisors solely to private funds, and have less than $150 million AUM; or
  - Non-U.S. advisors whose only U.S. clients are private funds and manage less than $150 million in assets from a place of business in the U.S.
- Non-U.S. advisors with no place of business in the U.S. and no U.S. clients or investors do not need to register, regardless of the amount of money they manage.
- Advisors relying on this exemption must calculate their AUM annually.
- Exempt private fund advisors are still subject to some regulation and SEC oversight, including:
  - Filing an abbreviated Form ADV;
  - SEC examinations; and
  - Antifraud rules, including the pay-to-play rule and rules against fraud on investors in pooled investment vehicles.
- *Please keep in mind that advisors eligible for this private fund advisor exemption may still be required to register with the states in which they operate.  Advisors should research the particular rules in their state(s).*

# Registering an Advisory Firm:

## <u>The Family Office Exclusion</u>

- The Dodd-Frank Act excluded family offices from the definition of "investment adviser" under the Investment Advisers Act ("Act") and comparable state laws. This means that family office advisors do not need to get registered and are not considered "exempt" advisors, unlike hedge fund managers or small advisors with few clients.

- A **family office** is a company that:
  - Only has family clients;
  - Is wholly owned and controlled by family members; and
  - Does not hold itself out to the public as an investment advisor.

- A **family client** includes any member of the advisor's household, other direct relatives (e.g., children and parents), employees of the family office and their direct relatives and any trusts, estates or investment vehicles composed of these people's assets.

- There is a "grandfathering" provision available for family offices that were not registered or required to be registered with the SEC on Jan 1, 2010 that only provide advice to:

  - Accredited investors who, at the time of the investment, were officers, directors, or employees of the family office and invested with the family office before Jan 1, 2010;
  - Any company owned exclusively and controlled by one or more family members; or
  - Registered investment advisors that provide investment advice, identify investment opportunities to the family office, make approximately the same trades for their own account and meet certain other conditions.

# Registering an Advisory Firm:

## Exemptions available to non-U.S. advisors with U.S. clients

Foreign advisors with any U.S. clients must register with the SEC regardless of the amount of assets managed. But they may qualify for one of the three following exemptions from SEC registration.

- ***The Foreign private advisor exemption*** is available to advisors who:
  - (a) do not have a place of business in the United States,
  - (b) have fewer than 15 U.S. clients and/or U.S. investors in in private funds managed by the advisor,
  - (c) manage less than $25 million AUM for those U.S. clients and investors,
  - (d) do not hold themselves out generally to the public in the U.S. as investment advisors, and
  - (e) do not act as investment advisors to any registered investment companies or companies that elected to be business development companies.
- ***The Private fund exemption*** is available to non-U.S. advisors (i.e., advisors with their principal place of business outside the United States) who:
  - (a) do not have any U.S. clients other than one or more private funds, and
  - (b) manage less than $150 million AUM in the U.S., solely attributable to private fund assets.
  - *Non-U.S. advisors may use this exemption regardless of the number or type of non-U.S. clients or AUM managed from a place of business outside the United States.*
- ***The Venture capital fund exemption*** is available to non-U.S. advisors whose only U.S. or non-U.S. clients are venture capital funds.

# Registering an Advisory Firm:

## Exemptions available to non-U.S. advisors with U.S. clients

- Non-U.S. advisors qualifying for the private fund or venture capital fund exemptions are known as “exempt reporting advisors.”

- Although these advisors do not need to register with the SEC, they must file and update some portions of Part 1A of the Form ADV, including detailed information about the private funds they advise.

- Even if a foreign advisor qualifies for one of these exemptions, it may still need to register with states in which the advisor has 6 or more clients, unless it qualifies for an exemption from registration under state law.

- These exemptions are discussed in our Spotlight on Registration and Compliance Requirements for Foreign Investment Advisors with U.S. Clients.

# How to Register an Advisory Firm:

## Key Steps and Overview of Form ADV

- Actual registration with the SEC and/or the states generally requires:
  - Registering with FINRA's Investment Adviser Registration Depository ("IARD");
  - Preparing Parts 1 and 2A of Form ADV and filing them through the IARD site;
  - Having Investment Advisor Representatives ("IARs") take appropriate registration exams, including the Series 65 or Series 66; and
  - Following up with regulators to confirm that registration was granted.

- The most important document for any advisor is the Form ADV, which is used by the SEC and state regulators. The Form ADV generally seeks detailed information about the firm, its clients, and its activities.
  - Part 1 is mainly used by regulators.
  - Part 2 serves as the basis for a disclosure document that advisors must provide their clients to inform them of advisors' services, qualifications, and potential conflicts of interest.

- Advisors must annually review and amend their Form ADV within 90 days of the firm's fiscal year end and promptly file amendments if the information becomes materially inaccurate during the year.

# How to Register an Advisory Firm:

## Details of the Form ADV

- **Form ADV Part 1:**
  - **Part 1A** must be filed by both SEC- and state-registered advisors.
    - It seeks information on 12 items covering the advisor's business, employees, number and type of advisory clients, compensation arrangements, custody of client funds or securities, AUM, types of advisory services provided, other business activities, conflicts of interest, and disciplinary history.
  - **Part 1B** is only required by state-registered advisors, not SEC-registered advisors.
    - It largely seeks information on bond and net capital requirements.

# How to Register an Advisory Firm:

## <u>Details of the Form ADV (continued)</u>

- **Form ADV Part 2**
  - **Part 2A Brochure** must be filed by both SEC- and state-registered advisors.
    - It includes information on the IA's business: general business practices, advisory business, fees and compensation, performance-based fees, types of clients, method of analysis, investment strategies, risk of loss, conflicts of interest, disciplinary information, Code of Ethics, participation in client transactions, personal trading, brokerage practices, review of accounts, client referrals, custody, investment discretion, proxy voting, and certain financial information.
    - Advisors must file this on the IARD site and provide it to clients when they sign up with the advisor, annually after that, or whenever material information change.
  - **Part 2B Brochure Supplement is not filed but must be provided to clients in certain situations.**
    - The supplement contains disclosures on 6 separate items about advisor personnel that provide advisory services to clients, including information regarding each person's formal education and business background, legal and disciplinary events, capacities in which he or she participates in investment-related business, compensation for sale of securities and investment products, economic benefits received from someone other than a client for providing advisory services, and contact information for the person's supervisor.
    - The supplement must be provided to clients whenever a new representative begins to provide advisory services to clients, information becomes materially inaccurate, a new disciplinary event occurs, or previously disclosed disciplinary information changes.

- *Additional details on the specific categories of information sought by Form ADV are available in our <u>Spotlight on Registration and Regulatory Filings brochure</u>.*

# How to Register an Advisory Firm:

## Overview of State Registration Requirements

- Advisors may also need to make certain filings in the states in which they are registered.
- Most states require some filings in addition to those mandated by the SEC, although the specific requirements vary by state.
  - Some states require advisors to file the Form ADV Part 1B (addressing state-specific topics such as bond and net capital requirements) and/or the Form ADV Part 2B Brochure Supplement (which the SEC does not require).
  - States may also require advisory firms to file a balance sheet, audited financial statements, a surety bond, sample advisory agreements, articles of incorporation, a privacy policy, proof of errors and omissions insurance coverage, written compliance policies and procedures, solicitor agreements and promotional/marketing and disclosure materials.

- All states (except Wyoming) require SEC-registered advisors with an office or a certain number of clients in the state to “notice-file,” i.e., provide state securities regulators online through IARD with copies of parts of Form ADV and a consent to service of process on an annual basis.
- Advisors must also pay certain fees to the states in connection with these filings.
- States typically require state-registered advisors to renew their registration annually.
- Some states, like Connecticut, require advisors to register any branch offices located in the state.

# Registering the Firm's Employees

- States typically require registration and licensing of supervised persons employed or associated with firms registered in that state or registered with the SEC. (Individuals do not need to register with the SEC.)
- Generally, the states require an employee to individually register as an "Investment Advisor Representative" (IAR) if the employee has a place of business in the state, or provides advice on securities, manages client accounts, holds himself out as providing investment advice or is compensated for soliciting clients from the state. Clerical and ministerial employees and supervised persons with no more than five natural person clients are generally excluded from the definition.
- The states may only impose registration requirements on IARs of SEC-registered advisors if those IARs have a place of business in the state and a client base of more than five and 10% natural person clients.
  - *The exact definition of an IAR varies by state so you should research the rules in your state(s).*
- Each state has its own qualification requirements for registering IARs.
  - Most states require IARs to pass the Series 65 or Series 66 examinations.
  - This requirement is typically waived for IARs who hold CFP or CFA or similar licenses.
- IARs must typically file a Form U4 (the Uniform Application for Securities Industry Registration) through the IARD/CRD system, pay registration fees, and file fingerprint cards.
  - These requirements vary: New York requires its own version of Form U4, and Wyoming does not register IARs.
  - IARs must amend Form U-4 to update inaccurate information or reflect material changes.
- Advisors must create Form ADV Part 2B brochure supplements for each IAR, and, in most states, must also upload those brochure supplements to the IARD system.

# Advisors’ Compliance & Legal Obligations After They Are Registered and In Business

Once registered, advisors have a variety of ongoing obligations under federal and state law. Among other things:

- Advisors must disclose important information to clients concerning the services they provide, certain business relationships, and actual or potential conflicts of interests;
- Advisors must not engage in prohibited marketing or advertising;
- Advisors are fiduciaries to their clients and must meet their fiduciary duties;
- Advisors are subject to specific client fund custody rules;
- Advisors owe a duty of best execution concerning their clients’ trades;
- Advisors must make ongoing regulatory filings;
- Advisors must adopt appropriate policies and procedures and memorialize them in writing; and
- Advisors must keep certain required books and records in the manner and for the time period regulators require.

# The Advisory Agreement

- As with most business relationships, the client relationship is established and defined by the contract between the advisor and the client.  Many states (but not the SEC) require an advisor’s agreement with each client to be in writing.  Even when not required, the best practice is to memorialize agreements with clients in writing for compliance and risk-management reasons.

- In drafting an advisory contract, advisors must ensure that the terms of the contract are consistent with their regulatory filings (e.g., Form ADV) and relevant laws and regulations.  A contract made in violation of the Act or applicable regulations is not enforceable by the advisor.

- Advisors are expected to update their agreements to deal with changes in applicable regulatory requirements and as necessary to deal with changes in the firms’ Form ADV information.

# The Advisory Agreement (continued)

- Under both state and federal law, advisory agreements must include material terms:
  - The fees the client will pay and the schedule of fees;
  - Whether the advisor has discretion to trade the account and the extent of that discretion;
  - Broker(s) used and best execution implications of using certain broker(s);
  - The advisor’s right or obligation to vote proxies on behalf of the client;
  - Conflicts of interest; and
  - Client’s receipt of certain disclosures.

- In addition, federal law prohibits:
  - Contractual provisions leading clients to believe they have waived causes of action under federal or state securities statutes;
  - Penalties for termination of the agreement by the client;
  - Impermissible fees, e.g., performance-based fees to non-qualified clients; and
  - Agreements failing to provide that assignment of the agreements to a new advisory firm requires client consent.

- *Additional information on the advisory agreement is available in our Spotlight on Advisory and Fee Agreements and Disclosures brochure .*

# Compensation and Fee Arrangements with Clients

- As fiduciaries, advisors must make full and fair disclosure of the fees they charge clients.

- Among other things, when the client hires an advisor, the advisor must provide clients with the Part 2A Brochure, which contains mandated information on fees and compensation including:
  - standard fee schedule, methods for assessing fees (including any performance fee arrangements), and other costs clients must pay;
  - the negotiability of fees and prepayment of fees and refunds if either party terminates the agreement; and
  - disclosure of brokerage practices and any conflicts of interest they create (such as soft-dollar arrangements or relationships with brokers used).

- States generally impose restrictions on client fee arrangements similar to the SEC's but some states prohibit any use of performance fees, place different limits on who can be charged performance fees or impose restrictions on how performance fees are calculated.

- Advisors must clearly disclose fees agreed with customers in the advisory agreement, Form ADV, and certain state filings.

- *Advisors should research the rules and regulations concerning advisory fees and charges in the state(s) in which the advisors do business.*

# Rules Concerning Fees Advisors May Charge

- The states and the SEC also have rules concerning the types of fees advisors may charge clients (which vary depending on the sophistication and net worth of clients). For instance, SEC-registered advisors:
  - Must set advisory fees that are reasonable in relation to the services provided when the following factors are taken into account:
    - The customary fee charged by other advisors for comparable services;
    - Whether the same services could be obtained by the client directly without the advisor's assistance and cost; and
    - Whether the advisor has a reasonable belief that its services would generate gains in excess of the fee charged.
    - When appropriate, advisors must disclose that their advisory fee is higher than the total fee charged for similar services and that the client may obtain similar services elsewhere at a lower fee.
  - Cannot charge performance-based fees (i.e., fees based on a share of capital gains or capital appreciation of client funds) except to certain clients, including clients with more than $1 million AUM or $2 million net worth, foreign clients, hedge funds, and certain mutual funds; and
  - Cannot charge termination fees that may penalize clients for ending the advisory relationship unless the fee is directly related to services already provided and not paid for.
- *Additional information on advisory fees is available in our Spotlight on Advisory and Fee Agreements and Disclosures brochure.*

# Restrictions on Advisor Advertising

- The SEC and many states allow advisors to advertise but place limitations on the content of the advertisements.
- The federal and state rules generally define “advertising” as any materials designed to maintain existing clients or solicit new clients for the advisor.
  - Advertisements generally do not include in-person, telephone or other one-on-one conversations, written communications responding to unsolicited client or potential client requests, or regular account statements or reports.
- There are many types of prohibited advertisements, including advertisements that:
  - Include testimonials; selected recommendations made in the past (without listing all recommendations for a particular period); unqualified uses of graphs, charts, or formulas; or offers of free reports, analyses, or services that are not in fact entirely free; or
  - Contain untrue statements of material fact or are otherwise false or misleading.
- Although many states have rules similar to the SEC, some states define advertisements less broadly. For example, some states define ads as communications to more than 5 people (while the SEC rules cover ads to more than one person.)
- Some states impose additional requirements as well, like requiring that advisors submit their advertisements for review by state securities regulators before use.

# Restrictions on Advisor Advertising:

## Summary of Restrictions on Reporting Performance

- Performance advertising presenting past returns to potential clients comes with specific restrictions and is one of the top compliance deficiencies identified by the SEC and state regulators.
- Advertised performance information must be net of advisory fees, brokerage or other commissions, and any other applicable charges.
- Advisors must also include specific disclosures in their performance advertising, including discussions about:
  - The effect of material market or economic conditions on the results portrayed;
  - Any dividend reinvestment reflected in the results portrayed;
  - The probability of loss when making claims about potential for profit;
  - All material facts relevant to any index comparisons;
  - Material conditions, objectives, or investment strategies used to obtain the results portrayed;
  - Limitations inherent in model results;
  - The effect of any intervening material changes in conditions, objectives, or investment strategies on the results portrayed;
  - Whether any of the securities or investment strategies of the model portfolio do not or only partially relate to the type of services offered by the advisor; and
  - Whether the advisor’s clients had investment results materially different from the results portrayed in a model.
- Actual performance information included in the ads may be based on either all accounts under management or selected accounts if excluding certain accounts does not make the results misleading and the advisor discloses certain facts about the selection.

# Restrictions on Advisor Advertising:

## Social Media Issues

- Advisors interested in having a social media presence must:
  - Comply with the antifraud provisions of federal and state securities laws, including by ensuring that any re-publication of third-party content does not constitute a testimonial or another form of prohibited advertising;
  - Adopt and periodically update the firm's policies and procedures regarding social media usage, including usage guidelines, content standards, monitoring and pre-approval; and
  - Follow certain rules if they re-publish, circulate, or reference content written by others, including commentary on social media sites. Among other things:
    - The advisor cannot change or affect which commentary is included or how it is presented, or restrict commentators' ability to voice their opinions;
    - The site must allow readers to view all public commentary <u>and</u> update new commentary on a real-time basis;
    - The site can only include content that is independent from the advisor, i.e., content that is not directly or indirectly written by the advisor or for which the advisor compensated the commentator;
    - The advisor must publish all of the unedited comments appearing on the site regarding the advisor; and
    - The advisor must publish all commentary in a content-neutral manner (e.g., in chronological or alphabetical order) and cannot highlight certain types of testimonials.
- *Additional information on the compliance aspects of advertising is available in our [Spotlight on Regulation of Advisor Advertising and Marketing brochure].*

# Other Disclosures Advisors Must Make to Clients

Advisors must provide clients with the Form ADV Part 2 disclosures and several other disclosures, such as:

- Disclosure of any agreements between the advisor and a solicitor for attracting new business;
- Disclosure of proxy voting policies and procedures and actual proxy votes the advisor made on behalf of the client;
- Disclosure of any trading conflicts that may impact best execution decisions, e.g., use of affiliated brokers, “soft dollar” arrangements, or interest in or material business relationships with broker dealers;
- Privacy notices to customers, which let clients opt out of sharing personally identifiable financial information with non-affiliated third parties; and
- Disclosures concerning any instances where the advisor may be acting as both the agent and principal in a transaction.

# Custody over Client Funds and Assets:

## When an Advisor Has “Custody”

- The “Custody Rule” is often overlooked or misunderstood by advisors.
- Under the federal “Custody Rule” and similar rules adopted by many states, an advisor may be deemed to have “custody” of client assets even if all client assets are housed with a proper custodian.
- Under the federal Custody Rule, advisors are deemed to have custody over client funds if they:
  - Have (however brief) possession of client funds or securities, including handling checks or putting client assets in the advisor’s own account to transfer it to the broker;
  - Have the authority (including a general power of attorney) to withdraw funds or securities from the client’s account maintained with a custodian to anywhere other than a destination pre-set by the client;
  - Have authorization to deduct advisory fees or other expenses directly from client accounts;
    - BUT an advisor is not deemed to have custody if the client instructs the qualified custodian to calculate and debit his account for advisory fees according to a method selected by the client (like with Interactive Brokers’ automatic billing option), and the advisor does not have access to the client’s funds.
  - Serve in a capacity (e.g., General Partner to a limited partnership, trustee of a trust, or managing member of an LLC) giving the advisor or a supervised person legal ownership or access to client funds or securities.

# Custody over Client Funds and Assets:

## What an Advisor with Custody Must Do

- Under SEC and most state rules, advisors deemed to have custody over client funds must:
  - Maintain client funds and securities with a "qualified custodian," e.g., banks, registered broker-dealers, futures commission merchants, or certain similar foreign entities, without commingling client assets with the advisor's assets;
  - Notify clients in writing of the qualified custodian's name, address, and the manner in which the funds or securities are held, both at account opening and following any changes;
  - Have a reasonable basis to believe that the qualified custodian sends account statements directly to the clients (or the client's independent designated representative) at least quarterly and that the statements detail the amount of funds and securities in the account at the end of the period and all transactions in the account during that period;
    - IB provides compliant quarterly account statements directly to advisors' clients.
  - Have an independent public accountant perform an annual "surprise" examination verifying the funds and securities under custody; and
  - If the advisor or a related person acts as the "qualified custodian", obtain an annual internal control report from an independent public accountant regarding the effectiveness of the advisor's related person's (or the advisor's itself) procedures for safeguarding client funds and securities.
- The surprise audit and internal control report provisions were adopted by the SEC in response to the Madoff scandal.

# Custody over Client Funds and Assets:

## <u>Overview of State Rules</u>

- Many states have "custody" rules that mirror the SEC's rules, while others have adopted different (generally more stringent) requirements.
- For instance, advisors that may not qualify as custodians under the federal Custody Rule may nonetheless be deemed custodians under certain states' definitions.
- Some states prohibit advisors from having custody over client funds.
- Other states impose bonding requirements on advisors with custody or discretionary authority over client funds to protect against larceny or embezzlement by advisors.
- *Advisors should review the particular laws and regulations in the state(s) in which they do business.*
- *Additional information on advisor custody is available in our <u>Spotlight on the Custody Rule brochure</u>.*

# Compliance Policies & Procedures

- Advisors are also expected to maintain policies and procedures reasonably designed to ensure compliance with applicable regulations.

- Regulators may penalize advisors for having deficient compliance policies and procedures even if the advisors did not break any substantive rules.

- SEC-registered advisors must:
  - Adopt and implement <u>written</u> compliance policies and procedures reasonably designed to prevent, detect, and promptly correct violations of the Act and its rules by them or any of their supervised persons;
  - Review those policies and procedures annually for adequacy and effectiveness in light of changes in business activity and changes in applicable laws and regulations; and
  - Designate a Chief Compliance Officer who is competent and knowledgeable regarding the Act, empowered with full responsibility and authority to develop and enforce appropriate compliance policies and procedures and who has sufficient seniority and authority within the firm to compel others to adhere to the firm's compliance policies and procedures.

# Compliance Policies & Procedures (continued)

- Under federal Rules, the advisor's compliance program is expected to cover the scope of the advisor's business and compliance responsibilities including:
  - Portfolio management processes and trading practices, including best execution obligations;
  - Any conflicts of interest, such as those raised by "soft dollar" arrangements;
  - Proprietary trading by the advisor and personal trades by its employees;
  - Accuracy of disclosures to investors, clients, and regulators, including account statements and advertisements;
  - Safeguarding of client assets;
  - Accuracy and safeguarding of books and records;
  - Marketing and advertising, including the use of third-party solicitors;
  - Valuation of client assets and fee assessments, based on these valuations;
  - Privacy of client information; and
  - Business continuity plans.
- Please keep in mind that the compliance policies and procedures are expected to describe a mechanism to meet the firm's obligations but do not need to memorialize every action to be taken.
- *Most states follow these basic federal requirements but some have adopted different, often more stringent, requirements. Advisors should research the particular rules in their state(s).*
- *Additional information on this topic is available in our Spotlight on Compliance Systems and Documentation brochure.*

# Code of Ethics

- The SEC and many states require advisors to adopt a formal Code of Ethics document setting forth a standard of business conduct for their supervised persons reflecting the fiduciary obligations of the firm and its supervised persons.
- An Advisor’s Code of Ethics must at least:
  - Require compliance with applicable securities laws;
  - Require supervised persons with access to nonpublic information (“access persons”) to report personal securities transactions and holdings on an ongoing basis and require the company to review these reports;
  - Require access persons to obtain firm approval before directly or indirectly buying a security in an IPO or limited offering;
  - Require all supervised persons to promptly report Code of Ethics violations to the firm’s Chief Compliance Officer or other appropriate personnel; and
  - Require that the Code of Ethics (and any amendments) be provided to all supervised persons and that supervised persons acknowledge receipt in writing.

# Other Required Policies & Procedures

Advisors must also adopt a number of other written procedures, including:

- Written privacy policies and procedures outlining the advisor’s administrative, technical, and physical safeguards to protect customer records and information that are reasonably designed to protect against unauthorized access or misuse of customers’ personal information; and

- Written proxy voting policies and procedures reasonably designed to ensure that advisors will cast votes in their clients’ best interests. These procedures are expected to describe how advisors will resolve material conflicts of interest between the advisor’s and clients’ interests, and disclose how clients can learn how their proxies were voted and obtain more information about proxy voting procedures.

# Books & Records Obligations:

## <u>SEC Rule</u>

- Advisors also must keep “books and records” covering the firm’s procedures and key aspects of its business.
- The SEC and state regulators may sanction advisors for failing to keep adequate books and records even if the advisor has not committed a separate, substantive rule violation.
- SEC rules require advisors to make and maintain true, accurate, and current books and records related to their investment business including the following:
  - Financial and corporate records;
  - Order memoranda and written communications concerning trading, including recommendations and trade confirmations;
  - Copies of compliance policies and procedures and records documenting their annual review;
  - Written agreements with clients;
  - Form ADV Part 2 brochure and brochure supplements and all amendments with a record of the dates these documents were provided to clients;
  - Copies of advertisements, and records supporting performance calculations used in the ads;
  - Records related to discretionary authority, including powers of attorney;
  - Code of Ethics, written employee acknowledgments, records of violations and responses, and other records required under the firm’s Code of Ethics;
  - Custody account records; and
  - Referral fee, political contribution, and proxy voting records.
- Advisors must generally maintain most of these records in an easily accessible place for 5 years, the first 2 years in the principal office, and must keep corporate documents in the principal office and preserve them for at least 3 years after the firm closes.

# Books & Records Obligations:

## State Rules

- States often have additional or different books and records rules than the SEC.

- Some states require advisors to maintain additional records, such as suitability records, litigation files, customer complaints, written supervisory procedures or a broader range of advertisements.
  - For instance, the SEC requires advisors to maintain advertisements sent to 10 persons or more, while Virginia requires retention of advertisements sent to 2 or more persons, and New York requires retention of advertisements sent to 5 or more persons.

- States may also require advisors to keep records for longer periods of time.

- *Additional information on these requirements is available in our Spotlight on Advisors' Recordkeeping Obligations brochure.*

# Other Periodic Federal Regulatory Reporting & Filings

- Depending on the nature and volume of their business, advisors may need to make various federal filings beyond the Form ADV, including:
  - **Form PF**, which requires advisors managing private funds with at least $150 million in AUM to provide information on risk exposure and the assets held;
  - **Schedules 13D or 13G**, which require holders of large positions of a specific stock to provide information about the acquirer’s identity, pending legal proceedings, and the nature and purpose of ownership;
  - **Form 13F**, which requires institutional investment managers with over $100 million in qualifying assets to provide information on the manager and its holdings; and
  - **Form 13H**, which requires certain “large traders” to provide information on their business, filings with the SEC, CFTC and foreign registrations, affiliates exercising investment discretion over exchange listed securities, and broker-dealer relationships.
    - Large traders are those managing one or more accounts that traded 2 million exchange-listed shares or shares with a fair market value of $20 million in a single day or 20 million exchange-listed shares or shares with a fair market value of $200 million in a month.
- *These filings must be updated annually, quarterly, or whenever material information changes.*
- *Additional information on regulatory filings is available in our Spotlight on Registration and Regulatory Filings brochure.*

# Other Periodic State Regulatory Reporting & Filings

- Most states require advisors to make at least annual filings regarding their financial information. Some states require all advisors to provide annual financial reports.
- Some states require that advisors with custody over client funds or securities or who make clients prepay advisory fees annually file an audited balance sheet.
- Other states require advisors with discretionary authority over client funds or securities to annually file a non-audited balance sheet.
- Some states (e.g., California) require advisors to report when their net worth falls below a certain level.

# Third-Party Compliance Services

- There are a variety of third-party compliance services available to assist advisors with these compliance obligations.

- Interactive has a Compliance Firms Marketplace on IB's Investors' Marketplace site, through which advisors can learn about and contact third-party compliance firms.  Additionally, information on third-party compliance firms, many of which provide discounts to advisors trading through IB may be found on the RIA Compliance Center.

- Third-party compliance service providers offer a variety of services, including:
  - Help preparing and filing SEC and/or state registrations, including fielding follow-up questions, providing advice on registration rules, and assistance with annual registration renewals;
  - Conducting periodic reviews of and filing amendments to filed documents;
  - Drafting customized documents such as the advisor-client agreement, compliance policies and procedures, Code of Ethics, a privacy policy, and/or a business continuity plan;
  - Offering compliance monitoring documents or tools such as monthly compliance checklists, and alerts and reminders of compliance requirements;
  - Offering compliance advice through compliance hotlines, or email or telephonic consultations;
  - Providing expert assistance in the initial design or annual review of compliance programs;
  - Testing and reviewing compliance systems and trading;
  - Conducting annual site visits, on-site mock regulatory audits, or last-minute SEC/state audit prep sessions; and
  - Providing access to online compliance tools.

# IB Tools to Help New Advisors

- As we discussed earlier, IB has resources available to help new advisors and registered representatives considering a move to the advisor model.
- IB's platform offers many benefits to advisors choosing the IB platform, such as best execution, a way to manage client accounts from one master account, a variety of automatic billing arrangements, and a wide range of trading tools and portfolio modeling tools. These advantages are discussed on the IB website interactivebrokers.com/ria and in a previous webinar interactivebrokers.com/independentpdf.
- *Barron's Magazine has named IB the best online broker for the fourth year in a row! IB achieved 4 1/2 stars out of 5 overall and got the highest score in three areas: trading experience and technology; portfolio analysis and reports; and costs.*
- Also, as I previously mentioned during this Webinar, IB launched an RIA Compliance Center website where advisors may find a series of "Spotlights" providing detailed overviews of key compliance topics, a guide to key regulatory and compliance steps in the transition to an advisory firm model, links to regulatory and third-party websites and information about third-party compliance firms, many of which provide discounts to advisors trading through IB.
- Advisors can also find information about third-party compliance firms through IB's Compliance Firms Marketplace.
- And IB is planning a new Marketplace in the IB Investors' Marketplace to help small or new advisors connect with existing advisors with a fully developed compliance structure looking to grow their firms.