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Texas Regulatory Review

Insight for Brokers and Advisers

Common Exam Deficiencies

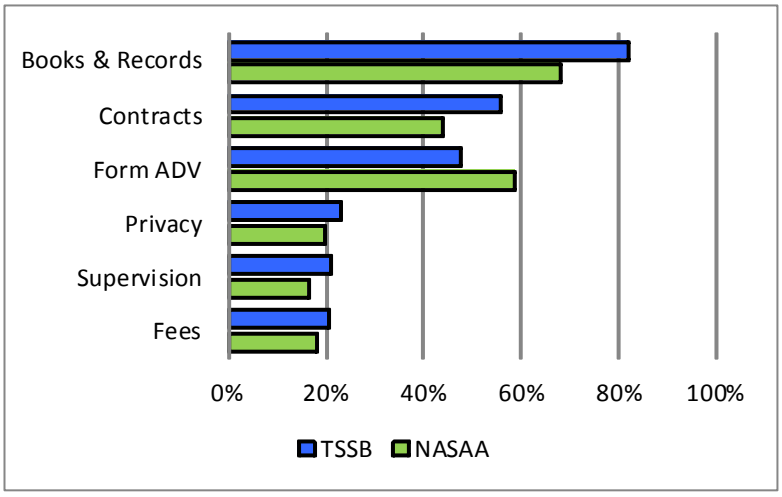
At the conclusion of a regulatory audit, the state's examiners inform the firm of all compliance deficiencies noted during the exam. This article focuses on some of the most common deficiencies cited in the first half of 2013 by Texas State Securities Board ("TSSB") examiners (the "Staff") following examinations of investment adviser firms.

First, the big picture. Over the course of a fiscal year, approximately 80% of TSSB regulatory exams result in at least one deficiency finding. Clearly, many of these findings are not significant enough to warrant formal action. However, the frequency and severity of deficiencies noted may reflect on a firm's approach to compliance issues. The following broad categories comprise the leading deficiencies: books and records; contracts; Form ADV responses; privacy policy delivery; and supervision.

The chart below compares the percentage of TSSB exams that found deficiencies in these categories with exams included in a national survey conducted by the North American Securities Administrators Association ("NASAA").[1]

Books and Records

The Staff reviews numerous books and records during an examination to understand each adviser's business practices. Most of these records are required to be maintained pursuant to §116.5 of the Rules and Regulations of the Texas State Securities Board ("Board Rules"). Generally, the Staff reviews a sample of most records, although the sample size will vary based on the type of record and scope of the audit. For example, the Staff reviews a sample of client files, including client contracts and client profile information. The extent of issues noted in



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Common Deficiencies (cont'd)

the sample often reveals the level of compliance with the books and records requirements.

The Staff rarely finds that an adviser is missing required records in every file reviewed. Instead, the Staff regularly notices that some files are complete while others are missing certain records or key information. This can be the result of an inconsistent approach to record maintenance. For example, an adviser may not be keeping client contracts in the same manner for all clients. This may cause issues during a regulatory audit if the adviser and Staff can't readily locate the contracts. Inconsistency also complicates an adviser's periodic efforts to review and update client contracts. Compliance with record-keeping requirements is enhanced by a consistent approach to records maintenance and updating.

Contracts

Key terms of an investment adviser's relationship with a client are often included in a written agreement between the adviser and the client. The Staff's review of contracts focuses on two issues: compliance with securities laws applicable to these contracts and an adviser's adherence to the terms of each agreement.

Section 116.12 of the Board Rules lists specific requirements related to advisory contracts. A very common deficiency cited by the Staff is the failure to include specific language in each contract as required by Board Rule 116.12(a). Often advisers amend or shorten the language described in §116.12. However, doing so will lead to a deficiency finding. Staff also considers basic anti-fraud principles when reviewing advisory contracts. A key example is the inclusion of a "hedge clause" that purports to limit an investment adviser's liability in a manner that may mislead a client into believing that the client has waived non-waivable rights. The appropriateness of a hedge clause requires a case-by-case analysis that depends on certain facts and circumstances.[2] Advisers considering including a hedge clause should be mindful of the scrutiny these clauses receive from regulators.

Significantly, the Staff regularly finds that an adviser has failed to sign or obtain signatures from all parties to the advisory contract. Advisers should take the time to ensure that all advisory contracts are executed properly.

Form ADV Responses

As reflected in the graph, it is common for a state regulatory audit to uncover issues with an adviser's Form ADV responses. The deficiencies can be categorized as either inaccurate or inconsistent. Misunderstanding the question is one reason for inaccurate responses to items on the Form ADV Part 1 or Part 2. A number of resources can help an adviser to understand questions on the Form ADV. First, the instructions to the Form ADV can be very useful. An adviser can also contact the Staff members in the Inspections & Compliance or Registration divisions of the TSSB for general assistance understanding Form ADV questions. Another frequent cause for inaccurate responses is an investment adviser's failure to update a response after a change in its business.

An investment adviser should remember to consider whether an update to the Form ADV is necessary in connection with revisions to its business. It could be helpful for an adviser to implement an annual process in which the responses to its Form ADV are checked to confirm that they have not become stale.

A number of questions on Form ADV Part 1 match disclosure items on Part 2. Failing to recognize this fact can lead to inconsistent responses. The chart on page seven, which is also available on the TSSB's website, identifies

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Advertising Fundamentals

Registered investment advisers use various methods to advertise the products and services they offer. As advertising outlets continue to evolve from newspapers and magazines to the Internet and social media, it is useful to review fundamental advertising concepts and regulations. It is critical to recognize when a communication or publication would be treated as an advertisement pursuant to the securities laws. For each item deemed an advertisement, the investment adviser should look to the applicable regulation(s) to ensure compliance. In addition to fundamental anti-fraud principles, Texas-registered investment advisers should look to §116.15 of the Rules and Regulations of the State Securities Board ("Board Rules").

Understanding basic advertising requirements and discerning when the advertising regulations must be considered strengthens an investment adviser's ability to market itself in a manner that is both effective and fair to the investing public.

What is an Advertisement?

Determining if an investment adviser's communication is an advertisement requires an examination of both the form and the content of the communication.

An investment adviser's communication may be regarded as an advertisement if it is:

(1) A written communication addressed to one or more person(s); or
(2) An announcement in any publication or by radio, television, the Internet, or similar electronic systems.

A common example in the first category is a template letter sent to more than one client or potential client. Other common examples may include newsletters created by the adviser and generic emails sent to multiple clients.

The second category includes communications through both traditional and electronic mediums. An investment adviser's website is perhaps the most common example. Social media is the prime example of newer forms of communication also found in the second category.

A communication by an investment adviser in any of the forms above would be treated as an advertisement if it offers "any service as an investment adviser." Whether a communication offers "any service as an investment adviser" is likely to be interpreted broadly. A good example is found in a SEC No-Action letter, in which the subject communication was a brochure prepared by Denver Investment Advisors for consultants to retirement plans.[1] The brochure included a profile of the firm and a partial client list. The brochure was provided only to consulting firms that requested information about Denver Investment Advisors (*i.e.*, not on an unsolicited basis). Furthermore, the brochure did not specifically solicit business or advisory clients. Nonetheless, the SEC reasoned that the brochure offered advisory services because it described the firm's investment advisory services and was distributed "for the ultimate purpose of maintaining existing clients and soliciting new ones."

Advertising Restrictions

Advertisements, like other communications by an investment adviser, are subject to the anti-fraud principles of applicable securities laws. This article will not detail the elements of "fraud," but instead highlight specific restrictions applicable to advertisements. However, many of these specific restrictions are founded on anti-fraud principles.

Past Performance

Investment advisers who wish to include past performance data in advertisements should take a cue from a Clint Eastwood movie, "The Good, the Bad and the Ugly." The adviser should be willing to discuss ***all*** material facts related to performance – not just the positive figures. For example, if an adviser is tempted to discuss the monster trade that netted clients a 150% return, then the adviser must also be prepared to

Advertising Fundamentals (cont'd)

include a list of every other investment recommendation from the previous year.

PRACTICE POINT

If an advertisement refers to performance over a recent period (*e.g.*, over the last 12 months), you will need to update the performance figures on a regular basis. Including specific dates associated with performance data may reduce the need to frequently update the advertisement.

All material facts concerning performance figures must be included so the numbers can be assessed in context. Board Rule 116.15(2) and (3) discusses some specific facts and circumstances, which must be addressed in an advertisement that includes performance figures.

Testimonials

Advertisements by an investment adviser may not use or refer to testimonials. This prohibition applies to a client's express endorsement and other statements of a client's experience with the investment adviser. An investment adviser may also be prohibited from including client statements about the adviser even if they do not relate directly to investment advice. Other items that advisers may be prohibited from distributing: independent third-party articles discussing the investment adviser; client lists; and third-party investment adviser rankings. Whether or not an adviser could distribute any of these is a fact-specific inquiry, so an adviser should first research guidance applicable to its specific scenario.[2]

Graphs, Formulas

An investment adviser's advertisement cannot represent that a graph, chart, formula or similar device can, in and of itself, be used to make trading decisions unless the advertisement also identifies difficulties and limitations in its use. These required disclosures must be "prominently" displayed in the advertisement.

When Free Actually Means Free

An investment adviser's advertisement cannot state that the adviser will provide a report, analysis or other service free of charge unless the report or service will in fact be provided free of any obligation.

What Should be Maintained and For How Long?

Advertisements, like many records created by investment advisers, must be maintained pursuant to §116.5 of the Board Rules. Whether or not the advertisement recommends a specific security is a key factor in determining the applicable retention period.

All written advertisements must be maintained for a minimum of three years from the end of the relevant fiscal year based on the requirement applicable to all written communications sent or received relating to any advice given or proposed to be given. *See Section §116.5(b)(2)(D) of the Board Rules.*

However, an adviser may be required to maintain an advertisement for five years from the end of the fiscal year if the advertisement contains a recommendation for the purchase or sale of a specific security. The five-year retention period only applies if such an advertisement was distributed, directly or indirectly, to 10 or more people who are either not clients or who are not connected with the adviser. Furthermore, this record-keeping requirement is not limited to written communications. *See Sections §116.5 (b)(1) and (a)(5) of the Board Rules.* So, for example, if the adviser recommends a specific security on a weekly radio show, the adviser should retain a record of the show for the five-year period.

PRACTICE POINT

A firm's website is an example of an advertisement that may be amended periodically. To satisfy the record-keeping requirements, an adviser should print or otherwise record the contents of a website before making changes. This enables the adviser to maintain an accurate record of the website for the required retention period.

Advertising Fundamentals (cont'd)

The following table may be a useful in determining the appropriate retention period for an advertisement:

3-year retention period	5-year retention period
Any written advertisement that does not recommend a specific security.	
An advertisement that recommends a specific security that is distributed to fewer than 10 persons who are not existing clients or persons affiliated with the adviser.	An advertisement that recommends a specific security that is distributed to 10 or more persons who are not existing clients or persons affiliated with the adviser.

As with many other regulated industries, investment advisers must follow specific rules when advertising their services. Identifying the communications that should be treated as advertisements is critical. Furthermore, understanding the principles associated with the specific restrictions will serve advisers well as they consider marketing their advisory services through either traditional or innovative methods.

Endnotes:

1. *See* SEC No-Action Letter, Denver Investment Advisors, Inc. (available July 30, 1993), CCH Fed. Sec. L. Rep. ¶76,689, 1993 WL 313090.

2. *See* SEC No-Action Letter, Gallagher and Associates, Ltd. (available July 10, 1995), 1995 WL 447626.

Client Profile Documentation: Don't Take It for Granted

Prior to 2011, no rule required Texas-registered advisers to maintain a record of client profile information despite its relevance to many investment recommendations. In August 2011, §116.5(a)(9) was added to the Rules and Regulations of the Texas State Securities Board ("Board Rules") to require that investment advisers record key client profile information. Unfortunately, in 2013 a failure to maintain this client information was the most common deficiency found among Texas-registered investment advisers -- accounting for almost 15% of all deficiencies.

Basic Requirements

Section 116.5(a)(9) of the Board Rules requires advisers to maintain documentation of each client's: (1) birth year; (2) employment status and occupation; (3) annual income; (4) net worth, excluding the value of the client's primary residence; (5) investment objectives; and (6) risk tolerance.

Pursuant to §116.5(a)(10) of the Board Rules, an adviser must update this information for each client at least every 36 months. This requirement is designed to ensure an advisers' records do not contain outdated client information, as a client's profile can change any time.

Under the securities laws, records required to be made by investment advisers also have prescribed minimum retention periods. Texas-registered advisers are required to preserve each record containing client profile information for a period of not less than five years from the end of the adviser's fiscal year in which the last entry was made on the record. *See Section 116.5 (b)(1) of the Board Rules.*

Client Profiles (cont'd)

"But I know everything about my clients…"

Many Texas-registered investment advisers have only one investment adviser representative. As a result, an investment adviser may believe that documentation of client profile information is unnecessary to render appropriate investment advice. Advisers, however, should not rely on their memory to account for client information. Even the best memory will not help an adviser comply with §116.5(a)(9). The information listed in §116.5(a)(9) must be recorded.

In addition to meeting the regulatory requirements, consistent documentation of client profile information has several practical benefits. It can help avoid confusion over the suitability of investment recommendations, both before and after the recommendation is made. Furthermore, sound documentation practices form a foundation for the adviser to grow its practice through additional clients and representatives. Accordingly, an adviser should consider future business plans when developing documentation practices.

Consistency can be key

Maintaining client profile information in a consistent manner is strongly recommended. Advisers, especially those engaged in other business lines (*e.g.*, insurance agents or Certified Public Accountants), often retain the required information through various forms and records accumulated over time. While the Board Rules do not require client profile information to be maintained in a single record, maintaining this information in a consistent manner is a good business practice and supports compliance efforts.

If the profile information is maintained in a reliable, uniform manner, an adviser can both more easily locate it and substantiate compliance with §116.5(a)(9). Consistent documentation also helps advisers update the client profile information as required by §116.5(a)(10). When consistently maintained, an adviser is able to easily coordinate necessary updates and ensure required data is obtained when client profile information is stored on a single, dated form.

Additional Practice Points

- Regardless of how you maintain the required client profile information, date your documentation. You will be able to quickly identify the most recent information and update as necessary.

- Don't rely solely on custodian dealer's forms unless they record all information required by §116.5(a)(9). Furthermore, if you do rely on the custodian's forms, remember that the adviser is responsible for ensuring that the information is periodically updated in accordance with §116.5(a)(10).

- As mentioned previously, some advisers seek to use client records from other businesses to claim compliance with §116.5(a)(9). For example, an adviser that also serves as a CPA for a client might reference accounting records to satisfy the requirements. However, it is generally a best practice to keep the records for each business line separate. Commingled records may be subject to review by TSSB examiners even if the records do not relate to investment advisory services. *See §116.5(c) of the Board Rules.*

- The Board Rules require you to update the client profile information at intervals not greater than 36 months. That doesn't mean you should wait three years to update files. If you learn a client's personal situation or investment preferences have changed, you should immediately update documentation.

Most advisers make suitable investment recommendations for their clients by accounting for key aspects of each client's investment profile, which is of primary significance. Board Rules 116.5(a)(9) and 116.5(a)(10) support this important objective. Advisers should review their approach to documenting client information and consider if alternative methods would enhance both compliance and business planning efforts.

Common Deficiencies (cont'd)

(Continued from page 2)

topics addressed on both parts of the Form ADV. Tools such as this chart can help achieve consistency between the disclosures contained in both parts of the Form ADV.

Topic	ADV 1A Item	ADV 2A Item	ADV 2B Item
Employees as Registered Reps	5B(2)	10A	4A
Employees are insurance agents	5B(5)	10C	4B
Use of solicitors	5B(6), 8H	14B	
Types of clients	5D	7	
Compensation	5E	5A 5E 10D 14	4A, 4B
Performance Fees	5E	6, 19C	
Assets under management	5F	4	
Services provided	5G	4	
Wrap Program	5I	4D, if so, Appendix 1 is required	
Advise on limited security types	5J	4B	
Other financial business	6A	5E, 10A,10B, 10C	
Other business or services	6B	19B	
Financial industry affiliations	5B, 7A	10A, 10B, and/or 10C, 19E	
Private Fund Adviser	7B	4, 5, 10C	
Your interest in client trades	8A	11B, 11C, 11D	
Sales interest in client trades	5B, 7B, 8B	11B	
Discretion	8C	4, 16, 18B	
Related brokers	8D, 8F	10A, 10C	
Recommend brokers	8E	12A	
Soft dollars	8F, 8G	12A	
Receive pay for referrals	8I	10D, 14A	5
Custody	9	15, 18B	
Disciplinary disclosures	11	9, 19D	3, 7
Direct Owners	Schedule A	4, 19A	

Privacy Policy Delivery

Investment advisers, considered financial institutions under the Gramm-Leach-Bliley Act, are required to create and deliver a privacy policy annually to clients. During a regulatory audit, the Staff will review the firm's privacy policy and its practices with respect to delivery of the policy to clients. The majority of advisers examined have created a privacy policy, but firms have frequently failed to deliver the privacy policy at the inception of the client relationship and again on an annual basis. Developing consistent practices for privacy policy delivery will help advisers meet their obligations under the federal law. Documenting delivery efforts also helps an investment

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adviser track and confirm its compliance efforts.

Supervision

All investment advisers registered with Texas are required to "establish, maintain, and enforce" a supervisory system. *See Board Rule 116.10.* However, what it takes to comply with this requirement may vary – often significantly – among investment advisers. This is because various factors must be considered in developing a supervisory system, including the number and types of employees; the number of registered investment adviser representatives; the firm's client base; the firm's advertising efforts; the types of products recommended to clients; and the other services offered to clients.

A firm should avoid copying another firm's procedures because no two investment advisers operate the exact same way. Instead, the adviser should carefully consider its specific business activities when developing its procedures and avoid adopting procedures that are outside the scope of the firm's actual business practices.

Understanding common issues identified by the Staff during exams can minimize the likelihood of violations. Furthermore, it may help advisers identify the Staff's exam priorities and noteworthy trends. While this article doesn't discuss all of the issues encountered by the Staff during its exams, the principles and approaches addressed may be helpful in shaping an investment adviser's fundamental approach to compliance.

Endnotes:

1. http://www.nasaa.org/wp-content/uploads/2013/10/IA-Sweep-2013-Final.pdf.

2. *See* SEC No-Action Letter, Heitman Capital Management, LLC (available February 12, 2007), 2007 WL 789073.

NOTICE

The TSSB recently adopted amendments to the Board Rules resulting in revised registration exemptions for advisers to private funds. These amendments become effective on March 31, 2014.

The TSSB amended §109.6 of the Board Rules and also created a new registration exemption under §139.23 of the Board Rules. Advisers to hedge funds, and other private funds, should review the amended rules to determine how they may be impacted. Additional information can be found on the TSSB website: http://www.ssb.state.tx.us/Texas_Securities_Act_and_Board_Rules/Adopted_Rules/AD_March_31_2014.php

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