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The Texas Regulatory Review

Insight for Brokers and Advisers

Introducing the Newsletter

Welcome to the first edition of the **Texas Regulatory Review: Insight for Advisers and Brokers**, a newsletter that will provide commentary to registered financial service professionals, with an emphasis on investment advisers and investment adviser representatives who do business in Texas. The State Securities Board developed this newsletter to help financial professionals navigate the changing world of securities laws, rules, and regulations. Specifically, the Texas Regulatory Review is intended to assist investment professionals in their practices by:

- Examining pending and newly adopted changes to State Securities Board rules and the Texas Securities Act;
- Explaining the duties and functions of the State Securities Board;
- Alerting IAs and BDs to common issues the staff finds as it performs duties in areas such as registration and compliance examinations.

It's important to note that articles do not constitute legal advice or offer advice that should be construed as "best practices." For questions about the content in the newsletter and to suggest topics for future issues, please contact ssbnews@ssb.state.tx.us.

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Understanding the Custody Rule

As you may already know, registered investment advisers must comply with certain requirements in order to maintain "custody" of client funds or securities. However, you may not realize that you may be deemed to have "custody" even if you don't physically hold clients' assets. Reviewing the relevant rules and existing guidance can help investment advisers understand if they may be deemed to have custody and what safeguards they must establish in order to comply with laws designed to protect clients.

The Texas State Securities Board's rule regarding custody of clients' funds or securities by registered investment advisers became effective in December 2011. Section 116.17 of the Rules and Regulations of the Texas State Securities Board (the "Rule") requires Texas-registered investment advisers that have custody of clients' funds or securities to implement certain safeguards to protect the funds or securities from loss, misuse, or misappropriation. The Rule closely tracks the SEC's rule for federal covered investment advisers.[1]

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Examination Expectations

Did you recently become a state-registered investment adviser? Never been through an examination by the State Securities Board? This article provides some basic information on what to expect from the examination process for state-registered investment advisers.

Any investment adviser or broker-dealer registered with the state is subject to examinations by the Inspections and Compliance Division (the "Staff"). However, this program focuses primarily on exams of investment advisers located in Texas and registered with the state. To this end, the Staff attempts to examine approximately 25% of these investment advisers on an annual basis. On average, a state registered adviser in Texas can expect to be examined every four years. However, the Staff incorporates a risk assessment into its exam selection process that may result in certain advisers being examined more, or less, often.

The examination program is designed to ensure that registered advisers are complying with applicable laws and regulations and meeting the applicable fiduciary responsibilities they owe to their clients. To achieve this objective, while expending state resources as efficiently as possible, the Staff conducts on-site examinations and/or makes written requests for information from investment advisers.

What to Expect During an On-Site Examination

Similar to other regulatory examinations, the Staff may or may not contact a firm prior to conducting an on-site examination. There are a number of factors considered by the Staff in determining whether to contact an adviser prior to an on-site examination. An unannounced examination, however, does not necessarily indicate the Staff suspects there is a problem with an adviser's business practices.

On-site examinations are conducted during regular business hours by two or more Staff examiners. Upon arrival, an investment adviser should expect each examiner to provide identification in the form of a business card and/or agency-issued identification card. If there is any doubt about the credentials presented, the adviser should contact a supervisor in the Inspections and Compliance Division.

Often, advisers have questions such as, "Why are you here?" or "Is there a complaint against us?" The common exam types include: routine examinations, sweep exams focused on a particular issue, or cause-based exams. As a matter of policy, however, the Staff will not indicate the reason for the examination.

Typically, the Staff will start the exam process by conducting a brief interview with key personnel such as management and investment advisory representatives. Then the Staff will begin the process of collecting documentation related to the adviser's business and clients. This usually includes reviewing the adviser's financials, advertising materials, and a sampling of client accounts.

The amount of time that an examination requires varies, depending on the complexity of the services offered and the number of clients served. A typical exam takes one to two days for the on-site field work to be completed. The examination process is meant to be interactive – advisers should ask the Staff questions related to regulatory processes and best business practices. At the conclusion of the on-site exam, and time permitting, the Staff may verbally highlight some of the deficiencies noted.

After the Examination

After the on-site process is completed, the Staff continues analyzing the records collected. The Staff may request additional information and documents in order to complete the examination.

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Custody Rule (cont'd)

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What is "Custody"?

For purposes of the Rule, custody includes "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them." The Rule provides three categories to help identify if an adviser has custody.

- The first is where the adviser obtains possession of client funds or securities. Notably, this would include situations where an adviser receives client checks. Exceptions are when the checks are payable to a third party or the adviser received a check inadvertently and returned it to the sender within three business days.
- The second includes any arrangement, including a general power of attorney, which permits the adviser to withdraw client funds or securities maintained with a custodian. The most common example under this category is when clients have authorized the adviser to withdraw advisory fees directly from their accounts. Another example is when the adviser provides bill-paying services for clients by accessing the clients' bank accounts or checkbooks.
- The third category is when an adviser is serving in a capacity that gives the adviser, or a "supervised person," legal ownership of, or access to, clients' funds or securities. Examples include when the adviser, or a supervised person, is a general partner for a limited partnership client (common where the adviser is managing a hedge fund) or a trustee for a client's trust.

The Responsibilities of Custody

Investment advisers that have custody, as defined by the Rule, are required to implement certain safeguards, with some exceptions.

The four basic requirements are:

- The clients' funds and securities must be maintained with a "qualified custodian," such as a brokerage firm or bank.
- Clients must be provided a written notice with basic information about the custodian.
- The adviser must have a reasonable basis to believe that the custodian will send account statements to the clients; and
- An independent public accountant must conduct at least one unannounced asset verification per year.

Each of these requirements includes additional detailed requirements, which are listed within the Rule.[2]

The Rule's requirements are designed to provide meaningful protection to clients by requiring independence in connection with the information provided to clients. Accordingly, a failure to comply with the Rule may warrant heightened scrutiny of an adviser's business practices.

Common Issues Surrounding Custody Rule

The Rule is not intended to be a one-size-fits-all regulation. To account for different business practices, there are a range of factors that could cause an adviser to be considered to have custody. In addition to the responsibilities listed above, the Rule includes both additional requirements and exceptions for a number of situations. Here we will focus on two of the most common areas found in examinations of Texas-registered investment advisers.

Fee Deduction

Many Texas-registered investment advisers are deemed to have custody solely because their clients have authorized them to withdraw advisory fees directly from the clients' accounts. These advisers have specific, limited authority over client funds,

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and as such they are not required to comply with the requirement that the clients' funds and securities be verified annually by an independent public accountant. These advisers must, however, comply with the other general requirements.

Advisers to a Pooled Investment Vehicle

There are several aspects of the Rule focused on advisers who are general partners of limited partnership clients (or in a comparable position for another type of pooled investment vehicle).[3] This often includes advisers who are managing a hedge fund or some other type of private fund.

In such situations, the limited partnership is likely considered the adviser's client. Accordingly, the adviser might satisfy the notice and account statement requirements by simply ensuring the adviser is provided this information. Consistent with the Rule's goal of ensuring that beneficial owners have independent access to information about their investments, the Rule requires the adviser to have a reasonable belief that the account statements for the limited partnership are sent by the qualified custodian to each limited partner.

However, advisers to pooled investment vehicles often want to prevent limited partners (or others) from using the account statements to copy their trading strategies. In recognition of the advisers' proprietary interests, these advisers can avoid providing each beneficial owner with notice of the custodian and custodial account statements if they have the limited partnership audited at least annually by an independent public accountant.

Not only would this independent audit allow the adviser to comply with the Rule without ensuring each limited partner received the account statements of the pooled investment vehicle, but it would also serve as a substitute for the independent asset verification. To account for the fact that the limited partners are receiving less independent information on a regular basis, the requirements of this audit are more significant than the independent asset verification. For example, the auditor must be registered with the Public Company Accounting Oversight Board (PCAOB) and each limited partner must be provided the limited partnership's audited financial statements.

Many funds are required to do the annual audits pursuant to their operating documents, not just to satisfy the requirements of an exception contained in the Rule. The Staff has seen numerous advisers obtain waivers of the required annual audit from limited partners. As a result, advisers will not obtain an annual audit of the fund. In such situations, it's important for advisers to note that obtaining a waiver from the limited partners might address the partnership's operating requirements, but it doesn't relieve advisers from the requirements of the Rule.

As you can see, even though there are very important details in the Rule, the principle is basic: in situations where an adviser has a certain level of access to client funds or securities, there should be sufficient independent control and review over those assets.

Endnotes:

1. *Compare* Rule 206(4)-2 under the Investment Advisers Act of 1940, 17 C.F.R. § 275.206(4)-2 (2010), *with* Rules & Regulations of the Tex. State Sec. Board, 7 Tex. Admin. Code Chapter 116.17 (Supp. 2012).

2. *See* Rules & Regulations of the Tex. State Sec. Board, 7 Tex. Admin. Code Chapter 116.17(b) (Supp. 2012). Also available at http://www.ssb.state.tx.us/Texas_Securities_Act_and_Board_Rules/.

3. While the remainder of the discussion refers only to limited partnerships and limited partners, the points apply equally to other organizational forms where the adviser is in a comparable position for a pooled investment vehicle.

Examinations (cont'd)

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While the length of this process also depends on the complexity of issues raised through the exam, advisers can expect it to last approximately 60-90 days. After the Staff completes its review, it will typically send the adviser a letter identifying the deficiencies found during the exam. The adviser will be asked to address the deficiencies and send a response to the Inspections and Compliance Division detailing the adviser's responses and corrective actions. Advisers will also receive a final letter if no deficiencies are found.

More information about the examination process is available on the State Securities Board website, www.ssb.state.tx.us, or by calling 512-305-8300 and asking to speak to a supervisor in the Inspections and Compliance Division.

The Need for Continuity Planning

Large organizations commonly develop and test business continuity plans (BCPs) for use in the event of significant business disruptions. However, smaller entities, especially those composed of only one person, often don't develop a BCP. The recent tragic events in Boston, Oklahoma and West, Texas are reminders of the need for such planning to minimize disruptions and lessen any potential harmful impact to clients. While terrorist attacks, natural disasters, or industrial accidents are rare, events such as fire, theft, and unexpected death are more common. The proper time to prepare for such events is well before they strike.

A well-developed business continuity plan should consider the various operational risks to which a registrant may be subject, and not simply emergency situations. Such external events to consider may be widespread utility outages, fires, theft or vandalism of offices or property, and death, incapacitation, or extended unavailability of key personnel, among others. Templates for such plans are widely available through internet searches or compliance service providers. Of course, each registrant will be affected by such factors differently and no one generic template or approach will be appropriate for every firm.

In a release associated with the rule requiring federally-registered advisers to maintain compliance policies and procedures, the SEC stated that an adviser's fiduciary obligation "includes the obligation to take steps to protect the clients' interests from being placed at risk as a result of the adviser's inability to provide advisory services after a [significant business disruption]."[1] The release listed certain minimum required elements of a reasonable compliance program, BCPs among them.

FINRA likewise adopted rules requiring "reasonably designed" BCP procedures for its member broker-dealers with Rule 4370.[2] While not directly applicable to investment advisers, guidance can be gleaned from this rule in developing and tailoring a BCP to the needs and operations of advisers. At a minimum, Rule 4370(c) requires broker-dealers to address data backup and recovery; mission-critical systems; financial and operational assessments; alternate communication methods among the firm, its clients, employees, and regulators; alternate physical location of employees; regulatory reporting; and critical business constituent, bank, and counter-party impact.

Perhaps most importantly, Rule 4370(c)(10) requires firms to determine "how the [firm] will assure customers' ***prompt access to their funds and***

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Continuity Planning (cont'd)

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securities" should the firm be unable to continue operations [emphasis added].

Advisers developing such a plan should determine how best to re-establish and sustain operations based on the specific facts and circumstances of each business operation. Such plans, once developed, should be in writing and made part of the overall compliance program of the firm. Training for all employees should be considered as well, especially among those employees responsible for activating or performing any part of the firm's BCP procedures.

For smaller advisers, perhaps the largest risk to consider is the possibility that a key investment advisory representative becomes incapacitated or dies unexpectedly. Prudent advisers should consider the possibility of such events and their impact on clients. How will clients be alerted? How will they be able to access their accounts? For active portfolio managers, how much time will elapse before clients' interests could be compromised by an extended absence?

Advisers may want to consider these and other factors in developing a comprehensive BCP:

- Geographic location and propensity for and experience with natural disasters such as hurricanes or tornadoes;
- Size and complexity of operations;
- Number of employees and duties of each (including key employees or managers);
- Access to transportation or digital networks and infrastructure;
- Remote office sites and facilities;
- Electronic and hard-copy data backup and recovery;
- "Mission critical" systems that are vital to continued operations;
- Succession planning to replace key personnel;
- Physical custody of funds or securities (especially among those advisers offering or managing private placements);
- Client alert systems and alternate points of contact for the firm and custodian(s);
- Trading frequency and strategies; and
- Other systems necessary for both short- and long-term sustained operations during and after a significant business disruption.

Finally, once a BCP has been designed and implemented commensurate with the varying risks identified, testing should occur at regular intervals. This will help ensure that all adviser personnel are knowledgeable about policies and procedures necessary to sustain operations. Testing should include all associated backup systems and facilities. Once a disruption to business has occurred, advisers may not want to initially test their plan under the stresses of an emergency situation.

No one approach to business continuity planning will be appropriate for all advisers. Yet prudent advisers will contemplate how they can be affected by unforeseen external factors and attempt to minimize disruptions accordingly. The factors listed above should provide a good starting point for most firms. At a minimum, firms should determine how to stay in contact with clients, how to quickly re-establish critical operations and systems, and how to allay any client concerns about access to their funds and securities during a business disruption or emergency. Finally, advisers should routinely test their programs to help ensure adequacy and reliability.

Endnotes:

1. SEC Release Nos. IA-2204; IC-26299 Final Rule: Compliance Programs of Investment Companies and Investment Advisers, available at http://www.sec.gov/rules/final/ia-2204.htm.

2. FINRA Rule 4370, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8625.