

Investment Adviser Workshop



Navigating the Dodd-Frank Act's New Regulatory Requirements for Investment Advisers

**Presented by
The Vermont Securities Division**

Workshop Topics

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- ❑ What Dodd-Frank Means for Investment Advisers
- ❑ IA Regulation in Vermont
- ❑ What to Expect from State IA Exams

DISCLAIMER

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The accompanying materials are presented as an educational experience, covering some of the changes mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

You will be subject to all relevant laws, regulations, rules and orders whether or not they are included in this presentation. The Vermont Securities Division reserves the right to change its position. We believe all information herein is truthful and accurate; however, mistakes can occur.

About Us

Our primary goal is to protect investors

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- ❑ The Vermont Securities Division regulates:
 - Investment Advisers & Investment Adviser Representatives
 - Broker-Dealers & Broker-Dealer Agents
 - Securities Issuers

- ❑ Other responsibilities of the Vermont Securities Division:
 - Securities-related Investigations
 - Consumer Complaints/Inquiries
 - Examinations
 - Investor Education

What Dodd-Frank Means For IAs

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Under the **Dodd-Frank Wall Street Reform and Consumer Protection Act**, state securities regulators will have greater responsibility for the regulation of investment advisers.

What Dodd-Frank Means For IAs

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- ❑ Dodd-Frank establishes a threshold of **\$100 million** assets under management (AUM) for federally covered advisers.
- ❑ Approximately **4,000** advisers nationwide will be affected, including about 150 domiciled or notice filed in Vermont.
- ❑ Eliminates the **private adviser** exemption.
- ❑ Law takes effect **July 21, 2011**.

What Dodd-Frank Means For IAs

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- ❑ In Vermont, all advisers with \$100 million or less under management will be required to register with the state **unless**:
 - They fall between \$25 million and \$100 million **and** are required to be registered in 15 or more states, or
 - The investment adviser qualifies for an exemption under Rule 203A-2 of the Investment Advisers Act of 1940.

What Dodd-Frank Means For IAs

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- ❑ Firms required to register with the Vermont Securities Division:
 - Firms with AUM of \$25 million or less (**through July 21, 2011**)
 - *Buffer between \$25M & \$30M – State or Federal*
 - Firms with AUM of \$100 million or less (**after July 21, 2011**)
 - *No buffer at this time*

- ❑ Firms with AUM of \$25 million to \$100 million **may** register with the Vermont Securities Division prior to July 21, 2011, but must also remain registered with the SEC until July 21, 2011.

What Dodd-Frank Means For IAs

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- ❑ **State authority over IAs with AUM of \$25-\$100 million**
 - IA's principal office and place of business is in a state that requires registration and, if registered, the IA would be subject to examination
 - If an IA is required to register in 15 or more states, the IA can remain with the SEC
- ❑ Some IAs will register with the SEC regardless of AUM, such as IAs to registered investment companies and IAs to a business development company under the Investment Company Act.

What Dodd-Frank Means For IAs

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Proposed Transition Schedule

- SEC Release IA No. 3110
- Proposed New Rule 203A-5:

Confirming SEC eligibility. Each IA registered with SEC on July 21, 2011 will file an amendment to ADV by August 20, 2011 to report AUM determined within 30 days of amendment filing.

Terminating SEC registration. IAs no longer eligible for SEC registration must file ADV-W by October 19, 2011.

What Dodd-Frank Means For IAs

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- ❑ **Private Fund Investment Advisers Registration Act of 2010** (Title 4 of Dodd-Frank) – Significant reforms to the regulation of advisers to hedge funds and other private funds, including:
 - Eliminates the private adviser exemption (203(b)(3))
 - Requires SEC registration for advisers to “private funds” with AUM of at least \$150 million
 - Requires SEC reporting for advisers to “private funds” with AUM of less than \$150 million and for advisers to “venture capital funds”
 - Defines “family office” to exclude it from IA
 - Defines “foreign private adviser” & exempts from SEC registration
 - Excludes advisers to private funds from the intrastate exemption from registration

What Dodd-Frank Means For IAs

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PRIVATE FUND DEFINITION

- ❑ **Private fund** – An issuer that would be an investment company under the Investment Company Act, but for the exceptions contained in **3(c)(1)** or **3(c)(7)** of that Act.

What Dodd-Frank Means For IAs

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❑ 3(c)(1)

- securities are not publicly offered and are owned by not more than 100 persons
- Interests typically offered pursuant to Reg D, Rule 506.
- accredited investors

❑ 3(c)(7)

- Securities are not publicly offered and generally not owned by more than 499 persons
- Investors must be qualified purchasers (individuals with investments of \$5,000,000/institutions with \$25,000,000 of investments)

What Dodd-Frank Means For IAs

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Advisers to Private Funds:

Registration and Reporting Requirements

- ❑ **Advisers solely to private funds with AUM of less than \$150 million**
 - Exempt from registration with the SEC
 - Reporting requirement with SEC
 - No state preemption, subject to national de minimis
- ❑ **Advisers solely to private funds with AUM of \$150 million or more**
 - Register with the SEC
 - States are preempted – Notice Filing Requirement

What Dodd-Frank Means For IAs

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Advisers Solely to Venture Capital Funds: Registration and Reporting Requirements

- ❑ Advisers solely to venture capital funds
 - Exempt from registration with the SEC
 - SEC reporting requirement
 - No state preemption, subject to national de minimis
 - No AUM provisions
 - SEC has proposed a definition of “venture capital fund” in Release No. IA-3111

What Dodd-Frank Means For IAs

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About State Regulation:

- ❑ **States are preparing to handle the switch.** State securities regulators are working to ensure a seamless, comprehensive and effective switching process.
- ❑ **Switching is not new.** Regulatory switches regularly happen when the asset levels of IA firms rise above or fall below mandated thresholds.
- ❑ **State registration is a smooth process for most IAs**, especially those that have made the switch before and those that operated prior to 1996 when most IAs were required to register both with the SEC and with each state in which they were doing business.

What Dodd-Frank Means For IAs

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About State Regulation:

- ❑ **States conduct a thorough review of adviser applications.** State reviews will not change with the migration of IAs with up to \$100 million in assets under management.
- ❑ Firms switching to state regulation for the first time can expect **thorough inspections generally on a more frequent basis** than they may have experienced before.
- ❑ Thorough inspections and strong internal compliance **benefit customer and firm alike.**

What Dodd-Frank Means For IAs

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NASAA IA Switch Resource Center

- ❑ The North American Securities Administrators Association (NASAA) is assisting states with the migration of investment advisers.
- ❑ NASAA's online **IA Switch Resource Center** includes an FAQ, calendar of events and additional guidance to help advisers make the switch to state regulation.
- ❑ Advisers can use the resource center to submit questions about the switch. The resource center is available at www.nasaa.org

IA Regulation

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Registration & Form ADV

IA Regulation: The Registration Process

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- ❑ File Parts 1 and 2 of Form ADV via the IARD.

- ❑ Other information required to be filed directly with the Division includes:
 - Investment Advisory Contract(s)
 - A Certified Balance Sheet for IAs with discretion but not custody
 - An Audited Balance Sheet for IAs with custody
 - Affidavit of Investment Advisory Activity
 - Vermont Investment Adviser Tax Certification Form (in-state only)
 - All Advertising Materials
 - A Certification Naming A Designated Supervisor
 - Written Supervisory Procedures Manual
 - The Firm's Privacy Policy
 - Any Other Information/Documentation requested by the Division

IA Regulation: The Registration Process

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- ❑ Once all information is received, your file is reviewed for compliance with statutes/rules/orders.
- ❑ The goal is to ensure that your firm is in compliance before conducting business.
- ❑ You will receive a deficiency letter or a phone call if:
 - You failed to include information required or requested;
or
 - You included information that does not comply with applicable statutes/rules/orders.

IA Regulation: The Registration Process

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- ❑ Must respond to deficiency letters, e-mails and/or telephone requests to continue with the application process.
- ❑ You will not receive notice when your firm is approved. That information is available on the IARD system.
- ❑ Ensure that the contact person's email address is correct as many notifications, sent before and after the application process has concluded, are sent through electronic communication.

IA Regulation: The Registration Process

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- ❑ To begin the registration process with Vermont, check “Vermont” under Item 1 of Form ADV Part 1B at the time of your annual amendment and at that time also file Form ADV Part 2.
- ❑ This will put you in a “no status” category.
- ❑ You must then submit the documents required for registration.

IA Regulation: The Registration Process

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You now have two choices regarding the timing of your registration.

- ❑ Move forward with **dual registration** with the SEC and your state securities regulator until July 21, 2011.
- ❑ Submit documents for review to your state but request to remain in a **pending status** with an effective date of July 21, 2011. Remember that your registration will only be effective on July 21, 2011 if the Securities Division has cleared your application for approval.
- ❑ The SEC has proposed allowing state-registered advisers or new advisers with \$30 million AUM to remain registered in the state in which the IA maintains its principal office and place of business. (See SEC Release No. IA 3110.)

IA Regulation: The Registration Process

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- ❑ The 2011 IARD Renewal Program Calendar is available online at: www.iard.com/renewals.asp
- ❑ **There will be no changes in the renewal process.**
- ❑ Proceed as you would in any other year.

IA Regulation: Registration | Annual Renewal Process

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- Completed through Web IARD.
- Registrants who fail to renew are considered inactive on Jan. 1 and are no longer a “Registered” Investment Adviser.

IA Regulation: Registration | Withdrawal Process

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- ❑ Withdrawal of Registrant is made by following the Form ADV-W instructions.
- ❑ Withdrawal of IA rep registration is made by following the Form U-5 instructions.
- ❑ Do not assume that by letting a registration lapse, the registrant has been withdrawn.
 - “Failure to Renew” status
- ❑ Make arrangements to maintain books and records for five years as noted on Form ADV-W.

IA Regulation: Registration | Form ADV Part 1

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□ Form ADV Part 1 is:

- Used to register and describe the details of the registrant with the Vermont Securities Division.
- Filed online via the Investment Adviser Registration Depository (IARD) .
 - IARD is an electronic filing system that facilitates investment adviser registration, regulatory review and public disclosure information of investment adviser firms.
 - FINRA is the developer and operator of the IARD system, which is sponsored by the SEC the North American Securities Administrators Association (NASAA).

IA Regulation: Registration | Form ADV Part 1

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- Material changes must be filed within 30 days.
 - Called an “other than annual amendment”
 - Do not file hard copy changes to Form ADV – Online ONLY

- What is a material change that requires an other than annual amendment?
 - Change of name, address, contact information, form of organization, custodial arrangements, disciplinary actions, etc.

- Required to file annual amendment within 90 days of end of fiscal year.
 - Amend regardless of whether there have been changes.

IA Regulation: Registration | Form ADV Part 2

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- ❑ The new Part 2 consists of three parts:
 - **Part 2A, the Firm Brochure**
 - Includes all firm details written in plain English to promote effective communication between you and your clients.
 - **Part 2A Appendix 1, Wrap Fee Program Brochure**
 - If you sponsor a wrap fee program.
 - **Part 2B Brochure Supplement**
 - For supervised persons who formulate investment advice for clients and have direct client contact.

IA Regulation: Registration | Form ADV Part 2

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Key Points

- ❑ Provides new and prospective clients with a brochure and brochure supplements written in plain English. No more “check the box.”
- ❑ Describes business practices, conflicts of interest, and the background of the investment adviser and its advisory personnel.
- ❑ Discloses meaningful information in a clearer format.
- ❑ Electronic filing in IARD is required.
- ❑ Part 2 brochures will be available for viewing through IAPD.

IA Regulation: Registration | Form ADV Part 2

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Key Points

- ❑ An adviser is a fiduciary whose duty is to serve the best interests of its clients.
- ❑ An adviser must deal fairly with clients and prospective clients, seek to avoid conflicts with its clients and, at a minimum, make full disclosure of any material conflict or potential conflict.
- ❑ Disclosures that clients and prospective clients receive is critical to their ability to make an informed decision about whether to engage an adviser.
- ❑ To evaluate the risks associated with a particular IA, its business practices and investment strategies, it is essential that clients and prospective clients have clear disclosure that they are likely to read and understand.

IA Regulation: Registration | Form ADV Part 2

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- ❑ What is required?
 - Part 2A: Firm Brochure **or**
 - Part 2A Appendix 1: Wrap Fee Program Brochure
 - Part 2B: Brochure Supplement

- ❑ File all parts of ADV Part 2 on the IARD system.

- ❑ You must file your *brochure(s)* (and amendments) through the IARD system using the text-searchable Adobe Portable Document Format (PDF).

IA Regulation: Registration | Form ADV Part 2

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Annual Delivery Requirements

- ❑ Item 2 of the Instructions for the new Part 2A of Form ADV “Preparing Your Firm *Brochure*” provides that each year a registered investment adviser must:
 - deliver, within 120 days of the end of the IA’s fiscal year, to each client a free updated *brochure* that either includes a summary of material changes or is accompanied by a summary of material changes, or
 - deliver to each client a summary of material changes that includes an offer to provide a copy of the updated brochure and information on how a *client* may obtain the *brochure*.

IA Regulation:

Registration | Form ADV Part 2 | Guidance

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- ❑ **Narrative format:** You must include the heading for each item provided by Part 2 immediately preceding your response to that item and provide responses in the same order as the items appear in Part 2.

- ❑ **Plain English:**
 - Use short sentences;
 - Use definite, concrete, everyday words;
 - Use active voice;
 - Use tables or bullet lists for complex material, whenever possible;
 - Avoid legal jargon or highly technical business terms unless you explain them or you believe that your *clients* will understand them; and,
 - Avoid multiple negatives.

IA Regulation:

Registration | Form ADV Part 2 | Guidance

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- ❑ **Disclosure Obligations as a Fiduciary** - You are a fiduciary and must make full disclosure to your *clients* of all material facts relating to the advisory relationship.

As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your *clients* that could affect the advisory relationship.

- ❑ **Full and Truthful Disclosure** - All information in your *brochure* and *brochure supplements* must be true and may not omit any material facts.

IA Regulation: Registration | Form ADV Part 2 | Overview

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- ❑ **Part 2A of Form ADV:**
Firm Brochure: 19 Items
- ❑ **Part 2A Appendix 1 of Form ADV:**
Wrap Fee Program Brochure: 10 Items
- ❑ **Part 2B of Form ADV:**
Brochure Supplement: 7 Items

IA Regulation: Form ADV Part 2A | Firm Brochure

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- ❑ 1. Cover Page
- ❑ 2. Material Changes
- ❑ 3. Table of Contents
- ❑ 4. Advisory Business
- ❑ 5. Fees and Compensation
- ❑ 6. Performance-Based Fees and Side-By-Side Management
- ❑ 7. Types of Clients
- ❑ 8. Methods of Analysis, Investment Strategies and Risk of Loss
- ❑ 9. Disciplinary Information
- ❑ 10. Other Financial Industry Activities and Affiliations
- ❑ 11. Code of Ethics, Participation or Interest in *Client* Transactions and Personal Trading

IA Regulation: Form ADV Part 2A | Firm Brochure

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- ❑ 12. Brokerage Practices
- ❑ 13. Review of Accounts
- ❑ 14. Client Referrals and Other Compensation
- ❑ 15. Custody
- ❑ 16. Investment Discretion
- ❑ 17. Voting Client Securities
- ❑ 18. Financial Information
- ❑ 19. Requirements for State-Registered Advisers

IA Regulation:

ADV Part 2A Appendix 1 | Wrap Fee Program Brochure

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- ❑ 1. Cover Page
- ❑ 2. Material Changes
- ❑ 3. Table of Contents
- ❑ 4. Services, Fees and Compensation
- ❑ 5. Account Requirements and Types of *Clients*
- ❑ 6. Portfolio Manager Selection and Evaluation
- ❑ 7. Client Information Provided to Portfolio Managers
- ❑ 8. Client Contact with Portfolio Managers
- ❑ 9. Additional Information
- ❑ 10. Requirements for State-Registered Advisers

IA Regulation:

ADV Part 2A Appendix 1 | Wrap Fee Program Brochure

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Instructions for Preparing your Wrap Fee Program Brochure

Who must deliver a wrap fee program brochure?

- ❑ If you sponsor a wrap fee program, you must give a wrap fee program brochure to each client of the wrap fee program.
- ❑ However, if a wrap fee program that you sponsor has multiple sponsors and another *sponsor* creates and delivers to your wrap fee program clients a wrap fee program brochure that includes all the information required in your wrap brochure, you do not have to create or deliver a separate wrap fee program brochure.
- ❑ A wrap fee program brochure takes the place of your advisory firm brochure required by Part 2A of Form ADV, but only for clients of wrap fee programs that you sponsor. See SEC rule 204-3(d) and similar state rules.

IA Regulation: Form ADV Part 2B | Brochure Supplement

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- ❑ 1. Cover Page
- ❑ 2. Educational Background and Business Experience
- ❑ 3. Disciplinary Information
- ❑ 4. Other Business Activities
- ❑ 5. Additional Compensation
- ❑ 6. Supervision
- ❑ 7. Requirements for State-Registered Advisers

IA Regulation: Form ADV Part 2B | Brochure Supplement

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Instructions for Preparing your Brochure Supplement

For which supervised persons must we prepare a brochure supplement?

- ❑ As an initial matter, if you have no clients to whom you must deliver a brochure supplement (see Instruction 2 below), then you need not prepare any brochure supplements. Otherwise, you must prepare a brochure supplement for the following supervised persons:
 - (i) Any supervised person who formulates investment advice for a client and has direct client contact; and,
 - (ii) Any supervised person who has discretionary authority over a client's assets, even if the supervised person has no direct client contact. See SEC rule 204-3(b)(2) and similar state rules.

IA Regulation: Form ADV Part 2B | Brochure Supplement

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Instructions for Preparing your Brochure Supplement

- ❑ **Note:** No supplement is required for a supervised person who has no direct client contact and has discretionary authority over a client's assets only as part of a team. In addition, if discretionary advice is provided by a team comprised of more than five supervised persons, brochure supplements need only be provided for the five supervised persons with the most significant responsibility for the day-to-day discretionary advice provided to the client.

See SEC rule 204-3(b) and similar state rules.

IA Regulation: Registration | Common Form ADV Deficiencies

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- ❑ The two parts of the Form ADV don't match.
- ❑ Failure to amend Part 1 within 90 days of fiscal year end.
- ❑ Not documenting that registrant is giving the ADV Part II to clients or offering it to them annually.
- ❑ Inaccurate Form ADV
 - Reporting a PO Box as principal office location
 - Stating your office hours are 9-5 daily, but you work another job during these hours
 - Typo in email or phone number

IA Regulation: Registration | Form ADV Part 2

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Form ADV Part 2 Resources

- ❑ The new Part 2 of Form ADV is posted on the websites of the SEC and the North American Securities Administrators Association (NASAA).

- ❑ NASAA has posted guidance for investment advisers filing the new Form ADV Part 2 in IARD.
 - **Visit the NASAA website, look in “Industry & Regulatory Resources”**

www.nasaa.org

IA Regulation: Forms Filed Annually

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- Form ADV Part 1 amendment (filed online).
- Investment Adviser Representatives are under a continuing obligation to update information required by Form U-4 as changes occur.
- Vermont Tax Certification Form for each Vermont domiciled Investment Adviser Representative (mailed, emailed or faxed).

IA Regulation: Forms Filed Annually

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- ❑ Additional filing required if registrant has discretion and/or custody
 - A certified (unaudited) balance sheet for advisers with discretionary authority, but not custody, that is represented as true and accurate by the preparer
 - An audited balance sheet for advisers with custody of client funds or securities

IA Regulation: Remember

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- Notify the Securities Division by the close of next business day if the firm's net worth falls below the minimum requirement, then file report of financial condition by the close of the next business day.
- If a bond is terminated, the firm is required to notify the Securities Division within two business days.

IA Examinations By The Vermont Securities Division

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What to Expect

State IA Exams: What to Expect

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- ❑ Our goal in **examining** Investment Advisers is to **protect** investors and legitimate business in Vermont.
- ❑ **Two Types of Examinations**
 - **On-Site** *conducted on the premises of the firm*
 - **Desk** *conducted from the examiner's office (via document request letters/emails/telephone calls)*

State IA Exams: Examination Focus

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- ❑ State IA examinations generally include the following areas:
 - Books and records
 - Financials
 - Registration – Form ADV Parts 1 and 2
 - Investment Activities
 - Complaints
 - Advertising and Marketing
 - Conflicts of interest
 - Custody
 - Supervisory/Compliance Procedures
 - Business Practices

State IA Exams: What to Expect

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- ❑ On-site portion of exam may last from one day to a week depending on several factors.
- ❑ Usually one or two examiners.
- ❑ Exams are nearly always unannounced.
- ❑ If an examiner arrives at your firm, you are required to allow the examiner to conduct the examination. Failure to do so may result in the revocation of your registration and will result in a full investigation.

State IA Exams: What to Expect

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- ❑ Introduction and description of the purpose of the visit.
- ❑ Identify contact/point person for the examiner.
- ❑ Initial interview conducted by examiner.
 - Tour of the office
 - *Where are your records?*
 - *Where is the copier?*
 - *Where can I work?*
 - Interview: Questions about your practice

State IA Exams: What to Expect

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- ❑ Be prepared with requested documents readily available.
- ❑ Try to have key personnel available.
- ❑ Even after the examiner has left your office, the exam is not over.
 - Most of the exam is done at the examiner's office and frequently additional documents or information is requested.

State IA Exams: What to Expect

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- Once post-exam work is complete, an exam report or deficiency letter may be sent.
- Registrant must respond to the deficiency letter in writing, usually within a set amount of time.
- Once all deficiencies have been satisfactorily addressed, exam is closed.
- Certain issues may be referred to enforcement.

State IA Exams: Common Exam Deficiencies

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- Failing to file Form ADV Part 1 amendment within 90 days of the end of fiscal year
- Inaccurate or incomplete Forms ADV Part 1 & 2
- Incomplete, inadequate, or no contract with clients
- Failing to meet required net worth requirements
- Failing to maintain current suitability information regarding clients

State IA Exams: Common Exam Deficiencies

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- Non-compliance with privacy requirements
- Incomplete or no written supervisory/compliance procedures
- Non-compliance with advertising rules
- Failing to maintain applicable books and records
- Not sending invoice of fees if auto-deducting fee

Resources

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- ❑ The Vermont Securities Division
 - www.vermontinvestorprotection.info

- ❑ North American Securities Administrators Association
 - www.nasaa.org
 - Investment Adviser Resources
 - Uniform Forms
 - IA Switch Resource Center

Questions?

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