

## **2014 Investment Adviser Rule Amendments Frequently Asked Questions (FAQ)**

### **What must the business continuity plan required under WAC 460-24A-200(1)(y) contain?**

The Securities Division created a new provision at WAC 460-24A-200(1)(y) to require that investment advisers retain a current written business continuity plan which is reasonably designed to enable the adviser to meet his or her fiduciary obligations in the event of emergency or significant business disruption. Having this sort of plan in place would be essential, for instance, for solo advisers who become incapacitated by illness, or for advisers whose business is disrupted by a natural disaster or act of terrorism.

The business continuity plan does not need to be lengthy, nor does it need to be prepared by outside professionals. The plan should simply provide instructions in the event of a business disruption. The plan should designate a contact person who has agreed to assist the adviser's clients in accessing their funds or records in the event of the death or disability of the adviser. The plan should describe what will happen to client funds over which the investment adviser has custody or exercises discretion, and should discuss the procedures for refunding any pre-paid advisory fees.

### **What type of written information must an adviser retain in order to comply with the recordkeeping requirement in WAC 460-24A-200(1)(s) that advisers retain written information about each security that an adviser recommends a client buy or sell?**

Pursuant to RCW 21.20.702, recommendations made by an investment adviser must be suitable for the customer. The Securities Division created a new recordkeeping requirement at WAC 460-24A-200(1)(s) to specify that advisers must retain written information concerning the basis for any investment advice or recommendation an adviser makes to a client to buy or sell a security. The Securities Division adopted this provision in order to ensure compliance with the existing suitability requirements in RCW 21.20.702. This requirement for written documentation provides protections for both investors and investment advisers.

The type of written information to be retained by the adviser will be different depending on the nature of the security recommended and the client for whom it is recommended. There are various sources that an adviser may use to gather this information, which will vary depending on the circumstances. These sources of information might include research services, industry publications, offering documents, financial statements, or an adviser's personal investigation of a company. The adviser should retain notes regarding the materials reviewed in evaluating the suitability of a security or an investment product for his or her clients.

**Do I need to re-execute all my existing advisory contracts to add provisions relating to proxy voting and electronic delivery of documents as specified in WAC 460-24A-130?**

The requirements specified in WAC 460-24A-130 for advisory contracts will apply only to contracts entered into or revised after the date the rule becomes effective. Therefore, the new rule does not require any action on your part for existing contracts. However, if an adviser does re-execute a contract with a client, the adviser must ensure that the new contract is compliant with WAC 460-24A-130.

The new rule at WAC 460-24A-130 specifies the requirements for the contents of advisory contracts. Many of these requirements were previously located in WAC 460-24A-200, the books and records rule, but have now been moved to a separate rule. However, advisers should be aware that there are a couple new requirements for advisory contracts to the new rule. The adviser now must indicate in the contract the nature and extent to which the adviser is granted proxy voting authority with respect to client securities. In addition, the adviser must now disclose in the contract the nature and extent to which the adviser will deliver documents (such as account statements) to the client electronically. Again, these changes will only apply to new contracts or contracts that are revised after the effective date of the rule.

**I am an adviser to a 3(c)(1) fund. Under WAC 460-24A-035, the individual investors in the fund are treated as clients for the purposes of registration under the Securities Act. What if a conflict arises between the fiduciary duty I owe to the individual investors in the fund and the fiduciary duty I owe to the private fund as a whole?**

A 3(c)(1) fund exists for the financial benefit of the investors who hold membership interests in the fund, rather than for the benefit of the investment adviser to the fund. Therefore, the interests of the individual investors in a 3(c)(1) fund should be aligned with the interests of the fund as a whole.

Under securities laws, the issuer of securities in a private fund must disclose all material information to investors, including the existence of conflicts of interest. These disclosures are typically made in advisory contracts, operating agreements, private placement memoranda, and Form ADV Part 2.

Conflicts of interest which arise from time to time between an adviser's personal interests and the fiduciary duty the adviser owes to investors. For instance, an adviser receiving a performance fee may be incentivized to pursue a high-risk investment strategy in order to maximize the potential performance fee, which may not always be in the best interests of the investors. Advisers manage the potential conflicts of interest such as these first by disclosing that there may be a conflict, and second by disclosing how the adviser will resolve the conflicts that do arise.

**I am an adviser to a private fund. How can I prevent the investors in my fund from disclosing my investing strategy to outside parties?**

Investors have the right to information about how their funds are being invested in the form of quarterly account statements. This is true whether their funds are held in an individual account or are invested in a hedge fund managed by the adviser. That is why advisers must provide investors with quarterly account statements under WAC 460-24A-105 and WAC 460-24A-107.

An adviser is not prohibited, however, from requiring investors to sign a non-disclosure agreement. In this type of agreement, an investor agrees not to disclose information about the adviser's investing strategy, as revealed to the investor in account statements or otherwise. A non-disclosure agreement may provide some protections for advisers concerned about the possible release of information to third parties. First, the agreement would serve to notify investors that the adviser intends such information to be non-public. Second, depending on the terms of the non-disclosure agreement, investors who violate the agreement could be subject to liability. Please note, however, that investors must be permitted to disclose their financial information to their tax professionals.

**The language of many of the rules in chapter 460-24A WAC has been altered to use a simpler "Plain English" style. Do I have to change my advisory agreement or other documents into "Plain English"?**

No. The Securities Division made many substantive changes to the investment adviser rules. However, some of the amendments were non-substantive changes designed to make the rules easier to read by using simpler language or formatting. There is no requirement that you revise your own documents to use simpler language.

**Who is considered an employee for the purposes of the new compliance policies and procedures rule at WAC 460-24A-120?**

The new rule at WAC 460-24A-120 requires investment advisers with more than one employee to adopt and implement written policies and procedures reasonably designed to prevent violation of the Securities Act of Washington by the adviser and its supervised persons. Compliance policies and procedures help protect against violations of the Securities Act by ensuring that all employees understand the firm's operating procedures and expectations.

For the purposes of the rule, an employee is anyone working for or associated with the investment adviser, either as a W-2 employee or an independent contractor. This includes both licensed and unlicensed individuals. Individuals working on behalf of an investment adviser, even if those individuals are unlicensed, may have access to personal client information and may be placed in positions in which they could commit fraud or otherwise violate the Securities Act. An inclusive definition of employee is therefore necessary to accomplish the purpose of the rule.

## **How do I comply with the new requirement that I conduct an annual review of compliance policies and procedures pursuant to WAC 460-24A-120?**

The new compliance policies and procedures rule at WAC 460-24A-120 is modeled after federal Rule 206(4)-7 and requires advisers with more than one employee to adopt compliance policies and procedures reasonably designed to prevent violation of the Securities Act of Washington by the adviser and its supervised persons. The rule also requires the adviser to review the adequacy of the compliance policies and procedures and the effectiveness of their implementation at least annually. It should be noted that under RCW 21.20.110(1)(j), either the failure to establish adequate procedures or the failure to follow existing procedures may be grounds for issuance of an enforcement action against an investment adviser or investment adviser representative for failure to supervise.

One purpose of the annual review of compliance policies is to ensure that policies are reasonably up to date, which provides protection for both the investment adviser and its clients. Policies may need to be updated to reflect any changes in the laws or rules that apply to the adviser's business. In addition, if an adviser's business has grown in size, or if the products or services offered by the adviser have changed, an update to compliance policies and procedures may be appropriate. For instance, an adviser that has recently begun to sell complex investment products such as variable annuities may want to update its compliance policies to ensure that its procedure for determining suitability is adequate for more complex products.

A second purpose of the annual review is for the adviser to review and evaluate whether existing compliance policies are actually being followed, and whether the policies are effective at preventing violations. In conducting the review, advisers should assess any recent compliance problems that have arisen for the firm and review whether the compliance policies and procedures could be improved to prevent problems in the future.

The review does not need to be conducted by outside professional services. The Securities Division anticipates that advisers will conduct the review themselves, as they have the most knowledge about how their businesses operate. An investment adviser may conduct the review on an as-needed basis when there are changes to the rules and laws affecting investment advisers, provided that the review occurs at least annually. Anyone conducting the review, however, must ensure that he or she is adequately informed about changes in the securities laws and rules affecting investment advisers.

**How can I demonstrate for the purposes of WAC 460-24A-150(6) that a client entering into an advisory contract with a performance fee understands the method of compensation and its risks?**

Amendments to the performance fee rule in WAC 460-24A-150(6) provide that an investment adviser or its investment adviser representative must reasonably believe that a client entering into an advisory contract that provides for performance fee compensation understands the method of compensation and its risks.

An adviser can demonstrate compliance with WAC 460-24A-150(6) by clearly disclosing the risks associated with a performance compensation arrangement in plain language in the advisory contract. An adviser may choose to structure his or her contract in such a manner to require a client to initial or otherwise acknowledge specific disclosures. This type of acknowledgment would tend to demonstrate that a client is aware of the method of compensation and the risks associated with it.

Additionally, an adviser can document the information he or she evaluated in determining that a client is a sophisticated investor for whom a performance compensation arrangement is suitable. This information might include an assessment of the client's educational background, financial knowledge, investment experience, and investment goals. An adviser might also document any discussions with the client regarding how the fee is calculated and why the adviser is being compensated by a performance fee. It should be noted that the fact that a client meets the definition of a "qualified client" does not in itself indicate that a performance compensation arrangement is suitable for the client.

**I am an adviser to a private fund. Can I charge a performance compensation fee for "stub periods" that occur when investors enter or withdraw from a private fund in the middle of the year?**

The compensation formula in WAC 460-24A-150(3)(c) specifies that performance compensation must be based on gains net of losses in the client's account for a period of not less than one year. This rule is intended to prevent an adviser from taking a performance fee based on short-term fluctuations in the market.

However, while the performance fee must be calculated based on a period of not less than one year, certain rolling period arrangements may be permissible. In addition, an adviser to a private fund may choose to limit when investors may invest in or withdraw from the fund, provided that this information is clearly disclosed to investors prior to their investment.