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Investment Adviser Guide

The following information is intended to be a brief overview concerning the investment adviser industry. Topics include definitions, characteristics of an investment adviser, regulators, application process, licensing periods, record keeping requirements, custody of client funds or securities, disclosure requirements, conflicts of interest, and regulator audits. This discussion does not purport to outline all aspects of the industry or all regulator requirements. You are urged to obtain and review the federal or state laws and rules that may apply to your activities.

- Investment Adviser & Investment Adviser Representative Registration
- Filings
- Licensing Period
- Recordkeeping
- Custody
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Investment Adviser and Investment Adviser Representative Registration

Investment advisers (“IA”) and investment adviser representatives (“IAR”) are persons who provide advice to others about investments for a fee and are required by most states to register or become licensed. Some states use the term “register” and others use the term “license.” For purposes of this Guide, the two have the same meaning.

Three essential elements that characterize an investment adviser are:

- Provides advice or analysis on securities either by making direct or indirect recommendations to clients or by providing research or opinions on securities or securities markets.
- Receives compensation in any form for the advice provided.
- Engages in a regular business of providing advice on securities.

Advisers must register or become licensed with either state or federal securities regulators, based on the following:

State Advisers:

- Have less than \$25,000,000 in assets under management.
- Provide only financial planning or other services that do not involve regular and ongoing management of clients' securities.
- Solicit clients on behalf of other advisers but provide no advice themselves.

Federal Covered Advisers:

- Have \$25,000,000 or more in client assets under regular and ongoing management.
- Are advisers to investment companies under the Investment Company Act of 1940.
- Are providing services in 30 or more states.
- Are eligible for an exemption by rules or orders under the Investment Advisers Act of 1940.
- Must make a notice filing with the state if they have a place of business in the state or have six or more clients in that state in a twelve-month period, regardless of place of business.

The IA firm holds the registration/license. The IAR is an individual who performs services on behalf of the registered/licensed IA. Some states include within the definition of an IAR a person (often called a solicitor) who regularly refers customers to an IA and who receives compensation for those referrals. Other states may have modified licensing requirements for solicitors.

Filings

An investment adviser and an investment adviser representative have a great deal of influence over the financial affairs of others – the clients. For that reason, state securities offices take an interest in how the investment adviser does its job. All states (except Wyoming), the District of Columbia and Puerto Rico each have a registration or licensing requirement for investment advisers. They may require:

- State advisers to register or become licensed.
- Federal covered advisers to make a notice filing of their Form ADV.
- A passing score on a competency examination for each individual acting as an investment adviser or investment adviser representative.
- Payment of a fee for processing the applications.
- Certain disclosures to the securities agency and/or the public.
- Registration of branch offices of the adviser.
- A bond or minimum net capital.

Application for registration/licensing is made by:

- Filing a complete Form ADV with the state in which one wants to offer services.
- Providing any state-specific forms required.

- Filing a Form U-4 application for each investment adviser representative who will provide services on behalf of the investment adviser.
- Remitting all required fees for the investment adviser and the investment adviser representative.

A notice filing for a federal covered adviser is usually made by:

- Filing a complete copy of its Form ADV as filed with the US SEC.
- Filing a Form U-4 application for each investment adviser representative who will provide services on behalf of the investment adviser.
- Payment of any required notice filing fees.

The SEC requires electronic filing via the Investment Adviser Registration Depository (IARD).

Licensing Period

Investment advisers and investment adviser representatives must renew their registration/license annually. In many states, the term is from January 1 to December 31 of a given year. However, some states have different renewal dates. Check with the state securities office in each state where you intend to do business. If an adviser becomes registered/licensed in the middle of a year, the fee is usually not prorated.

States send out a notice to renew a registration or license some time in advance of the end of the year. Check with each state for specific details. The renewal process for investment advisers will be handled via IARD.

Recordkeeping

An adviser is required generally to maintain and keep current the records listed below. Additional recordkeeping requirements may also be set by the home state of the adviser. It will be necessary to check with the home state regulator.

Records Required of All Advisers:

- Receipts and Disbursements Journals
- General Ledger
- Order Memoranda
- Bank Records
- Bills and Statements
- Financial Statements
- Written Communications and Agreements (including electronic transmissions)
- List of Discretionary Accounts
- Advertising
- Personal Transactions of Representatives and Principals
- Client Records:
 - Powers Granted by Clients
 - Disclosure Statements
 - Solicitors' Disclosure Statements
 - Performance Claims
 - Customer Information Forms and Suitability Information
 - Written Supervisory Procedures

Records Required of Advisers Who Have Custody of Client Assets:

- Journals of Securities Transactions and Movements
- Separate Client Ledgers
- Copies of Confirmations
- Record by Security Showing Each Client's Interest and Location Thereof

Records Required of Advisers That Manage Client Assets:

(These records are required to be maintained in an easily accessible place for a period of five years from the end of the fiscal year during which the last entry was made and, for the first two years, the records must be maintained in the adviser's principal office.)

- Client Purchases and Sales History
- Current Client Securities Position

Custody

If an adviser has direct or indirect access to client funds or securities, it is considered to have custody of client funds and is subject to additional scrutiny. State regulators will want to see how you handle those assets by asking the following:

- Has the adviser complied with the rules relating to safeguarding client assets in the adviser's custody?
- Does the Form ADV reflect that the adviser has custody?
- Are these assets maintained in segregated accounts?
- Does the adviser maintain the required records of client assets in its custody?
- Does the client get an itemized statement at least every three months showing the assets in the adviser's custody and the activity in the account?
- Has a surprise audit of client assets has been conducted at least annually by an independent accountant?
- If the adviser has discretionary authority over the client's account, is there any evidence of excessive trading, self-dealing, preferential treatment, unsuitable recommendations, unauthorized transactions or incomplete disclosure?

Disclosure

The most important duty of an investment adviser is the disclosure of all information relating to the relationship between an adviser and a client. Advisers have great leeway in tailoring their client services as long as clients know up-front about such things as:

- What kinds of services are available
- Who is providing those services
- What fees and other expenses will the client be subject to and are they negotiable
- Is the adviser being compensated from other sources
- Is the adviser affiliated with another adviser, a broker-dealer or an issuer of securities
- Can you implement a financial plan anywhere or do you only get to keep the plan if you implement it through the adviser
- What other potential conflicts of interest exist that might affect the adviser's recommendations

The key document in making these disclosures is Part 2 of Form ADV and/or the adviser's brochure. This document should clearly spell out the details of the advisory relationship and other business interests of the adviser. This is the reference tool with which the client or potential client can compare advisory firms for cost of services and for compatibility with their needs. That is why investment

advisory regulations require that Part 2 of Form ADV or the brochure be given to customers in advance or no later than the time of entering into a contract if rescission is permitted within a specifically allotted time.

Examiners will look for disclosure-related items not only in the disclosure document but in any material describing any facet of the adviser's business that a client or potential client might see. This can include:

- Advertising
- Seminar materials
- Web sites
- Print, radio and TV ads
- Bulk mailings
- Contracts
- Fee schedules
- Portfolio reviews

Fiduciary Duty

The anti-fraud provisions of the Investment Advisers Act of 1940 and most state laws impose a duty on investment advisers to act as fiduciaries in dealings with their clients. This means the adviser must hold the client's interest above its own in all matters. Conflicts of interest should be avoided at all costs. However, there are some conflicts that will inevitably occur, such as a person being licensed as a securities agent as well as an adviser. In these instances, the adviser must take great pains to clearly and accurately describe those conflicts and how the adviser will maintain impartiality in its recommendations to clients. The SEC has said that an adviser has a duty to:

- Make reasonable investment recommendations independent of outside influences
- Select broker-dealers based on their ability to provide the best execution of trades for accounts where the adviser has authority to select the broker-dealer.
- Make recommendations based on a reasonable inquiry into a client's investment objectives, financial situation and other factors
- Always place client interests ahead of its own.

When examiners review advisory books and records, they will be on the lookout for undisclosed or misrepresented conflicts of interest and prohibited practices. Some are obvious and some not so obvious. Some examples of practices that advisers should avoid are:

- Acting as an issuer or affiliate of an issuer of securities
- Recommending unregistered, non-exempt securities or the use of unlicensed broker-dealers
- Any activity that acts as a fraud or deceit on clients
- Charging unreasonable fees
- Failing to disclose to all customers the availability of fee discounts
- Using contracts which seek to limit or avoid an adviser's liability under the law (hedge clauses)
- Limiting a client's options with regard to the pursuit of a civil case or arbitration
- Borrowing money from or lending money to clients
- Other situations which require disclosure of the conflict include, but are not limited to:
 - The adviser or its employees are also acting as a broker-dealer and/or securities agent
 - The adviser is receiving transaction-based compensation, including 12b-1 or other marketing fees, related to securities recommended to its clients
 - The adviser receives any type of compensation from any source for soliciting or referring clients to another adviser or a broker-dealer.
 - Hidden fees in the form of undisclosed service charges, wrap fees or expenses reimbursed

by other parties.

The examiner will view perceived conflicts from the point of view of the customer; was the disclosure or lack of disclosure a factor in the client's decision to use an adviser's services or ratify an adviser's recommendations? Was the customer misled? Was the customer placed at a disadvantage or taken unfair advantage of as a result of the conflict and the adviser's compliance with disclosure requirements? The burden of proof lies with the adviser.

Audits

IA firms are subject to periodic, sometimes unannounced, audits by regulators. The purpose of an audit is to determine compliance with the regulator's licensing, books and records, and anti-fraud requirements.

A survey of state regulators has revealed the top five problems noted in audits:

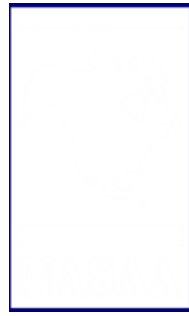
1. ADV disclosures
2. Custody
3. Poorly maintained books and records
4. Advertising
5. Poorly maintained financial records

Conclusion

As you can see from these materials, being involved in the investment adviser industry requires attention to detail and knowledge of your regulator's laws and rules. Consult with the securities regulator in your state, or with the SEC if appropriate, to determine the exact requirements for you or your firm.

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