

DEPARTMENT OF BUSINESS OVERSIGHT

Ensuring a Fair and Secure Financial Services Marketplace for all Californians

**CALIFORNIA
REGISTERED INVESTMENT ADVISER**



***Registration and
Examination
Compliance FAQs***

The statements in this publication are intended to address general questions and are not intended to exhaustively cover all aspects of the statutes and regulations or in the manner in which it may apply in certain circumstances. This guide is presented for general informational purposes only and should not be construed as the complete statutes and regulations, or the interpretation thereof.

Topic:	Refer to Question #
<u>Investment Adviser's Responsibilities</u>	1
<u>Materiality</u>	2
<u>Assets Under Management</u>	3
<u>Conversion from CA-Registered Investment Adviser to SEC-Registered Investment Adviser</u>	4
<u>Investment Adviser Representative</u>	5-6
<u>Owners & Officers as Investment Adviser Representative</u>	7
<u>Solicitor's Registration & Qualification Requirements</u>	8-9
<u>Certified Public Accountant as Solicitor</u>	10
<u>Investment Adviser Representative: Qualification, Registration, & Filing Requirements</u>	11-15
<u>Advisory Contract</u>	16
<u>Financial Planning Disclosures</u>	17
<u>Form ADV</u>	18-20
<u>Business Succession</u>	21-22
<u>Financial Requirements & Reporting</u>	23-28
<u>Discretionary Authority</u>	29
<u>Custody</u>	30
<u>Custody Requirements</u>	31
<u>Direct Fee Deduction: Custody, Safeguarding Procedures, Form ADV Disclosures</u>	32
<u>Pooled Investment Vehicles: Custody, Safeguarding Procedures, Form ADV Disclosures</u>	33
<u>Securities/Checks Received Inadvertently: Custody Issues and Record Keeping</u>	34
<u>Independent Party</u>	35

1. What responsibilities do I have to clients as an investment adviser?

As a registered investment adviser (IA or RIA), you are a “fiduciary” to your advisory clients.¹ This means that you have an ongoing obligation to act in the best interests of your clients and to provide investment advice that is consistent with that obligation. Among other things, common law fiduciary duties require that you act with undivided loyalty and utmost good faith towards your clients.² Failing to meet the fiduciary standard may constitute fraud.

In addition to an investment adviser’s common law fiduciary duties, the Corporations Code³ and accompanying regulations⁴ require investment advisers to act in a manner that promotes fair, equitable and ethical principles. As described in the California Code of Regulations, an investment adviser may not:⁵

- a) Make unsuitable investment recommendations;
- b) Place an order on behalf of a client without authority to do so;
- c) Exercise any discretionary power without a written delegation of authority, subject to limited exceptions;
- d) Make an excessive trade on behalf of a client;
- e) Borrow money or securities from a client, subject to limited exceptions;
- f) Loan money to a client, subject to limited exceptions;
- g) Misrepresent the qualifications of an adviser or advisory services to a client or prospective client;
- h) Provide a report or recommendation to an advisory client that was not prepared by the investment adviser, unless this is disclosed to the client;
- i) Charge an advisory fee that is unreasonable;
- j) Fail to provide written disclosures regarding the adviser’s conflicts of interest, including compensation arrangements connected with advisory services or charging a client an advisory fee without disclosing commissions;

¹ A fiduciary relationship forms between an investment adviser and client as a matter of law. *See Hasso v. Hapke* (2014) 227 Cal. App. 4th 107, 140; *see also S.E.C. v. Capital Gains Bureau* (1963) 375 U.S. 180, 191.

² *See* Tamar Frankel, *Investment Management Regulation*, Fourth. Ed., at 61-66 (describing fiduciary duties under state and federal law).

³ Corp. Code sec. 25238.

⁴ Cal. Code Regs., tit. 10, § 260.238.

⁵ *See* Cal. Code Regs., tit. 10, § 260.238, subd. (a)-(o).

- k) Guarantee a specific result from investment advice;
- l) Disclose the identity or investments of a client, without client consent or a legal requirement to make such a disclosure;
- m) Enter a written advisory contract, other than for impersonal advisory services, unless the contract includes information and disclosures as specified;
- n) Make any untrue statement of material fact or making a material omission in connection with soliciting an advisory client.

2. When is Information “Material?”

To the extent that investment advisers are required to disclose certain information to clients, such disclosures are usually limited to information that is “material.” Generally, facts are “material” if a reasonable investor would consider them to be important in evaluating whether to hire the adviser or follow the adviser’s recommendations. You must either eliminate or disclose all conflicts of interest that might incentivize you to render advice that is not objective. You must make full and accurate disclosure of all potential conflicts.

3. How are “Assets Under Management” calculated?

Assets Under Management, or “AUM”, is a regulatory calculation of the assets an investment adviser manages. Only securities portfolios for which an investment adviser provides continuous and regular supervisory or management services counts towards AUM.⁶ You provide continuous and regular supervisory or management services with respect to an account if:

You have discretionary authority over and provide ongoing supervisory or management services with respect to the account; or

You do not have discretionary authority over the account, but you have an ongoing responsibility to select or make recommendations, based upon the needs of the client, as to specific securities or other investments, the account may purchase or sell, and if such recommendations are accepted by the client, you are responsible for arranging or effecting the purchase or sale.

Factors: You should consider the following factors in evaluating whether you provide continuous and regular supervisory or management services to an account:

- (1) **Terms of the advisory contract.** If you agree in an advisory contract to provide ongoing management services, this suggests that you provide these services for the account. Other provisions in the contract, or your actual management practices, however, may suggest otherwise.
- (2) **Form of compensation.** If you are compensated based on the value of the client’s assets you manage over a specified period that suggests you provide continuous and regular supervisory or management services for the account.

⁶ For detailed information about calculating AUM, see FORM ADV Instructions OMB Number 3235-0049.

If you receive compensation in a manner similar to either of the following, that suggests you do not provide continuous and regular supervisory or management services for the account:

- (a) You are compensated based upon the time spent with a client during a client visit; or
 - (b) You are paid a retainer based on a percentage of assets for strictly providing financial planning services.
- (3) **Management practices.** Management practices can help determine whether an investment adviser provides continuous and regular supervisory or management services. For example, the fact that you make infrequent trades (e.g., based on a “buy and hold” strategy) does not mean your services are not “continuous and regular.”

Calculating AUM: In determining the amount of your assets under management, include the securities portfolios for which you provide continuous and regular supervisory or management services as of the date of your most recent Form ADV filing.

Include the entire value of each securities portfolio for which you provide continuous and regular supervisory or management services. If you provide continuous and regular supervisory or management services for only a portion of a securities portfolio, include as regulatory assets under management only that portion of the securities portfolio for which you provide such services. Exclude, for example, the portion of an account:

- Under management by another *person*; or
- That consists of real estate or businesses whose operations you “manage” on behalf of a *client* but not as an investment.

Significance of AUM

The amount of assets under management is significant for several reasons. In terms of licensing, AUM is important because it establishes whether an investment adviser must register with the Securities and Exchanges Commission (SEC) or with one or more state regulators. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) delineates whether an investment adviser should register with the SEC or the states.

- (1) Investment advisers with up to \$100 million in AUM are subject to state registration.
- (2) Investment advisers with between \$100 million and \$110 million in AUM can elect to register with either the SEC or the states in most cases.
- (3) Investment advisers with over \$110 million in AUM must register with the SEC.

4. How does a firm transition from being a state-registered to an SEC-registered investment adviser or vice versa?

To transition from a state-registered adviser to an SEC-registered adviser on the IARD system, mark the filing type "Apply for registration as an investment adviser with the SEC." After the SEC approves your registration you should file a "Partial ADV-W" to withdraw your state registration(s). Do *not* file your Partial ADV-W until your application for SEC registration is approved or you will be unregistered and may be unable to conduct advisory business during this period.

To transition from an SEC-registered adviser to a state-registered adviser, mark the filing type "Apply for registration as an investment adviser with one or more states." After your state registration has been approved, you should file a "**Partial ADV-W**" to withdraw your SEC registration. Do *not* file your Partial ADV-W until your state registration application(s) is approved by the Department or you will be unregistered and prohibited from providing advisory services during this period. For more information regarding transitioning from SEC to state registration, please consult the Department's website.⁷

Should you have any questions on form filings, you may contact FINRA Helpdesk at (240) 386-4848 for further assistance.

5. What is an "investment adviser representative"?

An investment adviser representative (IAR), sometimes referred to as a registered adviser (RA), or associated person, is defined in Corporations Code section 25009.5, subdivision (a), as any partner, officer, director or other individual, except clerical or ministerial personnel, who is employed by or associated with, or subject to the supervision and control of, an investment adviser that is required to obtain a certificate under this law, and who does any of the following:

- (1) Makes recommendations or renders advice regarding securities,
- (2) Manages client accounts or portfolios,
- (3) Determines which recommendations or advice regarding to give regarding securities,
- (4) Solicits, offers, or negotiates for the sale or sells investment advisory services, or
- (5) Supervises employees who perform any of these activities.

Important: Each officer, director or partner exercising executive responsibility (or persons occupying a similar status or performing similar functions), or each person who owns 25% or more of the firm is deemed to be acting as an IAR or associated person.

6. I have an investment adviser representative who performs advisory services on behalf of my firm and is under my supervision. Does the

⁷ Department of Corporations, *For SEC Licensed Firms Transitioning to California Registration*, Oct. 11, 2011, available at http://www.dbo.ca.gov/Licensees/Broker-Dealer_and_SEC_Investment_Advisers/Dodd-Frank/pdf/SEC_Transition_Instructions.pdf.

investment adviser representative need to be registered with the Department?

Investment adviser representatives located in California or who have clients who are residents of California must be registered with the Department. This presumption applies to IARs of both California-registered and SEC-registered investment advisers.

7. Are owners and executive officers considered IARs? If so, how should I report these persons?

All direct owners and executive officers should be reported on Schedule A of Form ADV and indirect owners should be reported on Schedule B of Form ADV.

Since officers, directors or partners who exercise executive responsibilities (or persons who occupy similar status or perform similar functions), or persons who own 25 percent or more of the firm are presumed to be IARs, Form U4 and the \$25 reporting fee should be filed for each individual through FINRA's Central Registration Depository (CRD). In addition, any individuals subject to this paragraph must meet the qualification requirements pursuant to California Code of Regulations, title 10, section 260.236.

Note: Under certain circumstances, the Department will require submission of a paper version of Form U4 if reasonably determined that an individual owner and/or an executive officer does not meet the definition of an investment adviser representative as stated in Corporations Code section 25009.5. On the paper Form U4, you only need to complete Item 1 and Items 9 through 15B. If the individual's Form U4 is on file with CRD and the information reported on Form U4 is current, you may provide a confirmation on your cover letter accompanying any documents filed directly with the Commissioner. It may not be necessary to file a paper version of Form U4 directly with the Commissioner.

8. I solicit clients for a registered investment adviser and receive referral fees. Do I have a registration obligation?

Yes. Any California RIA that engages and pays compensation to a solicitor for client referrals is responsible for reporting such solicitor by the filing of Form U4 on Web CRD.

Note: The RIA must contact the Department to request restricted approval for solicitors. However, if the solicitor is an entity other than an individual, the solicitor should seek registration as an investment adviser prior to accepting any compensation from client referrals.

9. I solely refer clients to registered investment advisers. Am I subject to qualification requirements of an IAR?

Any investment adviser representative employed by or engaged by an investment adviser only to offer or negotiate for the sale of investment advisory services of the investment adviser may be exempt from the qualification requirements of section 260.236 of title 10 of the California Code of Regulations.

However, solicitors seeking registration of their own investment advisory firm must meet

the qualification requirements if that firm has no other qualified IARs.

10. I am a Certified Public Accountant (CPA) and refer my clients to third-party investment advisers for referral fees. What qualifications and requirements must I follow?

CPAs who act as solicitors for a California RIA are subject to the requirements as stated in Question 11. However, CPA should also refer to section 5061 of the California Business and Professions Code and section 56 of article 9 of the California Board of Accountancy for additional compliance requirements.

11. What are the qualification requirements for investment adviser representatives (Cal. Code Regs., tit. 10, § 260.236)?

Each IAR, except those employed or engaged by an investment adviser solely to offer or negotiate for the sale of investment advisory services (solicitors), must qualify by passing the examination(s) as specified in California Code of Regulations, title 10 section 260.236, subdivision (a). The examination requirements are the Uniform Investment Adviser Law Examination (2000 Series 65) passed on or after January 1, 2000; *or* the General Securities Representative Examination (Series 7) and Uniform Combined State Law Examination (2000 Series 66). Waivers and exemptions to the examination requirements may be found in California Code of Regulations, section 260.236, subdivision (b) and (c), respectively.

When a Form U4 is filed via Web CRD, the system recognizes that an individual is qualified for the RA registration category if the individual meets one of the following criteria:

- Have a passing grade for the S65 within the past two years; *or*
- Have a passing grade for the S66 within the past two years and a passing grade for the S7TO and SIE within the CRD continuous registration period or two years prior to the beginning of the continuous registration period; *or*
- Have a passing grade for the S66 within the past two years and a GS/TR/TS within the CRD continuous registration period; *or*
- Currently hold one of the system-recognized professional designations; *or*
- Have held an approved RA registration with any jurisdiction within the past two years.

If the individual does not meet one of the above criteria, the system will automatically open a Series 65 window for 120 days.

12. How does an investment adviser firm report its representatives and what are the firm's responsibilities and duties (California Code of Regulations Cal. Code Regs., tit. 10, § 260.236.1)?

Firms register and report individuals by completing Form U4 through FINRA's Web CRD.

Upon employment of an individual as an investment adviser representative (IAR), the investment adviser must:

(A) Obtain a properly executed application for registration, Form U4,

(B) Obtain for its records evidence that such investment adviser representative meets the qualification requirements of California Code of Regulations, title 10, section 260.236 of these rules, and

(C) Ascertain by reasonable investigation the good character, business reputation, qualifications, and experience of an individual upon engagement as an investment adviser representative. Where an individual has previously been reported to the CRD, the investment adviser shall obtain and review a copy of Form U5 filed with CRD by such individual's most recent previous employer, together with any amendments thereto.

In addition, the investment adviser must conduct the investigation required by this section no later than 30 days following the filing of Form U4 with CRD or demonstrate that it has made a reasonable effort to comply with this section.

13. What are the reporting requirements for investment adviser representatives (Cal. Code Regs., tit. 10, § 260.236.1)?

- (1) Employment - Upon employment of an IAR, the investment adviser must file with CRD a Form U4, including any Disclosure Reporting Page(s), and pay registration fees accordingly. An IAR's "registration" is not deemed approved until formally approved by the Commissioner and notification of the approval has been received through CRD.
- (2) Changes - Within 30 days of any changes to Form U4, an amendment to Form U4 must be filed.
- (3) Termination - Within 30 days after the termination of an IAR, Form U5 must be filed with CRD in accordance with the form instructions and clearly state the reason(s) for termination.

14. What are the fees associated with registering an investment adviser representative?

To electronically file a Form U4 via Web CRD for a new IAR, FINRA charges \$10 system processing fee upon initial registration, and annually thereafter. In addition, the Department charges a registration fee of \$25 for each IAR per calendar year. This fee is paid to the Department via Web CRD upon initial registration and annually thereafter.

Note: State registration fees are set by statute and independent of any other applicable system fees charged or assessed by FINRA.

15. I am an Investment Adviser formed as a sole proprietorship. Do I need to file a Form U4 for myself?

Yes. Effective September 1, 2016, sole proprietors, who are deemed to be investment adviser representatives, are required to file Form U-4 with the CRD. Please note that if you are filing a Form U-4 for a sole proprietor, the \$25 registration fee and \$25 annual

renewal fees are waived.

16. Must I have a written contract with my clients? If yes, what information should my advisory contracts contain?

Pursuant to Corporations Code section 25234 and California Code of Regulations, title 10, section 260.238, subdivision (n), investment advisers must enter written advisory contracts with clients that include the following disclosures:

- (1) The services to be provided;
- (2) The term of the contract;
- (3) The advisory fee and the formula for computing the fee;
- (4) Whether the contract grants discretionary trading authority or is limited to non-discretionary authority only;
- (5) The contract will not be assigned without the consent of the client;
- (6) Any and all conflicts or potential conflicts of interest;
- (7) That nothing in the contract limits the client's legal rights under applicable state and federal securities laws or any other laws whose applicability is not permitted to be contractually waived; and
- (8) That Form ADV Part 2 will be provided before or at the time of contract signing and be offered annually thereafter.

Please refer to California Code of Regulations, title 10, section 260.238 and Corporations Code section 25234 for more information.

17. I provide financial planning services to my clients. What disclosure information must I provide in my advisory contracts for my clients?

In addition to the disclosures addressed in Question 16, Financial Planners should provide proper disclosures relating to any potential conflicts of interest that may result from compensation arrangements and other financial industry activities or affiliations.

Specifically, financial planning contracts should include the following additional disclosures:

- (1) Whether a conflict exists between the interests of the investment adviser or associated person and the interests of the client, and
- (2) That the client is under no obligation to act on the investment adviser's or associated person's recommendation. Moreover, if the client elects to act on any of the recommendations, the client is under no obligation to effect the transaction through the investment adviser or the associated person when such person is employed as an agent with a licensed broker-dealer or is licensed as a broker-dealer or through any associate or affiliate of such person.

Please refer to California Code of Regulations, title 10, section 260.235.2 for more information.

18. When am I required to update my Form ADV?

Form ADV should always contain current and accurate information. Please note that certain parts of Form ADV Part 1 and 2 contain similar questions and must be answered consistently; therefore, both parts must be updated concurrently. In addition to your annual updating amendment, you must amend your Form ADV by filing additional amendments, referred to as “**other-than-annual amendments**” during the year. If there are material changes to the Form ADV, an “other-than-annual amendment” must be filed within 30 days of the change.

Please see the table at the end of this FAQ document for help identifying those Form ADV items requiring prompt amendments. Advisers should also make sure that Part 1 and 2 are answered consistently in those areas where they overlap. All amendments to Part 1 and 2 of Form ADV should be electronically filed through the IARD system.

REMEMBER: You must also amend your Form ADV annually by filing an “**annual updating amendment**” within 90 days of the end of your fiscal year, even if there are no items in need of correction. This annual updating amendment filing requirement is meant to ensure the adviser reviews its Form ADV Part 1 and 2 at least once a year.

19. Can Part 2 of Form ADV be filed electronically through the IARD system?

Yes, Form ADV Part 2 **must** be filed through the IARD system. However, unlike Form ADV Part 1, Part 2 must be completed offline and uploaded to the IARD system. The form must be submitted in a text searchable pdf format in order to be accepted by the IARD system.

IARD system instructions for filing Part 2 of Form ADV can be found on the IARD web site at <http://www.iard.com/part2instructions.asp>.

Editable versions of Form ADV Part 2 can be obtained from the following website:

<http://www.nasaa.org/industry-resources/uniform-forms/form-adv/>

20. Do I need to file an annual updating amendment for Part 1 and 2 of Form ADV when there are no changes with the information provided?

Yes, an annual updating amendment of Form ADV Part 1 and 2 through the IARD system is required. When filing an annual amendment, the IARD system allows advisers to utilize the “Confirm” brochure option to confirm that the brochure on file is still current without having to upload a new version of the pdf file if there are no material changes to information provided in such brochure.

Note: Firms should only have one active firm brochure and brochure supplement for each of its representatives at any given time. Therefore, please ensure that older brochures are retired accordingly.

21. Should I file a new application with the Department if I change my sole proprietorship to a corporation?

No. A change in a RIA's form of organization or legal name that is verifiable with California Secretary of State will not trigger a practical change if there are no changes in control or management. Therefore, an amendment to the Form ADV is sufficient. The RIA will retain the same CRD number as prior to the change.

Successors should check "Yes" to Part 1A, Item 4A, enter the date of succession in Part 1A, Item 4B, and complete Schedule D (Section 4) accordingly.

22. Should I file a new application if I am an unregistered person acquiring an existing registered investment adviser?

Yes. A successor must file a new investment adviser application when the succession involves a practical change in control or management. The following types of successions require the filing of a new application:

- (1) Acquisitions: An unregistered person acquires a preexisting investment adviser business.
- (2) Consolidation: Two or more RIAs consolidate and conduct their new business through a new unregistered legal entity.
- (3) Division of Dual Registrants: An entity registered as both an IA and BD that decides to separate one of its functions to an unregistered entity.

A new investment adviser application under a new CRD number must be filed for these successions. Please refer to our [How to Register as a California Registered Investment Adviser](#) instructions for more information on how to complete the new filing. Once approved, the predecessor files a Form ADV-W to withdraw its license from the Department.

23. What are my minimum financial requirements (Cal. Code Regs., tit. 10, § 260.237.2)?

Minimum financial requirements vary based on the nature of services an investment adviser provides. Investment advisers who:

- (1) Have custody of client funds or securities must maintain at all times a minimum net worth of \$35,000;
- (2) Have discretionary authority over client funds or securities but do not have custody of client funds or securities must maintain at all times a minimum net worth of \$10,000; and,
- (3) Accept prepayment of fees more than \$500 per client and six or more months in advance must maintain at all times a positive net worth.

24. If I am an investment adviser and a broker-dealer, do I need to meet the minimum net worth requirements for investment advisers?

No. The aforementioned minimum financial requirements do not apply if the investment adviser is also licensed as a broker-dealer under Corporations Code section 25210. Similarly, RIAs registered with the SEC and RIAs who maintain a principal place of business outside of California and complies with the home state's minimum financial requirements are not subject to California Code of Regulations, title 10, section 260.237.2.

25. How is financial net worth determined?

"Net worth" must be calculated as the excess of assets over liabilities, as determined by Generally Accepted Accounting Principles (GAAP). The following items should not be included in the calculation of assets pursuant to California Code of Regulations, title 10, section 260.237.2, subdivision (d): prepaid expenses (except as to items properly classified as current assets under generally accepted accounting principles), deferred charges, goodwill, franchise rights, organizational expenses, patents, copyrights, marketing rights, unamortized debt discount and expense, and all other assets of intangible nature; home, home furnishings, automobiles, and any other personal items not readily marketable in the case of an individual; advances or loans to stockholders and officers in the case of a corporation, and advances or loans to partners in the case of a partnership.

The Department has created a [Minimum Financial Requirement Worksheet](#) which advisers may utilize when computing their net worth.

Common accounting record deficiencies found during our examinations include:

- Failure to depreciate fixed assets,
- Failure to maintain the financial records on an accrual basis,
- Failure to use an unearned fee or similar liability account for apportioning quarterly fees billed in advance over each month of the quarter being billed,
- Failure to reconcile all cash accounts (bank, brokerage, etc.) to the corresponding balance sheet account balances.

26. What happens if I do not meet the net worth requirement?

Advisers must notify the Department of a net worth deficiency by the close of the next business day following the discovery that the net worth is less than the minimum required. After transmitting such notice, advisers must file by the close of the next business day a report of its financial condition, including the following:

- (1) A trial balance of all ledger accounts;
- (2) A statement of all client funds or securities which are not segregated;
- (3) A computation of the aggregate amount of client ledger debit balance; and
- (4) A statement as to the number of client accounts.

In addition, **interim financial reports** must be filed within 15 days after each subsequent monthly accounting period until three successive monthly reports have been filed that show a net worth of more than 120 percent of the firm's required minimum net worth. The submitted interim financial reports must contain:

- (1) A year-to-date balance sheet and income statement prepared in accordance with generally accepted accounting principles;
- (2) A [Minimum Financial Requirement Worksheet](#);
- (3) A [Verification Form](#), that is signed under penalty of perjury and must affirmatively state that, to the best knowledge and belief of the person making the verification, the financial statements and supporting schedules are true and correct.

27. When computing my financial net worth on the Minimum Financial Requirement Worksheet provided by the Department, I notice that there is a 120-percent test (Cal. Code Regs., tit. 10, § 260.241.2). What if I do not meet the net worth at 120 percent?

Advisers who are subject to the minimum financial requirement must file **interim financial reports** to the Department within 15 days after its net worth is reduced to less than 120 percent of its net worth requirement. The first interim report must be filed within 15 days after its net worth is reduced to less than 120 percent of its required minimum net worth and must be as of a date within the 15-day period. Additional reports should be filed within 15 days after each subsequent monthly accounting period until three successive monthly reports have been filed that show a net worth of more than 120% of the firm's required minimum net worth. The submitted interim financial reports should contain:

- (1) A year-to-date balance sheet and income statement prepared in accordance with generally accepted accounting principles;
- (2) A [Minimum Financial Requirement Worksheet](#);
- (3) A [Verification Form](#), that is signed under penalty of perjury and must affirmatively state that to the best knowledge and belief of the person making the verification, the financial statements and supporting schedules are true and correct.

28. Do I need to file financial reports with the Department (Cal. Code Regs., tit. 10, § 260.241.2)?

Advisers who are subject to the minimum financial requirements pursuant to California Code of Regulations, title 10, section 260.237.2, must file annual financial reports with the Department within 90 days of the firm's fiscal year-end. The submitted annual financial reports must contain:

- (1) A year-to-date balance sheet and income statement representing the firm's fiscal year, prepared in accordance with generally accepted accounting principles;
- (2) A [Minimum Financial Requirement Worksheet](#);
- (3) A [Verification Form](#), signed under penalty of perjury, which affirmatively states

that, to the best knowledge and belief of the person making the verification, the financial statements and supporting schedules are true and correct.

Important: Advisers who have custody of client funds or securities must file audited financial statements prepared by an independent certified public accountant along with the supporting schedule of the net worth computation and the verification form.

Please refer to Question 31 for other requirements pertaining to investment advisers with custody of client funds or securities.

29. I obtain the client's permission before executing trades, but the brokerage firm will accept my instructions when trading on client accounts. Would I be considered to have discretionary authority?

Investment advisers will not be deemed to have discretionary trading authority over client accounts when placing trade orders with a broker-dealer pursuant to a third-party trading agreement if all the following are met:

- (1) The investment adviser has executed a separate investment adviser contract exclusively with its client which acknowledges that the investment adviser must secure client permission prior to effecting securities transactions for the client in the client's brokerage account(s), and
- (2) The investment adviser in fact does not exercise discretion with respect to the account as evidenced by the adviser maintaining copies of client permissions secured prior to the corresponding trade, and
- (3) A third-party trading agreement is executed between the client and a broker-dealer which specifically limits the investment adviser's authority in the client's broker-dealer account to the placement of trade orders and deduction of investment adviser fees.

30. How is custody of client funds or securities determined?

A person will be deemed to have custody if said person:

- (1) Directly or indirectly holds client funds or securities, or
- (2) Has any authority to obtain possession of them, or
- (3) Has the ability to appropriate them in connection with advisory services the investment adviser provides to clients.

31. What are the requirements for advisers who have custody of client funds and/or securities (Cal. Code Regs., tit. 10, § 260.237)?

Advisers with custody of client funds and securities are subject to the following custodial requirements:

- (1) Notice to the Commissioner that IA has custody via Form ADV.

- (2) Qualified custodian must maintain the funds and securities.
- (3) Notice to clients when an account is opened on clients' behalf.
- (4) Qualified custodian sends account statements at least quarterly to clients.
- (5) Independent verification (a.k.a. surprise examination) of the funds and securities of which the IA has custody.
- (6) \$35,000 (or \$42,000 at 120-percent test) minimum net worth requirement of section 260.237.2, subdivision (a), of title 10 of the California Code of Regulations.
- (7) Audited financial statements requirement of section 260.241.2, subdivision (a)(3), of title 10 of the California Code of Regulations.

Please refer to California Code of Regulations, title 10, section 260.237 for more information.

32. I deduct advisory fees directly from the clients' custodial accounts. Do I have custody of client funds and securities? If yes, are there any safeguarding procedures I may follow to avoid the custodial requirements?

Yes. If an RIA is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the adviser's instruction to the custodian, the RIA is deemed to have custody of client funds and securities.

Safeguarding Procedures: The Department allows advisers who have this type of fee deduction arrangement to be exempt from: (1) \$35,000 minimum net worth requirement, (2) audited financial statement requirement, and (3) the surprise verification requirements, if the following safeguard procedures are administered pursuant to California Code of Regulations, title 10, section 260.237, subdivision (b)(3):

- (A) The investment adviser has custody of the funds and securities solely as a consequence of its authority to make withdrawals from client accounts to pay its advisory fee.
- (B) The investment adviser has written authorization from the client to deduct advisory fees from the account held with the qualified custodian.
- (C) Each time a fee is directly deducted from a client account, the investment adviser concurrently:
 1. Sends the qualified custodian an invoice or statement of the amount of the fee to be deducted from the client's account; and
 2. Sends the client an invoice or statement itemizing the fee, including the formula used to calculate the fee, the value of the assets under management on which the fee is based, and the time period covered by the fee.

(D) The investment adviser notifies the Commissioner in writing that the investment adviser intends to use the safeguards provided in this paragraph (b)(3). Such notification is required to be given on Form ADV.

Form ADV Disclosure: Advisers who follow the abovementioned safeguarding procedures for direct fee deduction should respond accordingly on the following sections of their Form ADV: Part 1B (Item 2.I.(1)(a)(b) and(c)) and Part 2A (Item 15).

Note that if you have custody solely because you deduct your advisory fees directly from your clients' accounts, answer "No" to Part 1A (Item 9.A.(1)(a) and (b)) *and* do not include the amount of those assets and the number of those clients in your response to Part 1A (Item 9.A.(2)) of Form ADV.

Important: This exemption applies to the deduction of fees only. Advisers may have additional net worth requirements pursuant to California Code of Regulations, title 10, section 260.237.2, subdivision (a).

33. I manage a limited partnership (LP) and serve as the general partner (GP) of the LP. Am I considered to have custody? If yes, what are the requirements I must follow to comply with Cal. Code Regs, tit. 10, § 260.237?

Yes. When an investment adviser serves as a general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle that gives the adviser legal ownership of or access to client funds or securities, that adviser is deemed to have custody of those client funds and securities. An investment adviser acting in this capacity will be eligible for a waiver of the heightened custody requirements of California Code of Regulations, title 10, sections 260.241.2 and 260.237.2 if the adviser adheres to the safeguarding procedures of either Track 1 or 2, pursuant to section 260.237 as follows:

Track 1, Surprise Verification/Independent Party Safeguarding Procedures:

1. The adviser notifies Commissioner on Form ADV that adviser has custody;
2. The client funds and securities are maintained by a qualified custodian in a separate account in the name of the pooled investment vehicle;
3. The adviser promptly notifies the client in writing of the qualified custodian's name and address, and the manner in which the funds or securities are maintained, upon the opening of the account and following any changes to this information;
4. The qualified custodian sends an account statement, at least quarterly, to each client for which it maintains funds or securities, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period including investment advisory fees;
5. The adviser sends to all investors in the pooled investment vehicle on at least a quarterly basis, a statement that shows the following:

- A. Total amount of all additions to and withdrawals from the fund as a whole including the opening and closing value for the quarter based on the custodian's records.
 - B. Listing of all securities positions on the closing date of the statement required to be disclosed under GAAP.
 - C. Total additions to and withdrawals from the fund by the investor as well as the total value of the investor's interest in the fund at the end of quarter.
6. Enters into a written agreement with an independent party who is obligated to:
- A. Act in the best interest of the investors. The independent party will review the fees, expenses and capital withdrawals from the pooled account(s).
 - B. Send all invoices or receipts to the independent third party, detailing the amount of the fee, expense or capital withdrawal and the method of calculation such that the independent party can determine the payment is in accordance with the pooled investment vehicle standards (generally the partnership or membership agreement); and, forward to the qualified custodian approval for payment of the invoice, with a copy to the investment adviser.
7. Independent verification: The client funds and securities of which the adviser has custody are verified by actual examination at least once during each calendar year by an independent certified public accountant (CPA), at a time chosen by the CPA without prior notice or announcement to the adviser and that is irregular from year to year. The written agreement with the CPA must include the following:
- A. The first examination must occur within six months of becoming subject to this rule.
 - B. The certificate on Form ADV-E must be filed within 120 days of the date of the surprise exam chosen by the CPA.
 - C. If the CPA finds any material discrepancies, the CPA must notify the Commissioner within one business day of such findings.
 - D. If the CPA is terminated, the Commissioner must be notified via Form ADV-E within four business days and provide reasons for termination.

Track 2, Alternative Safeguarding Procedures Pursuant to California Code of Regulations, title 10, section 260.237, subdivision (b)(4): An investment adviser is not required to comply with items 3, 4, and 6 of Track 1 and shall be deemed to have complied with item 7 of Track 1 with respect to the account of a pooled investment vehicle if each of the following conditions are met:

- A. Account statements are provided as addressed in item 5 above;
- B. The fund is audited annually with the financial statements prepared in accordance with GAAP and distributed to all beneficial owners (investors) of the fund and the Commissioner within 120 days of the fund's fiscal year end;

C. The audit is performed by an independent certified public accountant that is registered with, and subject to regular inspection by the Public Company Accounting Oversight Board in accordance with its rules;

D. Upon liquidation, the adviser distributes the fund's final audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) and the Commissioner promptly after the completion of such audit;

E. The written agreement with the independent certified public accountant must require the independent certified public accountant to, upon resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed, notify the Commissioner within four business days by the filing of Form ADV-E accompanied by a statement that includes:

1. The date of such resignation, dismissal, removal, or other termination, and the name, address, and contact information of the independent certified public accountant; and
2. An explanation of any problems relating to examination scope or procedure that contributed to such resignation, dismissal, removal, or other termination.

F. The investment adviser must also notify the Commissioner in writing that the investment adviser intends to employ the use of the statement delivery and audit safeguards in Track 2. Notification is required to be given on Form ADV in the following sections as appropriate:

Form ADV

Part 1A Items 5.G(4); 7.A(16); 7.B; 9.A (or B), C, D, E and F

Part 1B Item 2.I(2)

Part 2A Items 4, 5, 6, 10, and 15

34. I receive a check from my client made payable to an unrelated third party. What should I do to not be deemed as having custody?

To avoid having custody, you must forward the check to the third party within three business days of receipt.

Important: You are also required to keep accurate records of the securities and funds you received and returned. Such records should contain the description of the checks/securities, when and from whom they were received, where they were sent, and a record of how they were returned.

35. Who can be an independent party?

For purposes of the “independent party” safeguarding procedure for pooled investment vehicles pursuant to California Code of Regulations, title 10, section 260.237, subdivision (a)(5)(B), an independent party is defined in section 260.237, subdivision (d)(4), as a person that:

A) Is engaged by the investment adviser to act as a gatekeeper for the payment of fees, expenses and capital withdrawals from the pooled investment;

(B) Does not control, is not controlled by, and is not under common control with the investment adviser;

(C) Does not have, and has not had within the past two years, a material business relationship with the investment adviser; and

(D) Does not negotiate or agree to have material business relations or commonly controlled relations with an investment adviser for a period of two years after serving as the person engaged in an independent party agreement.

