



Preparing for a State Books and Records Audit

This is the second in a series of updates designed to help state-registered investment advisers prepare for the upcoming state examinations.

Books and records inspection is a basic part of any regulatory examination. The condition of the adviser's records often sets the tone for the rest of the examination. A well-organized and complete set of records signals that the adviser is thorough, conscientious, and attentive to detail. On the other hand, an adviser whose records are missing or incomplete is asking for trouble from the outset. Not only can a books and records violation result in fines and penalties, but also missing or incomplete records is one way to insure more scrutiny and a longer and more probing audit.

Books and Records Basics

The books and records rule is 590-4-8-.09. Upon reviewing the rule it is immediately obvious that its requirements are at least as thorough as the federal counterpart for federal advisers, Rule 204-2 of the Investment Advisers Act of 1940. In fact, the first set of records each state-registered adviser is required to maintain are "those records required to be maintained" under federal rule 204-2 "notwithstanding the fact that the investment adviser is not registered nor required to be registered under the Investment Advisers Act of 1940." Rule 590-4-8-.09(1)(a). The federal rule is extensive, addressing 17 categories of records that must be maintained by all advisers, plus some 12 other categories of records that must be maintained by advisers with custody or doing particular types of business. The Georgia rule thus requires, by reference to the federal rule, that all advisers keep records of, among other things:

- cash receipts and disbursement journals and general ledgers;
- a memorandum of order for each order for the purchase or sale of a security;
- originals of all written communications received and copies of all written communications sent;
- a list of all accounts over which the adviser

has discretion;

- copies of all agreements and powers of attorney;
- copies of all advertising; and
- copies of the adviser's code of ethics and related reports.

This list is not exclusive. The records required to be kept under this section must be maintained either at the principal office of the adviser or, for certain customer-specific records, at the office at which the services were provided to the particular customer. They must be maintained for a period of five (5) years from the end of the fiscal year in which the record was created or in which the last entry was made. For advertisements, newsletters, articles and similar records, the retention period runs from the end of the fiscal year following the last publication. Certain categories of records can be relocated "off-site" after the first two (2) years, as

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long as they remain in "an easily accessible place" for the remaining three (3) years.

It should be noted that the Georgia rule contains specific requirements that in some cases materially modify the requirements of the federal rule. For example, Georgia requires that for any performance-related reports that are sent to two (2) or more persons, the adviser must maintain all working papers and other records used to calculate the performance or rate of return. The federal rule only requires that these records be maintained where the adviser sends such reports to ten (10) or more persons. Similarly, although Georgia mirrors the advertising retention requirement of the federal rule, it makes it clear that it includes "any communication by electronic media," a phrase that is not found in the federal counterpart. Elsewhere in the Georgia rules there are detailed procedures governing the use of internet advertising by investment advisers and others. See Rule 590-4-7-.02

The Georgia rule also refers to another federal

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Basics, continued

rule: IA Rule 206(4)-3 "Cash Payments for Client Solicitations." The federal rule evolved as a means for approving payments, usually in the form of referral fees, to persons who solicit business for registered investment advisers but are not themselves registered. The federal rule contains detailed requirements that must be met, including a written agreement between the adviser and the solicitor and point of sale disclosures to the referred customer. Neither the Georgia Securities Act nor the rules address the legality of a solicitor receiving such fees. An argument could be made, however, that by expressly requiring the maintenance of all books and records also required by IA Rule 206(4)-3, the Secretary of State implicitly recognizes that a solicitor is exempt from registration if it complies with the requirements of the federal rule.

It is unclear whether the Georgia books and record rule requires an adviser to create a record it otherwise would not have to create. Some records, for example, must be created by a federal adviser only because a rule that is inapplicable to state advisers requires it. In the case of these records it is unclear whether their inclusion in IA Rule 204-2 necessarily means they must be maintained under SOS 590-4-.09. In most cases, however, an analogous state rule exists that makes the requirement explicit. For example, IA Rule 206(4)-7(b) requires federal advisers to adopt written supervisory procedures, conduct annual reviews, and appoint a chief compliance officer. A state

adviser arguably does not have to maintain records "formulated pursuant to" that rule, even though such records are required to be maintained by IA Rule 204-2(a)(17). Nevertheless, under SOS Rule 590-4-8-.09 (1)(k), the state adviser must maintain "written procedures for supervising the activities of employees and investment adviser representatives that are reasonably designed to achieve compliance with applicable securities laws and regulations." There is a similar maintenance requirement for the disclosure statement, or brochure, to be provided to each client.

If you want to show the regulators you run a "tight ship," maintaining all required books and records is a good way to start out any audit. It will also help avoid having to pay penalties. If you improve your recordkeeping, you may also find it helps you conduct your business more efficiently, improve service to your clients, and avoid complaints.

This Month:

What State-Registered Advisers Need To Know To Prepare for Examinations (Part One)

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