InteractiveBrokers

SPOTLIGHT ON

Transitioning from a big bank or wire house to your own investment advisory firm

The contents of this Guide have been prepared for informational purposes only, and should not be construed as legal, compliance, or tax advice.
You should consult legal counsel before making any decisions likely to affect your legal rights.

If you are a registered representative working for a big bank or wire house, you may be wondering what it would take to start your own advisory firm.

This document highlights the major legal and regulatory considerations and pitfalls in transitioning to your own investment advisory practice. We provide you here with an overview of the major issues to consider and the factors you should take into account in deciding whether to become independent. Please keep in mind that there are other, purely business decisions, you need to make – such as selecting a name, an office, or a technology platform, running a trademark search for your firm's name, or hiring your staff – that we do not address here.

The entire transition process typically takes between six months and a year. This can vary depending on how long it takes you to separate from your current firm (both practically and without violating your employment contract) and how elaborate your advisory firm's business model will be. Please keep in mind that you can take many of the registration and other compliance-related steps discussed in this Guide simultaneously.

The decisions you need to make, steps you need to take, and documents you need to draft may seem daunting. But remember that you are not alone in this transition. You can always turn to legal counsel or compliance service provider(s) for help with any legal and compliance tasks.

And, as your broker and custodian, Interactive Brokers offers advisors trading on its platform compliance resources and information, trading and reporting support. For example, you can find more detailed information on the compliance topics discussed in this Guide on Interactive Brokers' RIA Compliance Center webpage.

CHECKLIST OF KEY STEPS TO TAKE IN FORMING YOUR ADVISORY FIRM

1. Review your employment and other agreements with your wire house and prepare an exit strategy that complies with those agreements while protecting your client relationships.

2. Select a business structure for your firm, enter into agreements with your co-owners, and adopt appropriate governing documents, such as bylaws and articles of incorporation, so that your firm can commence operations once registered.

3. Get liability and other insurance for your firm, and post any bonds required by federal and/or state law(s).

4. Determine if your firm needs to be registered with the SEC or in any of the states where it will do business.

5. If required, register with the SEC or state securities regulators and make the appropriate registration filings.

6. Make key operational decisions about your firm's operations (e.g., compensation, custody, and advertising).

7. Draft essential firm documents (e.g., disclosures, agreements, compliance policies and procedures).

8. Make sure that your firm observes all applicable ongoing compliance obligations (e.g., amending registration filings, conducting annual compliance reviews, and maintaining required books and records).

1. UNDERSTAND YOUR CURRENT OBLIGATIONS AND PREPARE AN EXIT STRATEGY

Determine your legal obligations to your current employer

The first step in starting your own firm is to determine what it would take to leave your current job and how to bring existing clients over without violating your employment and non-compete agreements with your current firm. This is essential to make sure your transition goes smoothly and your current employer does not sue you or throw roadblocks up when you start your own firm.

You should begin by reviewing your current employment situation and agreements with your employer (either alone or with legal counsel) and seeing what you agreed to and what obligations are enforceable under applicable law. Among other things, you should review any promissory notes, retention packages and signing bonuses structured as forgivable loans, restrictive covenants, non-solicitation, non-competition, and confidentiality agreements, and training agreements you may have with your employer to ensure that you do not violate them by establishing your own firm or bringing over existing clients.

You should pay special attention to:

- Provisions barring you from competing with your former employer;
- Non-solicitation provisions preventing you from soliciting former clients or colleagues for a specific period of time after your employment terminates;
- Provisions protecting your employer's trade secrets, including client information; and
- Provisions requiring you to reimburse your employer for training or other costs.

Some of these provisions (e.g., non-compete and non-solicitation clauses) may be enforceable in some states but not in others or otherwise limited by state law. For example, many states limit the application of non-compete agreements to a certain period of time or geographical area.

Given the potential complexity of these provisions and variety of state laws on these subjects, it would be best to consult with legal counsel. Among other things, your counsel can advise you on acceptable and prohibited ways to leave your current job, the timing of your transition and the rules governing soliciting (or bringing over) clients from your current firm. You may wish to choose a lawyer who can assist you throughout your entire transition process (including selecting a business structure and drafting your registration-related filings and other documents needed to operate an advisory business) so you do not have to engage a new lawyer after you decide whether and how to leave your wire house.

1. UNDERSTAND YOUR CURRENT OBLIGATIONS AND PREPARE AN EXIT STRATEGY (cont.)

Ensure the appropriate transfer of client information

You may be interested in opening your own advisory firm because you have clients you would prefer to serve through your own firm. But before you leave and start your firm, you should make sure your new firm will be able to service at least some if not all of your existing clients.

You should review all of the policies and agreements with your current employer and any applicable state and federal privacy laws to determine what, if any, client information you can take with you if and when you leave your wire house. You should also determine any steps you must take before bringing any client information with you.

There is a Protocol for Broker Recruiting (the "Protocol") that many wire houses, independent broker dealers, and advisory firms have signed onto. If both your current employer and your new employer (or firm) are signatories, you can avoid legal hassles concerning moving at least some of your clients to your new firm, as long as you follow the steps set forth in the Protocol regarding soliciting current clients and bringing client information with you when you leave your wire house. Because the Protocol is often more permissive than the agreements you may have with your employer, you may want to consider having your new advisory firm join the Protocol so that it covers your transition.

The Protocol allows you to take basic client contact information (name, address and contact information) but does not allow you to take account numbers, social security numbers or any client documents. The Protocol also allows you to provide another firm with information related to the scope of your client business as long as that information does not reveal client identity and you do not provide account statements or trading records. But you must follow the Protocol's written resignation procedure, and cannot start soliciting customers until after joining your new employer or firm. The Protocol leaves your current employer free to enforce any contractual, statutory, or other restrictions on soliciting customers before you leave your current firm.

If your transition is covered by the Protocol, it may protect you and the firm you join from monetary and other liability for soliciting current clients, but only if you follow its provisions closely.

Interactive Brokers can assist you with transferring client accounts to its platform once you have figured out what client information (and clients) you can legally take with you.

1. UNDERSTAND YOUR CURRENT OBLIGATIONS AND PREPARE AN EXIT STRATEGY (cont.)

Review your compensation agreements with your current employer

You should also review all of your existing compensation and benefits agreements to determine whether benefits like stock options have vested or you will lose them if you leave and start your own firm. You may be willing to give up these benefits but should investigate this so you can make an informed decision.

Keep your plans confidential

To avoid unnecessary complications, disputes, or premature termination by your current employer, you should avoid talking to your employer, co-workers, and even friends about your transition plans until you are sure you will start your own firm and are ready to resign. You may also wish to be careful about starting a new company or registering an online domain name containing your name or listed under your name too early.

Be prepared for your current employer to find out that you plan to or have registered your own investment advisory firm

Your current employer will likely learn of your plans once you take certain steps in starting your own firm. SEC- and most state-registered advisory firms must make their registration filings electronically on the Investment Advisor Registration Depository ("IARD") system, and must identify certain owners and officers of the firm in their Form ADV. In addition, investment advisor representatives ("IARs") must file Forms U4 when they associate with the advisory firm. All of these filings are publicly available so your current employer will be able to review them and could determine that you are acting as an officer, owner, or representative for another firm.

Given the sensitivity of your transition and the implications of your employer finding out about your plans, you may choose to retain legal counsel or a compliance professional who can help you time your filings to avoid prematurely jeopardizing your current job.

1. UNDERSTAND YOUR CURRENT OBLIGATIONS AND PREPARE AN EXIT STRATEGY (cont.)

If you would prefer to join an existing firm, be sure to do your homework on it

If you decide you want to leave your wire house but do not want to deal with the overhead and compliance obligations of running your own advisory firm, you can join an existing advisory firm. If you choose to join an existing firm, you should conduct due diligence on that firm to be sure that you are comfortable with its business model and compliance infrastructure. Among other things, you should determine whether that firm is registered and where it is registered. You should review the firm's Form ADV, website and other publicly available information about the firm and any materials the firm provides you.

2. ORGANIZE YOUR FIRM

Decide on a business structure for your advisory firm

If you decide to form a new investment advisory firm, you need to name and form a company (assuming you do not have one already). To do this, you must set up your company and obtain approval from the state corporations office and an employer identification number ("EIN") from the Internal Revenue Service. You should do this before attempting to register your advisory firm, as some states require advisors to include incorporation-related documents such as articles of incorporation in their registration filing.

You may choose to have your firm be a sole proprietorship, general or limited partnership, corporation, limited liability company, or business trust. Advisors generally avoid sole proprietorships and general partnerships because those entities do not limit the personal liability of the owners for debts or legal judgments of the business and are not readily transferrable to new owners. You can generally limit your personal liability by establishing either a corporation or a limited liability company ("LLC"), which is the form chosen by most advisory firms. The benefits of these corporate forms vary by state, however, so be sure to review your state's rules. Please also keep in mind that these corporate forms may protect the company's owners from personal monetary liability but may not protect the firm's principals from regulatory, disciplinary or criminal liability if they violate federal or state securities laws.

When deciding how to structure your business, you should also consider factors other than personal liability, such as tax implications, filing and registration requirements and costs, the costs associated with maintaining the specific type of entity, whether the ownership structure preserves the owner's control over the business or provides for the firm to operate after its owner's death, and ease of dissolution. You should consult with legal counsel and a tax professional to determine the type of business entity most suitable for your firm, and the most favorable state of incorporation.

2. ORGANIZE YOUR FIRM (cont.)

Once you select the corporate structure and form the entity, you should draft and enter into written agreements with your business partners and create a formal governing agreement, e.g., Articles of Incorporation, Bylaws, Operating Agreement, Partnership Agreement, Trust Instrument, etc. This will protect your rights and allow the entity to commence operations.

3. INSURE YOUR FIRM AND POST ANY NECESSARY BONDS

Insure your firm against risks and obtain any required bonds

Registered investment advisors are generally not required to maintain any type of insurance. Nonetheless, most registered advisors maintain liability or Errors & Omissions ("E&O") insurance, often available at relatively low costs. E&O insurance is intended to protect an investment advisory firm and its officers, directors, and employees from claims relating to the investment advisory services the firm offers. You may be able to obtain significant discounts on an E&O insurance policy through your broker or another service provider. Advisors may also want to take out additional insurance depending on the types of other risks of running a business they want to protect against, including commercial property and liability insurance, director and officer liability insurance, and employment practices liability insurance as well as fidelity bonds (covering losses resulting from fraudulent acts by specified employees).

State and federal law may require advisors to post certain types of bonds and/or meet minimum net capital requirements. Many states impose net worth and bonding requirements on registered investment advisors, generally requiring advisors with discretionary trading authority or who are deemed to have "custody" of client funds (as discussed in more detail below) to maintain a minimum net worth between $10,000 and $35,000 and supplement any net worth deficiency with a surety bond. Advisors registered and in compliance with the minimum net worth and bonding requirements of the state where the advisor has its principal office do not need to meet the (higher) requirements of any other states where the advisor does business. 15 U.S.C. § 80b-18a(c). Because state rules on net worth and bonding requirements vary widely, advisors should research their state's specific requirements and/or consult legal counsel on this issue.

Please keep in mind that certain registration forms you must complete (e.g., Part 1B of Form ADV discussed below) seek information on any bonds obtained by the advisory firm. So your firm should be prepared to provide this information when it makes its registration filings. Also, federal law requires advisors providing investment advice to ERISA plans or having the power to exercise discretionary authority over plan assets to be bonded.

3. INSURE YOUR FIRM AND POST ANY NECESSARY BONDS (cont.)

You should carefully determine what insurance coverage or bonds you may need, and review the scope and coverage of all insurance policies you are considering with an insurance agent so that your firm is appropriately protected from relevant risks.

You can find additional information on these insurance and bonding requirements in our Spotlight on Insurance and Bonding Considerations for Registered Investment Advisors.

4. DETERMINE APPLICABLE REGISTRATION REQUIREMENTS

Determine whether your advisory firm must register with the SEC or state securities regulators

Once you have formed your investment advisory firm, you need to determine whether your firm should get registered and if so, with what regulator(s). This will depend on the amount of assets under management ("AUM") your firm has (i.e., the securities assets the firm continuously and regularly manages) and the location of the firm's office(s).

Generally, large advisory firms, i.e., firms with more than $100 million AUM, must register with the SEC, while mid-sized advisors with between $25 million and $100 million AUM must register with the state in which they have their principal office and in other states where they have offices or more than a de minimis number of clients. Smaller advisory firm with less than $25 million AUM may be required to register in states in which they have offices or a certain number of clients set by the state.

Under the federal de minimis rule, firms registered in the state where they have their principal place of business may have up to five clients in each other state where they do not have an office without having to register. This rule may come into play as you grow your firm's business and expand around the country. Please keep in mind that certain states, like Texas, expect even advisors with one in-state client to file certain forms and pay filing fees even if the firm is not registered in the state (or required to register there).

Firms in states that do not regulate or examine advisors (e.g., New York and Wyoming) or firms required to register in 15 or more states may register with the SEC rather than the states.

Please also keep in mind that you may need to change your registration as your firm grows or shrinks. For instance, if you start out with 6 clients and $30 million AUM, you will register with the state where your main office is located, but if you grow your business to more than $100 million AUM, you will need to register with the SEC.

4. DETERMINE APPLICABLE REGISTRATION REQUIREMENTS (cont.)

Similarly, if you are just starting out, you may not have any assets under management or at least may not have the $100 million AUM required to register with the SEC. You may nonetheless file for SEC registration if you anticipate having at least $100 million AUM within 120 days of registration approval. If you end up having less than $100 million AUM after those 120 days, you will need to withdraw your firm's SEC registration and register with the appropriate state(s).

Your firm may also fall within an exemption to registration, depending on the types of clients you have. Advisory firms with certain types of clients do not need to register (although some may still need to make certain filings with the SEC). For instance, advisors whose only clients are private funds and have less than $150 million AUM and advisors to venture capital firms do not need to register, although they may need to make certain regulatory filings with the SEC and their states. Family office advisors are not deemed "investment advisers" so they do not need to register. Please keep in mind that some of these advisors may be required to register under state law even if they are exempt from SEC registration.

Given the complexity of many of these registration rules, you may wish to consult with legal counsel or a compliance professional to determine whether you need to register or whether you qualify for any exemption or exclusion from registration, and where (SEC or one or more states) you may need to register.

5. MEET REGISTRATION REQUIREMENTS

Understand what you need to do to register

To register with the SEC or a state, advisory firms must:

- Create an account with FINRA's Investment Adviser Registration Depository ("IARD");
- Prepare a Form ADV and file it through the IARD site;
- Have Investment Advisor Representatives ("IARs") take or retake (if needed) appropriate registration exams, including the Series 65 or Series 66, and file any appropriate forms or documents, e.g., Form U4, fingerprint cards, etc.; and
- Follow up with regulators to confirm that registration was granted.

The most important document for any advisor is the Form ADV, which is used by the SEC and state regulators, and generally seeks detailed information about the firm, its clients, and its activities. It is composed of two main parts, Part 1 and Part 2, each of which is in turn divided into a subpart A and B. Part 1 is a publicly available document mainly used by regulators. Part 2 serves as the basis for a disclosure document that advisors must provide their clients to inform them of advisors' services, qualifications, fees, and potential conflicts of interest prior to entering into an advisory agreement.

5. MEET REGISTRATION REQUIREMENTS (cont.)

Advisors registering with the SEC or a state must file Form ADV Part 1A and 2A. In addition, advisors registering with one or more states also may need to file Form ADV Part 1B and the Part 2B Brochure Supplements for investment advisory personnel. SEC-registered advisory firms must also "notice file" their Form ADV Part 1A with all the states where they conduct business. You should consult the specific state rules on the notice-filing requirement as they may vary.

The states sometimes require firms to submit other documents such as balance sheets, audited financial statements, surety bonds, sample advisory agreements, articles of incorporation or a membership agreement, privacy policy notice, proof of errors and omission insurance coverage, written compliance policies and procedures, solicitor agreements, marketing materials (business cards, letterhead, etc.) and disclosure materials. Some states may also interview firm principals to test their knowledge of applicable rules and regulations.

Prepare your firm's Form ADV

The Form ADV seeks a variety of information that advisors must compile. Both SEC- and state-registered advisors must file Part 1A of the Form ADV. It seeks information about the advisor's business, form of organization, principal office, employees, number and type of advisory clients, compensation arrangements, custody of client funds or securities, AUM, types of advisory services provided, other business activities, conflicts of interest, and disciplinary history. Part 1B, only required for state-registered advisors, largely seeks information on bond and net capital requirements, and litigation, judgment and disciplinary information.

Part 2 of Form ADV is the written disclosure brochure that advisors must deliver to their clients, which describes the firm's practices. The Part 2A Brochure contains information on the advisory firm's business, including general business practices, advisory business, fees and compensation, performance-based fees, types of clients, method of analysis, investment strategies, risk of loss, conflicts of interest, disciplinary information, Code of Ethics, participation in client transactions, personal trading, brokerage practices, review of accounts, client referrals, custody, investment discretion, proxy voting, and certain financial information. Advisors must provide their clients with the Form ADV Part 2A brochure when they sign up with the advisor, annually after that, or whenever material information change.

If your firm offers several distinct types of advisory services (e.g., both U.S. securities and offshore investment services) you may decide to draft and use separate brochures as long as each client receives the information about your firm's services and fees relevant to them. But you must file all of these different brochures.

5. MEET REGISTRATION REQUIREMENTS (cont.)

The Part 2B Brochure Supplement contains disclosures about advisory personnel providing advisory services to clients. The Part 2B supplement seeks information regarding each representative's formal education and business background, legal and disciplinary events, capacities in which he or she participates in investment-related business, compensation for sale of securities and investment products, economic benefits received from someone other than a client for providing advisory services, and contact information for the person's supervisor. Firms must provide the Part 2B supplement to clients whenever a new representative begins to provide advisory services to clients, information becomes materially inaccurate, a new disciplinary event occurs, or previously disclosed disciplinary information changes. In addition to providing Part 2B supplements to clients, advisors registered in some states must also file these documents.

Register your firm's investment advisor representatives

Advisory firms must not only register the firm but also register the people who provide advisory services, called Investment Advisor Representatives or IARs. The majority of states require registered advisory firm to register at least one IAR when the firm itself files for registration.

Firms register IARs by filing a Form U4 for the representative on the IARD/CRD system. In order to register, IARs must generally successfully pass the Series 65 or Series 66 (and Series 7) exams, or hold one of the professional designations states waive the examination requirement for, including Certified Financial Planner ("CFP"), Chartered Financial Analyst ("CFA"), or Chartered Financial Consultant ("ChFC").

Because states have different rules concerning who must register as an IAR, you should review the rules of the states in which your representatives do business. For instance, states may require an owner of an advisory firm to register as an IAR, even if he does not provide investment advisory advice, if the owner refers clients to the firm and receives a portion of the firm's profits as compensation. Some states require all persons who own 25% or more of the firm to register as IARs even if they do not refer clients to the firm.

Please note that the SEC does not require SEC-registered advisory firms to register any IARs. But the states do require SEC-registered firms to register IARs that have a place of business in the state.

5. MEET REGISTRATION REQUIREMENTS (cont.)

Pay applicable registration fees

State-registered investment advisory firms must pay initial and annual renewal licensing fees to the states where they are registered and SEC-registered firms must pay fees to the states where they do business. These fees are detailed on the IARD site at http://www.iard.com/fees.asp.

The SEC also requires advisors registering with the SEC and exempt reporting advisors to pay fees for filing initial registration or initial reports and annual updating amendments to Form ADV through IARD. (These fees are separate and in addition to any fees paid to the states.) These initial registration fees and annual updating fees range from $40 to $225, depending on the firm's assets under management. Exempt reporting advisors must pay $150 for each initial report and $150 for each annual updating amendment. SEC-registered and exempt reporting advisors must pay fees for their annual updates to the Form ADV but do not have to pay fees for any updates during the year due to material changes in the advisors' information.

You can find additional information on registration rules and registration filings in our Spotlight on Registration Requirements and Filings for Investment Advisors and Their Employees and our Spotlight on State Registration Requirements for "Small" Investment Advisors.

Give yourself enough time to complete the registration process

Please keep in mind that the registration process takes some time, typically two to four months.

It often takes firms a month to gather the information and prepare the registration application and other documents associated with the registration process.

The SEC and/or states must then review and approve your application before you can begin acting as a registered investment advisor. The SEC must approve or deny an advisory firm registration application within 45 days. Similarly, some state regulators are required by law to approve or deny a complete application within a specific timeframe, typically between 30-60 days. But generally, the states may take up to 30-45 days and sometimes as long as 60-90 days to approve or deny an advisory firm's registration application. States may also request additional documents or raise follow-up questions during this period. Also, this registration process may take longer for firms that have a disciplinary history, are under investigation, or employ representatives with disciplinary issues.

The state registration process may require additional communications with various state securities regulators and can be complex so you should consider using legal counsel or a compliance service provider to act as a liaison to facilitate and expedite the registration process.

6. MAKE CRUCIAL OPERATIONAL DECISIONS

Decide on and disclose your firm's fee structure

Once you get your business set up, you need to decide how you will charge for your services. Advisors typically charge a fee calculated based on a percentage of a client's portfolio, an hourly rate, or a flat fee. You should negotiate these arrangements with your clients but keep in mind that you may not simply charge any type of fee or amount your clients are willing to pay. The SEC and states have established rules concerning what types of fees advisors may charge.

For example, SEC-registered advisors:

- must set advisory fees that are reasonable in relation to the services provided;
- cannot charge performance-based fees (i.e., fees based on a share of capital gains or capital appreciation of client funds) except to certain clients, including clients with more than $1 million AUM or $2 million net worth, foreign clients, hedge funds, and certain mutual funds; and
- cannot charge termination fees that may penalize clients for ending the advisory relationship unless the fee is directly related to services already provided and not paid for.

State rules are similar to the SEC's but may be stricter. For instance, some states prohibit charging performance-based fee to anyone or place tighter limits on the types of clients that can be charged performance-based fees.

In addition, advisors are considered fiduciaries to their clients and must make full and fair disclosure of the fees they charge clients in the advisory agreement, Form ADV, and certain state filings.

You will need to decide your firm's general fee structure before you attempt to get registered because the registration forms include questions on the subject. Specifically, Part 2A of Form ADV – the main disclosure document advisors must provide to clients and one of the documents advisors must file with the SEC and the states discussed above – seeks relatively detailed information on fees and compensation.

6. MAKE CRUCIAL OPERATIONAL DECISIONS (cont.)

At the time your firm files the Part 2A Brochure or starts providing it to clients, it should have decided at least the following compensation-related matters:

- Your standard fee schedule, methods for assessing fees (including any performance fee arrangements, and any direct billing arrangements), and other costs clients must pay (e.g., custodian fees, mutual fund expenses);
- Whether and to what extent fees are negotiable;
- Whether fees may be prepaid;
- When and how fees will be refunded if either party terminates the agreement; and
- Brokerage arrangements and any conflicts of interest they create (such as soft-dollar arrangements, or relationships between the advisor and any brokers used).

You can find additional information on the fee arrangements advisors may reach with clients in our Spotlight on Advisory and Fee Agreements.

Determine whether your firm will have "custody" of client funds or securities

The SEC and many states have adopted "Custody Rules" under which investment advisors may be deemed to have "custody" over their clients' assets even if those assets are with a broker-dealer, bank, or other qualified custodian. Advisors with "custody" over client assets must meet additional obligations, including providing additional disclosures, obtaining independent audits and retaining certain records.

An advisory firm may be deemed to have custody of client assets if it has even brief possession of client funds (like handling checks or housing assets during a transfer from one broker to another) or the firm is authorized to withdraw or has access to funds or securities in client accounts maintained with the custodian. You should carefully structure your business and agreements with your clients and custodian to ensure you do not have custody under the governing rule if you wish to avoid the additional obligations that come with having custody. Or, if you do have custody over client funds, be sure that you comply with the resulting obligations.

You can find additional information on what can lead advisors to have custody and the obligations associated with having custody in our Spotlight on the Custody Rule for Registered Investment Advisors.

6. MAKE CRUCIAL OPERATIONAL DECISIONS (cont.)

Determine whether to use third-party solicitors to attract clients

Under SEC and certain state laws, registered advisors can hire third-party solicitors to help locate clients and can pay those solicitors for referring clients. Before using these solicitors, you should prepare certain documents, including:

- A written agreement between your firm and the solicitor describing the solicitor's activities, how the solicitor will be compensated, his agreement (or undertaking) to abide by your firm's instructions and the Investment Advisers Act, and memorializing that the solicitor will provide the client with a copy of your firm's Form ADV Part 2 disclosure and the solicitor's separate written disclosure;
- A separate written disclosure that the solicitor must provide to each client containing information on:
    - the name of the solicitor;
    - the name of the advisory firm;
    - the nature of the relationship between your firm and the solicitor;
    - a statement that the solicitor will be compensated by your firm for his solicitation services and the terms of the compensation arrangement; and
    - whether the client will pay an additional charge or a higher advisory fee because the solicitor recommended your firm to the client and the amount of the additional charge.
- The client's written acknowledgement that he received your firm's brochure and the solicitor's written disclosure described above.

Decide whether and how to advertise your firm's services, and draft advertising and marketing materials and a website

You must also decide whether and how you will advertise your firm's services. There are many options. Will you set up a website? Will you use brochures? Newsletters? Will you send out direct mail to likely clients? Do you want to host or speak at seminars?

Under SEC and state rules, advisory firms can advertise their services to existing or potential clients but the regulators place important limitations on the content of advertising and marketing materials. For instance, SEC rules generally forbid: testimonials; selected recommendations made in the past without listing all recommendations for a particular period; unqualified uses of graphs, charts, or formulas; offers of free reports, analyses, or services that are not in fact entirely free; or advertisements that contain untrue statements of material fact or are otherwise false or misleading.

State laws may require advisors to submit their advertisements for review by state securities regulators before use.

6. MAKE CRUCIAL OPERATIONAL DECISIONS (cont.)

Advisors must also be very careful with ads containing performance information. In their ads, advisors must present investment performance net of advisory data and must include very specific disclosures regarding the performance results portrayed fees.

In addition, advisors looking to advertise via social media must comply with recent rules concerning that forum, which are largely geared toward making sure that the advisor provides objective, unfiltered information and does not, for example, include some comments it likes but removes others it does not.

You can find additional information on acceptable forms of advertising and any significant restrictions in our Spotlight on Regulation of Advisor Advertising and Marketing.

7. DRAFT ESSENTIAL FIRM DOCUMENTS

Draft client-facing documents

After or at the same time you draft your Form ADV, you will have to prepare an advisory agreement setting forth the roles, expectations, rights and obligations that you and your clients have to one another. Even though a written agreement may not be required, it is best to memorialize your agreements with your clients in writing for a variety of reasons. If your arrangements with different clients are similar, you most likely can prepare a single model agreement to use with your clients. If your arrangements with clients differ, you may want to draft different agreements for these variations (e.g., have one agreement for discretionary accounts, another for non-discretionary ones) or include different options within your standard agreement.

Your firm's advisory agreement with its clients should discuss the material terms of your arrangement such as:

- The fees the client will pay and the schedule of fees;
- Whether you have discretion to trade the account and the extent of that discretion;
- Broker(s) used and best execution implications of using certain broker(s);
- Your right or obligation to vote proxies on behalf of the client;
- Any conflicts of interest; and
- The client's receipt of certain disclosures, such as the Part 2A brochure and your firm's privacy notice.

7. DRAFT ESSENTIAL FIRM DOCUMENTS (cont.)

The SEC and the states do not let advisors include certain terms in their agreements with clients. For example, SEC-registered advisory firms cannot include the following provisions in their advisory agreements:

- Contractual provisions leading clients to believe they have waived causes of action under federal or state securities statutes;
- Penalties for termination of the agreement by the client;
- Impermissible fees, e.g., performance-based fees to non-qualified clients; and
- Provisions failing to provide that assignment of the agreements to a new advisory firm requires client consent.

You should also consider adopting an investment policy statement for your clients, which can become an exhibit or attachment to the advisory agreement. Among other things, this statement should set forth your client's investment goals and objectives, strategies for achieving those objectives, risk tolerance, and liquidity requirements.

Separately or as part of their written advisory agreement, advisors must also provide their clients with certain other disclosures. Among other things, advisors must disclose:

- Any agreements between the advisor and a solicitor for attracting new business;
- Proxy voting policies and procedures and actual proxy votes the advisor made on behalf of the client;
- Any trading conflicts that may impact best execution decisions, e.g., use of affiliated brokers, "soft dollar" arrangements, or interest in or material business relationships with broker dealers; and
- Any instances where the advisor may be acting as both the agent and principal in a transaction.

Advisors must also provide customers with privacy notices, letting them opt out of sharing personally identifiable financial information with non-affiliated third parties.

Draft policies and procedures

You will also need to adopt formal written procedure documents that explain how your firm will meet its principal compliance obligations and follow those procedures. These policy and procedure documents should, at the least, include compliance policies and procedures reasonably designed to prevent violations of the Investment Advisers Act or other applicable state laws and a Code of Ethics including employee trading policies and gift and entertainment policies. The SEC and various states have different requirements so please review applicable state law.

7. DRAFT ESSENTIAL FIRM DOCUMENTS (cont.)

For instance, all SEC-registered advisory firms must adopt and implement written compliance policies and procedures reasonably designed to prevent, detect, and promptly correct violations of the Investment Advisers Act by the firm and its supervised persons touching on the following issues:

- Portfolio management processes and trading practices, including best execution obligations;
- Any conflicts of interest, such as those raised by “soft dollar” arrangements;
- Proprietary trading by the advisor and personal trades by its employees;
- Accuracy of disclosures to investors, clients, and regulators, including account statements and advertisements;
- Safeguarding of client assets;
- Accuracy and safeguarding of books and records;
- Marketing and advertising, including the use of third-party solicitors;
- Valuation of client assets and fee assessments, based on these valuations;
- Privacy of client information; and
- Business continuity plans.

SEC-registered advisors must annually review these policies to make sure they are sufficient and effective. Firms must also employ a competent chief compliance officer able to administer the firm’s compliance program.

SEC-registered advisors must also have a written Code of Ethics setting forth a standard of business conduct for their supervised persons reflecting their fiduciary obligations. Among other things, the Code of Ethics must require that:

- The firm and all supervised persons comply with applicable securities laws;
- Supervised persons with access to nonpublic information report any personal securities transactions and holdings on an ongoing basis, and the firm’s compliance group reviews these reports;
- Access persons obtain firm approval before directly or indirectly buying a security in an IPO or limited offering;
- All supervised persons promptly report Code of Ethics violations to the firm’s Chief Compliance Officer or other appropriate personnel; and
- The Code of Ethics (and any amendments) provided to all supervised persons and supervised persons acknowledge receipt in writing.

7. DRAFT ESSENTIAL FIRM DOCUMENTS (cont.)

Other written procedures that advisors may need to adopt include:

- Written privacy policies and procedures outlining the advisor's administrative, technical, and physical safeguards to protect customer records and information against unauthorized access or misuse of customers' personal information; and
- Written proxy voting policies and procedures reasonably designed to ensure that advisors will cast votes in their clients' best interests, which describe how advisors will resolve material conflicts of interest and disclose how clients can learn how their proxies were voted and obtain information about the firm's proxy voting procedures.

Most states also require advisors to implement written compliance policies and procedures. You should review applicable state provisions to determine the specific policies and procedures that your firm should have in place. You may wish to engage legal counsel or a compliance consultant to help draft the policies and procedures your firm must adopt.

These compliance policies and procedure requirements are discussed in more depth in our Spotlight on the Compliance Systems and Documentation Advisors Must Maintain.

Draft employment agreements with your firm's employees

You should also draft employment agreements with all supervised persons and other employees. These agreements should clearly set forth the terms of the employment relationship including compensation terms, responsibilities, non-solicitation and/or non-competition restrictions and confidentiality.

8. OBSERVE ONGOING COMPLIANCE OBLIGATIONS

Recruit and train your firm's Chief Compliance Officer

To make sure you meet your compliance obligations, you should hire designated staff and/or retain an outside compliance firm to manage your compliance functions. You may do this through an in-house Chief Compliance Officer, a firm employee who oversees compliance functions and/or with the help of a third-party compliance firm.

SEC-registered investment advisors must designate a Chief Compliance Officer who is competent and knowledgeable regarding the Act, empowered with full responsibility and authority to develop and enforce appropriate compliance policies and procedures and who has sufficient seniority and authority within the firm to get others to observe the firm's compliance policies and procedures. You or another advisor may take on this role initially. But as your business grows and your firm's compliance needs expand, you should hire a qualified person whose only job is to serve as your Chief Compliance Officer.

8. OBSERVE ONGOING COMPLIANCE OBLIGATIONS (cont.)

Although most states do not require advisors to designate a Chief Compliance Officer, they do require firms to designate a supervisor, principal, or another person responsible for compliance and supervision. (Firms must disclose the person filling this role in their ADV Part 1B.) Some states require that the firm's designated compliance officer have certain qualifications, e.g., having scored at least 80% on the Series 65 exam and having two years of supervisory experience.

Amend and renew your firm's registration filings

SEC- and state-registered advisory firms must file annual amendments to their Form ADV in the IARD system within 90 days of the end of their fiscal year. They must also update their Form ADV within 30 days of any material changes.

Advisors must also send a summary of material changes to clients each year (within 120 days of the end of the firm's fiscal year) and send, or offer to send, the firm's updated Form ADV Part 2. Firms also need to update their Form ADV Part 2A whenever material changes occur.

The states also require advisory firms and their IARs to renew their registrations annually.

Implement periodic and recurring compliance procedures

It is essential that advisors follow through on the compliance procedures described in their written policies and procedures manual. Regulators may sanction a firm for not following their stated policies and procedures even if the firm did not violate any substantive rules. Advisors should also make sure that they implement periodic reviews to ensure the firm is meeting its ongoing compliance and filing requirements. Among other things, the firm should be sure that it has procedures in place for:

- Periodic updates to the firm's and IARs' various filings: The firm should have a process in place to assess and update its various registration filings, including Form ADV, state registration, Form U4, etc.;

- Periodic provision of disclosures to clients: The firm must periodically provide certain disclosures to clients (e.g., the annual Part 2 brochure delivery requirement) and have a process in place for keeping track of those requirements;

8. OBSERVE ONGOING COMPLIANCE OBLIGATIONS (cont.)

- Annual compliance reviews: The firm should implement a process to review the adequacy and effectiveness of its compliance policies in light of changes in business activity, changes in applicable laws and regulations, and any compliance issues experienced in the previous year;

- Ongoing reviews of the firm's agreements, policies and procedures, and disclosures: The firm should periodically ensure that these documents are consistent, accurately describe the firm's actual practices, and have been appropriately disclosed to or agreed to by clients, as required;

- Review of employee trading activities: The firm should review employees' trading activities, including any reports filed by employees pursuant to the firm's Code of Ethics;

- Best execution reviews: The firm should review the quality of executions received by its brokers and conduct due diligence to confirm the quality of its brokers' executions;

- Advertising material and compliance reviews: The firm should establish a protocol for approving advertising and website material;

- Making other necessary regulatory filings: The firm should have procedures in place to determine what other filings it may need to make with regulators and make those filings. These additional filing obligations may be triggered either by the type of entity (e.g., private fund) and/or by the management of a certain amount of assets, ownership of a certain percentage of a company's stock, or the trading of a certain amount of stock. For instance, firms may need to file a Form PF (for private funds) or Schedules 13D or 13G, Form 13F, and Form 13H (for large traders);

  - Mock exams: From time to time, the firm should conduct mock exams to prepare for potential

- visits and audits by SEC and/or state regulators;

- Employee compliance training: The firm should establish a compliance training program for its personnel; and

- Due diligence and compliance review of third-party solicitors (and other service providers): The Investment Advisers Act and many state laws require advisory firms to make a bona fide effort to confirm that third-party solicitors are complying with their agreement with the advisor.

8. OBSERVE ONGOING COMPLIANCE OBLIGATIONS (cont.)

Create and maintain required records

Advisors also must generally keep “books and records” covering the firm’s procedures and key aspects of its business. This may sound mundane but it is essential: regulators may sanction firms that are meeting all of their substantive obligations just for failing to keep books and records properly.