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Milne Legal's RIA Checklist for 2015

Introduction

As SEC registered investment advisers ("RIA") prepare to implement their compliance policies and procedures in the New Year, Milne Legal thinks it is an ideal time to provide you with its 2015 RIA compliance-checklist.

I. Filing Requirements

RIAs have certain regulatory filing requirements under the Investment Advisers Act of 1940 (the "Act") and/or under the Commodity Exchange Act (the "CEA"). Below is a list of some of these mandatory filing requirements that you should plan for as you begin 2015.

A. Form ADV

You must amend your Form ADV each year by filing an annual updating amendment within 90 days after the end of your fiscal year. For RIAs whose fiscal year is the calendar year, the ADV must be amended and filed on the IARD system prior to March 31st 2015. In addition to updating your firm's Form ADV annually, be mindful that RIAs must amend Form ADV (i.e., other-than-annual amendments) promptly if certain sections of the form become either inaccurate in any way or if other sections become materially inaccurate. The SEC has stated to "make sure your Form ADV is complete and current. Inaccurate, misleading, or omitted Form ADV disclosure is the most frequently cited finding from our examinations of investment advisers."

Importantly, RIAs must distribute a free updated ADV Part 2 (the "brochure") each year, within 120 days of the end of the RIA's fiscal year (April 30th for Calendar year RIAs), to each client that either includes a summary of material changes or is accompanied by a summary of material changes. Alternatively, the RIA may choose to deliver to each client a summary of material changes that includes an offer to provide a copy of the updated brochure and information on how a client may obtain the brochure.

Be mindful that there are initial and annual IARD filing fees for RIAs (see Release No. IA-3126), therefore, make certain sufficient funds are credited to your firm's IARD Daily Account prior to submitting your Form ADV.

B. Form PF

RIAs with \$150 million or more of “private fund” assets under management are required under the Act to submit periodic reports on Form PF. “Small Private Fund Advisers” must file Form PF within 120 days of the end of their fiscal year (April 30th for RIAs using the calendar year as their fiscal year). “Larger Private Fund Advisers” are divided into 3 different types with filing dates ranging from 15 days at the end of each quarter, 60 days from the quarter end, and 120 days following the end of their fiscal year. If you are an RIA advising private funds, make certain to place these filing dates on your compliance calendar for 2015.

C. Form 13F, Form 13H, Schedule 13D and Schedule 13G

Form 13F. Non-US RIAs must report their holdings on Form 13F if they (i) exercise investment discretion over \$100 million or more of “13(f) securities”, and (ii) use the U.S. mail (or other means or instrumentality of U.S. interstate commerce) in the course of its business. Form 13F is required to be filed within 45 days of the end of a calendar quarter, i.e., for Q4 2014, no later than February 16, 2015 (as the 15th is not a business day). The SEC publishes the official 13(f) securities list on a quarterly basis which may be found at <http://www.sec.gov/divisions/investment/13flists.htm>.

Form 13H. An RIA, among others, that qualifies as a “large trader” must file Form 13H and obtain a large trader identification number, and provide such number to each SEC registered broker-dealer through which it transacts orders. Rule 13h-1(a)(7) generally provides that the relevant levels for large trader status are trades in certain defined equity securities that are equal to or greater than: (i) during a calendar day, either two million shares or shares with a fair market value of \$20 million; or (ii) during a calendar month, either twenty million shares or shares with a fair market value of \$200 million. See Rule 13h-1(a)(1) for the definition of “Large Trader”.

The initial filing of Form 13H must be made *promptly* (within 10 days) after meeting or exceeding the trading levels found under Rule 13h-1(a)(7). Large traders must submit an Annual Filing within 45 days (February 15th) after the end of each calendar year.

Schedules 13D and 13G. When an RIA acquires “beneficial ownership” of more than 5% of a voting class of a company’s publicly traded equity securities, the RIA is required to file a Schedule 13D with the SEC (unless the RIA is eligible to file the more abbreviated Schedule 13G in lieu of Schedule 13D). Schedule 13D must be filed within 10 days of acquiring more than 5% of the company’s equity securities.

D. Commodity Trading Adviser (CTA)

RIAs must consider whether their advisory activities triggers CTA registration. A CTA is an individual or organization which, for compensation or profit, *advises* others as to the value of or the advisability of buying or selling futures contracts, options on futures, retail off-exchange forex contracts or swaps. If you are a CTA, and an exemption does not apply, you must register with the CFTC and, if you exercise discretion of client’s accounts, become a member of the National Futures Association.

E. Commodity Pool Operator (CPO)

Similar to CTA registration, all RIAs must evaluate whether their business activities trigger CPO registration. A CPO is an individual or organization which operates a commodity pool and solicits funds for that commodity pool. A commodity pool is an enterprise in which funds contributed by a number of persons are combined for the purpose of trading futures contracts, options on futures, retail off-exchange forex contracts or swaps, or to invest in another commodity pool. In general, registration is required unless the CPO qualifies for an exemption.

F. Investment Adviser Representative (State Filings)

Each RIA would be wise to evaluate each state that it conducts business in to see if its activities trigger the state(s) registration, licensing or qualification requirements on investment adviser representatives (IAR). Use Form U4 to register as an IAR and Form U5 to terminate your IAR status. RIAs must be mindful that Form U4 must be amended within 30 days to reflect any material changes that take place with any IAR of the firm. For information on particular state requirements see the website for the North American Securities Administrators Association at <http://www.nasaa.org/industry-resources/investment-advisers/ia-switch-resources/state-investment-adviser-registration-information/>

G. Broker-Dealer Registration

RIAs should evaluate their order routing processes to ensure that their routing of clients' orders does not trigger broker-dealer registration, as required under Section 15 of the Securities Exchange Act of 1934 (Exchange Act). For example, Section 3(a)(4)(A) of the Exchange Act generally defines a broker broadly as "any person engaged in the business of effecting transactions in securities for the account of others." If an RIA's activities meet the definition of a "broker" or "dealer" under Section 3 of the Exchange Act, and an exemption does not apply, then they must register as a broker-dealer with the SEC.

H. Trade or Business in the United States (U.S. Tax Issue)

Many non-U.S. RIAs providing advisory services to U.S. residents often fail to consider whether their business contacts in the U.S. trigger tax filing and payment obligations to the Internal Revenue Service.

Begin the new year, most likely with the assistance of U.S. tax counsel, to determine if your firm's income is "effectively connected" to a U.S. trade or business or, if a double tax treaty applies, has business profits that are attributable to a "permanent establishment" in the U.S. Not pro-actively addressing this tax issue for your non-U.S. RIA firm would be a mistake.

II. Code of Ethics

Each RIA must be certain to adopt and enforce a written Code of Ethics which must reflect the RIA's fiduciary duty to its clients. The Act requires the Code of Ethics to contain several mandatory duties, including requiring employees who are "access persons" to report their personal trading activities when initially hired and on a quarterly basis thereafter.

RIAs must distribute the Code to the people it supervises (referred to as “supervised persons”) and receive a written acknowledgement that the employee has read the code and agrees to abide by it. Retain copies of all versions of the Code and Employee Acknowledgments.

III. Privacy Notice

RIAs must, according to Regulation S-P, have a written privacy notice that is distributed to clients *initially*, meaning at or prior to entering into an advisory contract and, thereafter, distribute the notice on an *annual* basis. Clients must be given the opportunity to *opt-out* of any non-public personal information being distributed to nonaffiliated third parties. The privacy notice can be distributed to clients along with other documents but the notice must remain clear and conspicuous, i.e., easily identifiable by the clients.

IV. Compliance Training for Employees

RIAs should consider having compliance training for all employees on an annual basis, if not on a semi-annual or quarterly basis, depending on the size and activities of the RIA. RIA’s should train employees every time there is a material regulatory change and simultaneously update their compliance manuals. Without periodic and continuous employee training sessions, it is ML’s experience that it is incredibly difficult, if not impossible, to properly supervise the members of the firm and to keep the firm soundly adhering to all requirements mandated under the Act.

V. Surprise Examination

Generally, RIAs that have “custody” of clients’ assets must undergo a surprise examination each year conducted by an independent public accountant to verify the client’s securities and funds. The exam should not be held on the same date each year but should be conducted at different times from year to year.

Form ADV-E. The independent accountant must file, within 120 days from the date the exam begins, Form ADV-E electronically with the SEC by using the IARD system.

Exception. RIAs that have custody of clients assets solely because they are authorized by their clients to withdraw funds from the clients’ accounts will not be required to have a surprise examination or to report on Form ADV that it has custody.

VI. Business Continuity Plan

As part of an RIA’s compliance policies and procedures, the SEC expects an RIA to develop a business continuity plan and test such plan at least on an annual basis. Under Investment Advisers Act Release No. 2204, the SEC stated that “We believe that an adviser’s fiduciary obligation to its clients includes the obligation to take steps to protect the clients’ interests from being placed at risk as a result of the adviser’s inability to provide advisory services after, for example, a natural disaster or, in the case of some smaller firms, the death of the owner or key personnel. The clients of an adviser that is engaged in the active management of their assets would ordinarily be placed at risk if the adviser ceased operations.”

VII. Annual Compliance Reviews

Under Rule 206(4)-7, RIAs must review their compliance policies and procedures annually to measure their adequacy and the effectiveness of their implementation throughout the year.

The SEC stated that “Although the rule requires only annual reviews, advisers should consider the need for interim reviews in response to significant compliance events, changes in business arrangements, and regulatory developments.” Therefore, ML is of the opinion that Annual Compliance Reviews should not be reserved as an end of the year exercise but such reviews should be taking place throughout the year as material events take place within the firm and as advisory laws change.

VIII. Fiduciary Duty to Clients

The *hallmark* or *cornerstone* of any RIA compliance program is the fiduciary duty that it owes to each of its clients. Indeed, this duty must permeate throughout all aspects of an RIAs business, applied on a *continuous* basis.

The U.S. Supreme Court in SEC v. Capital Gains Research Bureau, Inc. held that Section 206 of the Act imposed a fiduciary duty on investment advisers. The Court further stated that “investment advisers could not completely perform their basic function -- furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments -- unless all conflicts of interest between the investment counsel and the client were removed.”

As a fiduciary, the SEC has stated that the following obligations are required from all RIAs:

- (i) Provide only “*suitable advice*” to its clients, which generally means that the advisor is aware of the client’s risk tolerance, financial background, education, and investment objectives;
- (ii) Have a *reasonable, independent* basis for its investment recommendations, which requires the RIA to conduct thorough research on the securities being recommended to clients, perhaps best decided upon through an organized, *independent investment committee, which can be used to show the RIA’s independent decision making process*;
- (iii) *Disclose all Material Facts*, particularly if a conflict of interest (or potential conflict of interest) is involved with any client. It is not enough for the advisor to have a sincere belief that he or she is acting in the best interest of the client if a conflict is involved – the conflict must be disclosed to the client and the client’s approval secured; and
- (iv) Obtain *best execution* for clients’ securities where the RIA directs brokerage transactions. The duty of best execution can be particularly concerning when the RIA directs trades to an affiliated broker-dealer to execute its clients’ orders. While the Act does not prohibit it, this affiliation creates an inherent conflict of interest that must be disclosed.

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Dustin W. Milne
Managing Partner

“Milne Legal wishes each of its clients, colleagues and friends in the European community a great start to 2015. It is our hope that each RIA will begin the New Year prepared and with an absolute commitment to effectively implement its tailored and robust compliance program throughout the entire year of 2015.”



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