



# LEGAL AND REGULATORY CONSIDERATIONS

Navigating the Transition to Independence as an RIA

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# EXECUTIVE SUMMARY

Going independent as a registered investment advisor (RIA) introduces a variety of considerations—from your value proposition and brand to your product and service offering, your pricing model, and your marketing approach. Whether you choose to start your own RIA or join an existing one, the RIA model can not only offer greater choice and flexibility, but also greater responsibility—a more invigorating opportunity than you could experience working in other advisor channels. This industry report is designed to help you weigh the legal and regulatory considerations and requirements around going independent as an RIA. It is divided into the following sections:

- Evaluating your needs, goals, and objectives
- Assessing your employment situation and forming an exit strategy
- Choosing your entity structure
- Protecting your business from the unexpected
- Evaluating the type of licensing and registration you may require
- Preparing and filing appropriate disclosure documents and form filings

While this transition can seem daunting, keep in mind that many highly successful RIAs started at the same point not so long ago. By taking advantage of help from experienced attorneys, compliance consultants, and trusted service providers, and by following time-tested and well-defined procedures, you too can successfully navigate the transition to an RIA model.

Keep in mind that this report is not intended to provide specific advice or advocate one advisory model over another. As with any new venture, you should consult with industry experts, as well as legal and compliance counsel, to address your specific business needs and circumstances.

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# EVALUATING YOUR NEEDS, GOALS, AND OBJECTIVES

## **Assessing your market and defining your offering**

Before you begin to undertake any of the legal and regulatory steps outlined in the following pages, you should devote sufficient time and thought necessary to building a strategic plan that charts your vision. Begin by conducting a thorough assessment of your current client base, paying specific attention to the products and services your clients both require and desire. Examining your clients for commonalities such as these, combined with your particular area(s) of expertise, will help you define your niche and your ideal prospect profile.

Gaining clarity around the types of clients that will best fit your business model will help you determine the appropriate mix of services for your firm. Of course, not all services need to be offered in-house; if outsourced services such as estate planning and tax planning make sense for your practice, you should begin to identify potential partners and initiate discussions as part of your strategic planning process.

## **Navigating the shifting regulatory landscape**

You will need to build strong internal controls to comply with the ever-shifting landscape of laws, rules, and regulations. As an RIA/business owner in one of the most heavily regulated industries, you need to realize that compliance with those requirements is an important endeavor. Undoubtedly, one of the most difficult challenges facing new independent advisors is staying abreast of the latest regulatory rules and compliance requirements. This is one area, however, where cutting corners can have a devastating and lasting impact. Once you've made the decision to pursue independence as an RIA, you should seek legal and compliance counsel as soon as possible.

## **Timeline and key milestones**

Typically, advisors take about six months to make the transition to an RIA model. Depending on the complexity of your business model, however, this timetable can be somewhat compressed or significantly expanded. The legal and regulatory steps discussed in this report do not generally occur sequentially, but rather overlap. The following timeline provides an overview of the key milestones to becoming an independent RIA.

## EXHIBIT 1: OVERVIEW OF TRANSITIONING TO INDEPENDENCE

<b>1. Evaluating your needs, goals, and objectives.</b>	<ul style="list-style-type: none"><li>• Assess your current client base.</li><li>• Consult legal and compliance counsel.</li></ul>
<b>2. Assess your employment situation.</b>	<ul style="list-style-type: none"><li>• Engage legal counsel to review employment agreements.</li><li>• Formulate an exit strategy.</li></ul>
<b>3. Choose an entity structure.</b>	<ul style="list-style-type: none"><li>• Determine tax structure, liability issues, location, name.</li><li>• Write business partnership agreements.</li></ul>
<b>4. Protect your business.</b>	<ul style="list-style-type: none"><li>• Determine insurance needs, including business, E&amp;O, key person, life, and disability policies.</li></ul>
<b>5. Determine license and registration.</b>	<ul style="list-style-type: none"><li>• Register with SEC or state.</li><li>• Register individuals.</li></ul>
<b>6. Prepare and file disclosures and form filings.</b>	<ul style="list-style-type: none"><li>• Complete Form ADV, Parts 1 and 2.</li><li>• Complete Form U4.</li></ul>

# ASSESSING YOUR EMPLOYMENT SITUATION AND FORMULATING AN EXIT STRATEGY

Reviewing your current employment situation is a pivotal step in planning for your transition. Clearly, sound strategic planning is vitally important, but for many advisors the restrictions set forth in the employment agreement with their existing firms and the compensation tied to employment may dictate when and how they choose to make the transition.

A typical timeline for an advisor transition from strategy through inception is around six months. A crucial early part of this 180-day plan will encompass a comprehensive assessment of your employment situation and the formulation of an exit strategy. Developing an exit strategy, along with a course of conduct during the pre-resignation period, often means the difference between a smooth transition and getting drawn into a protracted legal battle with your ex-employer.

## Assessing employment-related agreements

One of the first and most important steps in planning your transition will be to engage legal counsel to conduct a review of the various agreements between you and your current employer. Counsel should review all legal agreements, focusing on:

- Any promissory notes or other forgivable loan arrangements
- Training agreements
- Non-solicit provisions
- Non-compete provisions
- Privacy and confidentiality provisions

By reviewing these agreements, your legal counsel will be able to assist you in weighing your options and developing an optimal timeline and strategy for departure.

## Promissory notes, training agreements, and other forgivable loan arrangements

Many advisors sign promissory notes, training agreements, or other forgivable loan documents upon joining a new firm or during the course of their employment. The hiring firm, for example, may give a new advisor a certain percentage or multiplier of annual production in upfront cash or another form of upfront compensation. Almost universally, advisors must repay the unvested portion of that money if they resign or are terminated before a specified period of time.

These arrangements became increasingly popular in the wake of the market turmoil in 2008. Several of the largest wirehouses offered retention packages and signing bonuses as a means to dissuade their top producers from leaving, as well as to lure top talent away from rival firms. Many advisors felt obligated to accept the money and sign the retention packages so as to avoid any suspicion of disloyalty or the perception that they may be considering a transition.

In general, such signing bonuses and retention packages come with extended repayment terms, which typically average from five to nine years, depending on the firm. Programs vary, but most share a few key common features:

- Although the loans are usually forgivable, the forgiveness of the retention amount depends on achieving some benchmark level of production over time.
- Not all of the bonus or retention money is paid upfront, but rather is predicated on future production targets.
- The financial advisor is required to stay with the firm until the end of the contract in order to be relieved of all repayment obligations.

Those advisors who accept a retention package, signing bonus, or some similar payment generally have an obligation to repay the remaining balance upon termination. Often, however, advisors in this position believe they have been aggrieved in some way by the firm and thus want to resist a repayment obligation. A common claim by departing advisors is that they were not given the support or sales assistance promised, which is essential to their success. Given the present culture of seemingly open-ended

litigation, many advisors incorrectly assume that mere allegations will be enough to make a substantial debt disappear. The truth, however, is that most firms are typically unyielding about such debts. Consequently, the decision whether to repay, contest, or negotiate a promissory note, if one exists, will be a crucial component of your exit strategy and timeline.

### **Non-solicit, non-compete, and confidentiality provisions**

Most promissory notes, agreements, and other standard employment contracts signed by advisors contain non-solicitation and confidentiality restrictions, as well as provisions permitting injunctive relief if those restrictions are violated. Generally, since the early 1990s, the majority of advisors who have joined one of the major wirehouses have been required to sign some form of agreement containing these provisions, known as restrictive covenants.

Restrictive covenants are colloquially referred to in the industry as “non-competes,” although that is a technically inaccurate term. Essentially, these non-solicit restrictions seek to prevent representatives from soliciting their clients, or other firm employees, after leaving the firm. Moreover, the confidentiality provisions seek to prevent advisors from taking the firm’s confidential and proprietary information when they depart. These restrictive covenants, with respect to soliciting clients and prohibiting the use of confidential information, are quite enforceable.

This is where the Protocol for Broker Recruiting comes into play. In many cases, such restrictive covenants may be somewhat neutralized with proper application of the protocol. Keep in

mind that following the protocol does not guarantee a seamless transition. However, using the protocol to your advantage depends on being well informed about its nuances, and is yet another area where it's critical to strategize with legal counsel.

### Participating in the Protocol for Broker Recruiting

The protocol originated in 2004 with the goal of furthering clients' privacy and freedom of choice, as advisors moved between firms. If a departing advisor follows the protocol, the advisor and his or her new firm can be protected from monetary or other liabilities for soliciting current clients. Thus, an effective application of the protocol might be your single greatest tool in quickly building your new advisory firm from your existing book of business.

First, you need to determine whether the protocol is available to you, as not all companies are signatories. While most of the large wirehouses and independent broker-dealers are signatories and adhere to the protocol, notably absent members are most large banking institutions, trust companies, and hedge funds. If the protocol is unavailable or not used, there is a higher likelihood that a departing advisor could end up in an employment dispute (litigation or arbitration) after transition. While there are many factors—such as the size and origin of the departing advisor's book of business, the aggressiveness of the employer, and the state

of the advisor's relationship with the employer—that can mitigate the chance of post-employment disputes even where the protocol is not invoked, advisors would be well advised to consider the protocol if available.

Keep in mind, however, that joining is not as simple as merely signing up. You should be aware of the potential pitfalls and strict guidelines and parameters that must be closely followed. We recommend that you consult with an attorney who is familiar with the protocol to help alleviate potential missteps.

If you have a joint production or similar team agreement with other individuals, the protocol provides specific rules that may be relevant to your business depending on whether the team agreement has been defined in writing. In particular, the protocol addresses team/partner relationships in the event one or more members of a team depart the firm while others are left behind.

Team or joint production arrangements are either formal or informal. Formal arrangements are commonly governed by team or joint production agreements, many of which contain non-solicitation restrictive covenants preventing a departing or separating team member from soliciting the remaining team members' clients. Informal agreements are not bound by contract and usually feature only an agreement to work together toward a joint production number.

Different rules apply depending on whether the team arrangement is formal or informal. If a formal agreement is in place, the protocol mandates that you must follow the agreement. In such cases, wirehouse firms have typically been very vigilant in enforcing their rights to use the protocol. Consequently, if and when a departing representative subsequently calls on the team's clients, these large brokerage firms have often been quick to resort to legal action and to protect the business of the remaining representatives.

Where no formal agreement exists between team or joint production members, the language of the protocol document favors the originator of the account. Specifically, the protocol document contains language providing that where a team has no formal agreement in place and is in existence for less than four years, a departing representative may recruit only clients he or she introduced to the team relationship. This is often a gray area because origination can be disputed or attributed to more than one team member. If the team has been in place more than four years, then the departing representative generally may solicit any of the clients serviced by the team.

In short, strictly adhering to the protocol can significantly help to curtail potential litigation and arbitration between departing advisors and their employers. Effectively using this tool can mean the difference between a smooth exit and a drawn-out legal battle with your ex-employer. Once again, you should have detailed conversations with your legal counsel to avoid these potentially costly delays.

## **PROTOCOL PROCEDURES**

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To avail yourself of the protections of the protocol, you generally must adhere to the following procedures:

### **Prior to resignation**

- You may not disseminate to third parties any account statements or other documentation that reveals the identity of your present clients. However, you can disclose information related to your business that does not reveal the clients' identities (for example, the type of client accounts (IRAs, etc.) and an estimate of your annual billings/gross commissions).
- You may not solicit any of your clients to transfer their accounts to your new firm. This act could constitute a breach of your duty of loyalty and result in immediate termination and potential Form U5 (Uniform Termination Notice for Securities Industry Registration) disciplinary disclosure issues.

### **Upon resignation**

Assemble only the following client information. You are prohibited from removing any other documentation or information.

- Name
- Address
- Phone number
- Email address
- Account title

Deliver your resignation in writing to your branch manager along with a copy of the client information you are taking with you. You must include the account numbers for each of your clients' accounts in the information you provide to your employer, but you are prohibited from taking with you clients' account numbers or any other information not listed above.

### Lessons learned

Although keeping strict confidentiality about your plans may seem obvious, one of the most common causes of the premature discovery of an advisor's transition is a lack of discretion about who is aware of your plans. As the adage goes, "loose lips sink ships." One common way that departure plans are discovered by management is through gossip, which can come in many forms—from a rival or whistle-blower trying to curry favor with management to concerned assistants or junior producers anxious about the safety of their

position in the company after a mentor is gone. Inadvertent disclosure can also come from well-meaning family members, friends, or business associates who may know of your plans. News quickly travels through a community by word of mouth, and your departure plans are no exception.

Perhaps the best way to convey the importance of preparing an effective exit strategy is by providing specific examples of the pitfalls and problems advisors have encountered in the past.

## EXHIBIT 2: COMMON CAUSES OF PREMATURE DISCOVERY

See how easy it is to be discovered:

### The Insecure Team Member

A team tells their sales assistant about the impending move in order to include her in the new firm and to assure her of a continuing role with the team. They even offer her a more generous compensation and benefits package. The team cautions the assistant to keep their plans quiet, but in the weeks leading up to departure she gets cold feet, wondering whether she would be in a more secure position by staying at the current firm. She approaches the branch manager and quickly divulges the team's plans. The manager terminates the team before their new advisory firm is founded.

### The Well-Intentioned Client

An advisor tells his clients of his intentions to leave the firm. He explains that he is leaving because he does not feel he can properly service them at the current firm. The client calls management to complain that their advisor is not being treated properly and the firm should be ashamed. The client explains that the advisor told her he is leaving and she is going to follow him. Shortly thereafter the advisor is terminated and that client's account is assigned to a new representative who begins fostering a relationship while the advisor gets his new firm in order.

### The Proud Parent

An advisor tells his family members of plans to leave the firm. At brunch on Sunday, his proud mother tells her friend of her son's plans to be an entrepreneur. The friend has a connection to the advisor's branch manager. A week later, the branch manager pops his head in the advisor's office and asks, "So, when are you leaving?"

### The Service Provider

An advisor goes scouting for office space on his lunch hour. He works in a smaller-market city with a close-knit business community. In making small talk with the real estate agent, the advisor reveals he works for a big wirehouse in town. It turns out that the real estate agent is the golf partner of the advisor's branch manager. He calls the branch manager and says, "One of your advisors was just looking for office space. I didn't know your firm is looking to move." Branch manager responds, "We aren't." The next day, he confronts the advisor.

## CHOOSING YOUR ENTITY STRUCTURE

Once you have evaluated your employment options and made the decision to make a transition to the independent RIA model, one of your first steps will be to decide on the appropriate legal structure for your company. If you are coming from a wirehouse, bank, or other employment situation in which you do not already have a company through which you operate, you will need to form one. If you come from a platform where you have an existing company (for example, to manage your office), you will need to evaluate whether that company is the best vehicle for your new independent RIA.

### Types of entities

Although theoretically you can form your RIA as one of several entity types—sole proprietorships, general partnerships, limited partnerships, corporations, or limited liability companies—practically speaking, your attorney will likely recommend either a corporation or a limited liability company (LLC). Many RIAs are formed as LLCs because of the personal liability protections LLCs can afford. Of the remainder who opt to form as corporations, a growing number are choosing to make tax elections to be treated as S corporations. Again, however, you should choose an entity structure that is closely aligned with your particular business model. You might need a more complicated structure, including the establishment of a holding company, and you should discuss entity formation in detail with your attorney.

### Liability and succession

Sole proprietorships and general partnerships are not typically recommended because of the lack of limited liability protection afforded by these structures; that is, the owners' personal assets could be at risk for all of the liabilities of the business. Sole proprietorships and, to a lesser extent, general partnerships face significant issues and disadvantages related to succession. Although limited partnerships can be structured to afford limited liability and avoid succession issues, LLCs can provide the same benefits in a simpler and often more cost-effective structure. Both corporations and LLCs provide limited liability protection and the ability to provide for proper succession planning.

## Taxation

Because tax treatment is a very important factor in the structuring decision, laws vary by state, and the facts of each situation are different, you must fully evaluate the various options with the advice and counsel of both an experienced attorney and accountant to select the entity structure that is best for your firm. We provide a general overview here of some of the things you should discuss and confirm with your tax advisor. Typically, both corporations that have made S-corporation elections and LLCs have pass-through tax treatment—meaning that, in general, there is no entity-level tax. So, if the entity has, for example, \$100,000 in net profit after paying all expenses including salaries and bonuses, the owners of the S corporation or LLC will pay personal income tax on that \$100,000, but it will not also be subject to taxation at the entity level. There are, however, certain exceptions to this avoidance of double taxation. For example, although neither the federal government nor the states tax S corporations or LLCs at the entity level, New York City does, and it does so at differing tax rates. Conversely, C corporations (corporations that have not made S elections) are taxed at both the entity level and at the owners' personal income tax level once dividends are paid to the owners.

Keep in mind that there are other tax differences between S corporations and LLCs that may make one or the other a better choice depending on your circumstances and the location of your firm. For example, currently self-employment tax in an S corporation typically applies only to the salary received by its owners and not to any additional

## SUCCESSION PLANNING:

### **BUILD A STRUCTURE FOR THE LONG TERM**

Stephen operated his advisory firm as a sole proprietorship. He built a very strong business with good clients and steadily growing assets under management, revenues, and profits. In due course, Stephen had a couple of junior advisors working for him, and he and his family were able to enjoy a very nice lifestyle from the cash flow his practice generated. Unfortunately, however, while Stephen did a lot of things right in terms of growing his RIA firm and increasing his cash flow over time, he did little to build and structure his firm as an asset, with value separate from him. At the time of Stephen's unexpected and untimely death at age 55, he did not have a succession plan and was still operating his firm as a sole proprietorship.

With proper planning and sound legal structuring, his junior advisors could have been set up to take over, and the practice that was his life's work could have survived his death. Instead, Stephen's firm ceased to exist upon his death, and nobody had authority to act on behalf of his clients. The custodian's hands were tied because it could not take action for any client until each had signed a new investment management agreement with a new advisor. The junior advisors were free to attempt to take the firm's business without compensation to Stephen's estate, and his clients were left to fend for themselves.

Additionally, the entity that was supporting his family's lifestyle was gone, and they received no value for the firm. Unfortunately, this is not an isolated case and, sadly, all of these dire consequences could have been easily avoided with solid legal structuring and planning.

distributions, whereas owners of an LLC pay self-employment tax on all of their income, however it is characterized. There has been talk in Congress about reconciling this difference, however, so a discussion with your professionals about the current status of federal, state, and local tax law needs to dictate your decision.

### S corporations vs. LLCs

If S corporations and LLCs are typically the preferred RIA structures from limited liability, succession planning, and taxation perspectives, what factors generally drive advisors, their attorneys, and accountants to choose one over the other? In addition to the tax analysis, the primary factor in deciding between the two is whether the legal restrictions, applicable to S corporations but not applicable to LLCs, are important to your particular situation. These restrictions include the type of shareholders permissible for S corporations (for example, S corporations cannot have foreign shareholders and are, with a few exceptions, precluded from having other corporations and most trusts as shareholders).

Furthermore, S corporations are prohibited from having multiple classes of stock. This means that preferred returns, liquidation preferences, shifting distribution splits, and other variations (commonly used among business partners and often a requisite for obtaining investment capital) are not permitted for S corporations.

Because LLCs do not carry these restrictions, they may afford more flexibility, not only for current needs, but also for future growth. Note, however, that LLCs may be more expensive to set up and maintain in certain states, and therefore may have inherent disadvantages depending upon your particular needs and location. Consulting with an attorney and tax consultant can help you make an informed decision.

### Deciding where to form your RIA

Once you've determined the appropriate legal structure for your entity, the next decision is where to form it. Most often, this decision comes down to a choice between forming in the state in which the firm will be physically located or in Delaware (or a state with similar legal benefits). Why do so many corporate entities form in Delaware? Delaware's statutory and case law has typically been considered favorable to founders, majority owners, and management in lawsuits by minority owners alleging things such as mismanagement, waste of company assets, or breach of fiduciary duty. Therefore, if you as a founder and majority owner of your RIA are considering allowing minority owners (including investors) to have a stake in your firm, you may want to consider forming in Delaware.

There are several other states that have adopted laws similar to Delaware's laws and the advice of your attorney can assist in an analysis. But Delaware remains a popular

choice because of its decades of case law. If, however, you are not planning to have minority owners or investors in your firm, either initially or in the foreseeable future, your attorney may likely recommend forming your new entity in the state in which your firm is physically located.

### Choosing a name

Deciding on a name for your company is a crucial and difficult choice. You want to make sure that the name of your firm accurately conveys your company's value proposition and creates the brand image you want. From a succession and valuation perspective, you want to choose a firm name that isn't inextricably tied to you. While "The John Smith Advisory Group" may do wonders for the ego, it can do considerable damage to the long-term value and sustainability of your practice.

From a legal perspective, you will need to ensure that the name you choose is available in the state in which you are forming your entity. The state will block formation if there is another company with the same, or a very similar, name in that state. Unfortunately, most advisors make the mistake of assuming that state approval of the entity name affords them rights to it. An experienced attorney will always recommend the additional step of running a trademark search and possibly even filing for a trademark.

### SUCCESSION PLANNING: PROTECT YOUR BRAND

Mary formed her RIA firm a year ago with a name that she loved. Her home state approved the formation as there were no other entities in that state with conflicting names. Because it was important to her to have her marketing materials reflect the image and quality of her firm, Mary paid a graphic designer, website designer, and copywriter to create branding and marketing materials. Given the tremendous feedback she received on her company name and logo, she invested significant capital in her website, brochures, letterhead, business cards, and other collateral material. Mary's business grew quickly in that first year and she built strong brand identity.

One day, however, she received a letter from an attorney in another state informing her that, by using her company name, she was infringing on the trademark rights of the attorney's client and that, if she did not cease and desist, they would commence legal action. She called her attorney to find out how this could happen. "I thought the state said we had the name," she said. "I thought so, too," replied her attorney.

Mary then spoke to a trademark attorney and found out that because she had not done any trademark work and because the company in the other state had used the trademark before her, she would need to change her corporate name and rebrand her company. These efforts cost her significant legal and rebranding fees and, in essence, wasted the year of brand identity she had built in the industry.

Given the time, effort, and investment that go into building a brand, the risks associated with not running a trademark search can be cataclysmic. Imagine the impact if three years after your firm's founding—as its reputation grows, public awareness rises, and assets under management continue to climb—another company that may be located in an entirely different state with trademark rights to the same or a similar name to the one you have chosen claims that you have violated its trademark rights and legally forces you to stop using your company name.

Over the last ten years as the Internet has grown, trademark search, analysis, and filing have become much more important. Today, everyone is easier to find and, as a result, the corresponding number of cease-and-desist letters for violating trademark rights has increased exponentially. In addition to the cost of rebranding your company, you could also face the potential risk of being liable for damages.

### **Business partnership agreements**

If you are not going to be the only owner of your company, you need to formalize a written agreement with your business partners. These agreements set forth how voting and decision making will be handled, how distributions and tax liability are allocated, and what happens in certain future events. The events governed by this agreement will typically include transfer of ownership during an owner's lifetime, and upon death, disability, divorce, and bankruptcy.

You face numerous risks if your business partnership does not have a written agreement. For example, without a written agreement, ownership in your company may be transferred by your business partner to anybody during his or her lifetime (including competitors) and, upon death, ownership might transfer to persons who may know nothing about your business.



# PROTECTING YOUR BUSINESS FROM THE UNEXPECTED

Prior to commencing operations, every business should obtain insurance to protect the firm against common general business risks. For investment advisors, however, the addition of errors and omissions insurance provides important protection against more industry-specific risks. While there is no legal requirement to maintain most types of insurance, you should protect your company against these risks and the financial impact of a claim because of the litigious environment in which we live. You may also want to consider other insurance coverage, such as that intended to fund the purchase of a partner's ownership interests upon death or disability.

## General business insurance

There are a host of insurance coverages that can be categorized as general business insurance. These include liability insurance (which protects your firm against personal injury claims), property and casualty insurance (which will insure your office and its contents in the case of theft, fire, and other casualty), automobile insurance (if you have company vehicles), business interruption insurance (which reimburses your firm for lost profits in the event of certain types of business interruptions), and employment practices insurance (which insures you against discrimination and other employment practices claims). A small business package policy often includes some, but not all, of these coverages, so you will need to carefully review various policies and work closely with a trusted insurance agent.

## Errors and omissions (E&O) insurance

E&O insurance covers damages incurred resulting from claims against an advisor for professional liability or errors and omissions. Depending on the type of insurance coverage obtained, these errors and omissions include any mistakes by you, your employees, and certain endorsed independent contractors, as well as the costs associated with defending claims of fraud or misappropriation of funds that are found to be untrue. However ethical you and your firm may be, these types of claims can happen from time to time, and they are not covered by your general business insurance.

## Life and disability buy-out insurance

If you have a business partner, your attorney will likely recommend purchasing cross-purchase term life insurance (in connection with your shareholders' or operating agreement) to fund a buy-out of a partner's ownership interest upon death. With the exception of those cases where health issues trigger uninsurability or prohibitively expensive premium costs, many multiple-owner firms choose to obtain cross-purchase life insurance. Similarly, disability buy-out insurance will fund the buy-out of a partner's ownership interest upon permanent disability. It should be noted, however, that disability buy-out insurance may carry premiums that are significantly higher than those for life insurance.

## Important insurance policy decisions and provisions

With all of these insurance policies, you will need to make important decisions about the proper amount of coverage and optimal deductible amounts. The ability to obtain certain coverages and the premium costs will

be affected by a variety of factors including the size of your company, your assets and revenues, your prior claims history, and, especially in the case of E&O insurance, your product mix (for example, mutual funds, alternative investments, and private investment funds) and whether you have discretionary client accounts.

You must closely review your policies' scope of coverage and their exclusions with a trusted insurance agent to make sure your coverage matches your business needs. You should also research the strength and rating of the insurance carriers you will be using. Whenever possible and available, make sure that the insurance company has a "duty to defend," requiring the carrier to defend claims whether warranted or not and that the costs of defense are outside the policy limits. For example, if you have \$1 million in coverage, the full \$1 million would be available to pay any damage claim, while the costs of defense would be paid by the insurance company over and above the \$1 million. Finally, you need to know whether your policies are based on incidents or claims made, so that you do not allow any gaps in coverage.

## DETERMINING THE TYPE OF LICENSING AND REGISTRATION YOU REQUIRE

After you receive advice from your legal counsel on the optimal business plan for your firm, including your corporate needs and current employment situation, you will be prepared to register your investment advisory business, ensuring that your filings are completed in furtherance of the plan that has been mapped out. Assuming that you will be required to register as an investment advisor, your first step will be to determine with which regulatory authority you must register your firm.

Investment advisors must register with either the SEC or various states. In many cases, only SEC registration is required, so you should first determine if you need to, or are able to, register with the SEC. If you cannot register with the SEC, you will need to register with one or more states or qualify for an exemption from registration.

### SEC registration

There are a number of qualifications for registering with the SEC, but it is unlikely that your firm will qualify for SEC registration upon initial filing of your application. However, the SEC will allow you to register if you anticipate being eligible for SEC registration within 120 days of application approval. Under this provision, you will be required to amend your filing within 120 days to show that you have achieved eligibility.

### Assets under management

The most common and well-known threshold for SEC registration is predicated on your firm's assets under management (AUM). Typically, as of the time of this paper's publication, a firm must register with the SEC if it manages \$100 million or more in assets. The determination of AUM is predicated on those securities portfolios for which you provide continuous and regular supervisory or management services, and the calculation criteria, defined in Item 5.F. of the instructions of Part 1 of Form ADV (Uniform Application for Investment Advisor Registration), can be tricky. As such, you should seek out guidance from your trusted counsel.

Furthermore, if your firm manages between \$25 and \$100 million in assets, it must register at the state level unless one of the following is true:

- It is not required to be registered in the state in which it maintains its principal office and place of business (home state).
- It would not be subject to examination as an investment advisor by its home state.
- It would be required to register with 15 or more states.

### Other SEC qualifications

While AUM is the most common and clear determinant of state or federal registration, there are others including whether:

- The advisor's principal office and place of business is outside the United States.
- The advisor's principal office and place of business is in Wyoming.
- The advisor has a contract to act as advisor or sub-advisor to a registered investment company.
- The advisor is a pension consultant who provides investment advice to employee benefit plans, governmental plans, or church plans with respect to assets having an aggregate value of \$200 million or more. You are not eligible for this exemption if you only advise plan participants on allocating their investments within their pension plans.
- The advisor is under common control and shares the same principal office and place of business with another SEC registered advisor.

Given the complexity of determining factors, and the recent changes to registration requirements resulting from the Dodd-Frank Wall Street Reform and Consumer Protection Act, you will need to consult with your legal advisor to determine the appropriate registration authority or authorities for your firm.

### SEC filings

The SEC is allowed up to 45 days to approve an investment advisor filing. Assuming that your filing is complete and accurate, it can take anywhere from one to six weeks to be approved. Factors that influence the approval timing include the individual at the SEC who is assigned to your filing, as well as the time of year your application is filed. During the holiday season and times of increased filings (such as March of each year), the SEC will typically be slower to respond than at other times during the year.

### State filings

Even though you may be required to register only with the SEC, states retain the ability to require you to notice file if you are conducting any business in that state. A notice filing is limited to filing certain aspects of your existing SEC filings and paying a fee. States cannot require you to meet any additional filing or registration requirements.

You will need to examine the notice filing requirements of each state to determine where you need to notice file. Some states allow you a certain number of clients, while others require the filing prior to engaging any clients in their state.

### State registration

If you determine that you will not be eligible for SEC registration, you must register at the state level. Unlike the single approval process for SEC registered investment advisors, state advisors may have to go through the full registration and approval process in multiple states. Therefore, you will first need to determine with which states you have to register.

### National *de minimis* standard

Section 222 of the Investment Advisers Act of 1940 (the Advisers Act) contains the national *de minimis* standard, which says that no state can require the registration of an investment advisor who meets the following two standards:

- Does not have a place of business located within the state
- During the preceding 12-month period, has had fewer than 6 clients who are residents of that state

In essence, a state may require you to register if you have a place of business in that state or you have more than five clients in that state (regardless of having a place of business). Each state has implemented rules based on

that standard, so you must look to each state where you are planning to conduct business to determine where you need to register.

### Timing

State registration requirements and timeframes can vary from state to state and can generally take longer to process than SEC filings. Because of this inconsistency, you must factor in sufficient time for state filings and approvals when developing your start-up plans and building your timeline.

Certain states have similar provisions as the SEC, mandating that they either approve or move to deny a filing within a certain amount of time (typically between 30 and 60 days). Those states are typically faster than other states, even though they may exceed their allotted time for a variety of reasons.

Other states can be slower because of limited staff and additional work that must be done to approve the filing. Further, it is typical for many states to provide comments and request changes to documents based not only upon their rules, but also the opinion of the individual reviewing the document. The result is often an approval time that surpasses three months in some states.

## Registration of individuals

A firm's federal or state registration determines which individuals need to register as Investment Adviser Representatives and where they need to register. Once it is determined that an individual needs to register, the registration is conducted at a state level. The SEC does not register or determine qualifications for individuals.

### SEC registered firms

Section 203A of the Advisers Act says that no state may require the registration, licensing, or qualification of any supervised person of an SEC registered investment advisor unless the following two conditions have been met:

- That person qualifies as an Investment Adviser Representative<sup>1</sup>
- That person has a place of business located within the state

Therefore, no matter where individuals have clients, they would have to be registered only in those states where they themselves (not the firm) have a place of business.

### State registration

Unlike the state registration requirements for firms, individual registrations are always on a

state-by-state basis. There is no national *de minimis* standard for representatives, so individuals are typically required to register wherever the firm is registered. Furthermore, states vary in how they define Investment Adviser Representative and often include more individuals than would typically have to register under an SEC registered firm.

### Qualifications

Investment Adviser Representative qualification is one of the few areas that is not impacted by whether a firm is registered with the SEC or an individual state. Each state has the ability to determine the qualifications it requires. Typically Investment Adviser Representatives must meet one of the following qualifications:

- They have passed the Series 65 examination.
- They have passed the Series 7 and Series 66 examinations.
- They hold one of a number of professional designations, such as the CFA, CFP, ChFC, PFS, or others designated by that state.

Once again, due to the varying registration requirements and qualifications for each individual state, you should consult with your attorney to determine the appropriate registration for your particular firm.

1. "Investment Adviser Representative" is defined in Rule 203A-3 of the Advisers Act.

# PREPARING AND FILING APPROPRIATE DISCLOSURE DOCUMENTS AND FORM FILINGS

To register as an investment advisor you will need to prepare and file certain documents. While filling out the registration forms is relatively easy, be careful to provide proper responses in order to limit regulatory and civil liability.

## Form ADV

All firms must file Form ADV Parts 1 and 2. The documents are filed electronically through the Investment Adviser Registration Depository (IARD). First, you will have to fill out entitlement forms in order to open an account with the Financial Industry Regulation Authority (FINRA), the administrator of the IARD site. Through the IARD you will both make your filings and pay your fees.

### Part 1

Form ADV Part 1 is predominantly composed of check-the-box responses and short disclosures regarding ownership information. You are not required to deliver this document to clients, although the filing is public and can be retrieved by anyone through the Investment Adviser Public Disclosure (IAPD) site.

### Part 2

Form ADV Part 2, however, is your most important regulatory document. Part 2 is your written disclosure brochure that will be delivered to all clients and prospective clients. It is typically referred to as your disclosure brochure. The disclosure brochure is also filed on the IARD system and is publicly available through the IAPD site.

Completing registration is fairly straightforward, but you should take special care when developing the disclosure brochure. The form's instructions require certain sections and disclosures, but you must always consider that, as a fiduciary to your clients, you are held to a higher standard of disclosure than other professionals. Therefore, you must disclose all material facts regarding conflicts of interest between you and your clients.

### EXHIBIT 3: DISCLOSURE BROCHURE

Topic	Issues to Consider
<b>Your Advisory Business</b>	How do you want to position your services to your clients? Will you be doing financial planning or just managing assets? Will you look to manage all of a client's assets or just a portion that you specialize in?
<b>Fees and Compensation</b>	What kind of fees do you want to charge? Will you have a set fee schedule or look to negotiate within a range of fees? Will you charge performance-based fees?
<b>Methods of Analysis, Strategies, and Risks</b>	This section of the disclosure brochure presents an opportunity for you to provide a detailed explanation of what you do and how you do it. This section can encompass anywhere from one to five pages of the disclosure brochure.
<b>Disciplinary Issues</b>	Do any of your personnel have disciplinary issues that need to be disclosed? These would typically include regulatory fines, suspensions, civil proceedings, criminal proceedings, and the like. Don't wait until the last minute to survey all of your staff to determine what disclosures you may have to provide.
<b>Outside Business Activities</b>	Assess what other lines of business your firm and any personnel will be involved in. This may include acting as a registered representative of a broker-dealer, insurance agent, or real estate agent, as well as more obscure activities like managing an asset or investment with friends who also happen to be advisory clients. These activities need to be disclosed as potential conflicts of interest.

The disclosure brochure must be written in plain English and should not be a template, but rather a document that accurately describes your specific firm. There are certain areas that may look similar to other firms' descriptions, but you need to take care that the document reflects your firm's business practices and not those of another firm you think is similar. You should concentrate on certain areas both for proper disclosure and to differentiate your firm. Whether you draft

the disclosure brochure on your own, or use legal or compliance counsel, you should brainstorm and outline some of the topics shown in Exhibit 3.

#### Filings for individuals

Investment Adviser Representatives, as discussed earlier, will typically be required to register by filing a Form U4 (Uniform Application for Securities Industry Registration or Transfer) through the IARD/CRD system. In

addition, your firm must also prepare a brochure supplement for the following personnel:

- Any person who formulates investment advice for a client and has direct client contact
- Any person who has discretionary authority over a client's assets, even if the supervised person has no direct client contact

### Additional state filing documents

State registered investment advisors may have to file additional documents with the states in which they are registering. These documents include:

- Balance sheet
- Surety bond
- Client agreements
- Marketing materials including letterhead and business cards

Some states may even require one or more principals of the firm to be interviewed regarding the firm and key personnel's knowledge of rules and regulations.

### Client agreements

Second only to the disclosure brochure in importance, client agreements serve not only to set expectations for your firm and its clients, but also help protect your firm. Investment advisors are not technically required to have an advisory agreement. Providing services without an agreement, however, is highly inadvisable.

While it may be tempting to use another firm's client agreements, this common mistake too often leads to problems. Client agreements

should be drafted based on your firm's specific and unique business practices as described in your disclosure brochure. Areas of concentration should include:

- A consistent description of your fees, including the agreed-upon fees, but also the frequency of billing and how valuation will be calculated
- A clause that prohibits you from assigning the agreement without the client's consent
- The ability to specify which accounts you are managing and those that you are not managing
- Whether you will vote client proxies
- A disclosure of brokerage practices and compensation arrangements (including any soft dollar arrangements)
- A requirement that clients acknowledge certain things, such as the receipt of your disclosure brochure and privacy notice
- Arbitration clauses (note that arbitration clauses and any type of clause that limits your firm's liability must be carefully crafted to not violate the Advisers Act)

Depending upon your business model you may need multiple agreements. For example, a typical firm may need:

- A financial planning agreement
- A discretionary investment management agreement
- A non-discretionary investment management agreement
- A wealth management agreement

When considering the terms of your agreements, keep in mind that state registered investment advisors must look to the rules and regulations of the states in which they are registered. Many states have specific requirements and prohibitions as to what can or cannot be included in an agreement.

### Policies and procedures

While not part of the registration process, developing proper policies and procedures is a critical undertaking that should be addressed early in the transition process. Once in place, a good compliance program is much less time intensive to maintain than the alternative of backtracking to catch up on missed regulatory filings, certifications, and reviews, which can be a daunting—if not impossible—task. Developing policies and procedures is the most common area where advisors leverage other advisory firm materials or purchase template documents. These practices may be fine, as long as you treat them as merely a starting point and customize them to ensure accuracy with your business.

You should focus on three fundamental considerations when developing your policies and procedures:

- Regulatory requirements
- Best practices
- Your specific business, including the level of resources to which you have access

The common theme of SEC and state differences carries over to the development of your policies and procedures. Rule 205 of the Advisers Act requires that SEC registered investment advisors adopt and implement a

### REGULATORY CONSIDERATIONS: PROPER FIRM REGISTRATION

Amelia registered her firm as an investment advisor with the SEC. After four years of operation, Amelia's firm is examined by the SEC. The firm currently claims \$425 million in assets under management. After reviewing the firm's client agreements, however, the SEC discovers that Amelia manages her client accounts by allocating assets among separate account managers. The firm must get consent from clients prior to hiring or firing a manager. The SEC informs Amelia that her firm actually has no assets under management because in order to claim assets as under management when using other managers, the firm must have discretionary authority to hire and fire managers. Therefore, Amelia must register her firm with thirteen states where she has clients and withdraw from SEC registration. Alternatively, Amelia must have her clients sign new agreements giving discretion in order to stay SEC registered.

written compliance program reasonably designed to prevent any violation of the Advisers Act by the advisor or any of its supervised persons. The rule requires you to formalize policies and procedures intended to address your fiduciary and regulatory obligations under the Advisers Act. The policies and procedures need only encompass compliance considerations relevant to the operations of your firm.

While the Advisers Act does not specify topics and practices that should be covered by the compliance program, there are certain areas that must be covered based on other

### **REGULATORY CONSIDERATIONS: PROPER REPRESENTATIVE FILING**

Max is a breakaway advisor from a major wirehouse. He registers his new firm with the SEC and registers himself as an Investment Adviser Representative in his home state of Connecticut. Max gets approved by the SEC and starts bringing over clients. Unfortunately, Max never confirmed his representative filing, which is listed as deficient by Connecticut because he does not have the requisite qualifications (Series 65, Series 7 and 66, or an approved designation). Max is a certified financial planner, but his CRD record did not reflect his accreditation.

Two years later, Max receives an inquiry from Connecticut asking if he has been acting as an Investment Adviser Representative without registering. Max now sees that his filing was marked deficient, but explains that he was qualified. Connecticut acknowledges that he was, but because he was not actually registered, they fine him for acting in an unregistered capacity. Not only is Max faced with the monetary ramifications of this oversight, but the fine will also need to be listed on Max's U4 and possibly on the firm's Form ADV. This situation could have easily been avoided if Max had been diligent in confirming his registration.

regulations, as well as those that the SEC has stated it expects to see. The topics shown in Exhibit 4 should be covered in every SEC advisor's policies and procedures.

These required sections are constantly evolving, so no list will ever be exhaustive. Furthermore, regardless of any new requirements, the Advisers Act mandates that you review and test the effectiveness of your compliance program at least annually. In addition, you may want to cover additional areas as best practices, such as how your firm brings on new personnel, how you plan to handle any compliance violations, ERISA issues, and custody issues.

State registered investment advisors will need to look at each state in which they are registered to determine which policies and procedures must be implemented. Some states provide little or no guidance on what, if any, policies and procedures a firm must have in place. In such circumstances you should establish and document a basic set of policies and procedures. At a minimum, you should create insider trading, personal securities transactions, business continuity, privacy, and best execution policies and procedures.

#### EXHIBIT 4: TOPICS TO ADDRESS IN POLICIES AND PROCEDURES

Topic	Description
<b>Portfolio Management Processes</b>	Include a description of how your firm allocates investment opportunities among clients.
<b>Trading Practices</b>	Describe how your firm determines best execution, along with your batch trading processes and the use of any soft dollar arrangements.
<b>Code of Ethics</b>	Dictate policies and procedures to ensure that proprietary trading of your firm and personal trading activities of supervised persons are done within your fiduciary duty to clients.
<b>Accuracy of Disclosures</b>	Explain how your firm ensures the accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements.
<b>Safeguarding of Client Assets</b>	Explain how you protect client assets from conversion or inappropriate use by advisory personnel.
<b>Recordkeeping</b>	Describe your firm's process to ensure accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use.
<b>Marketing Advisory Services</b>	Explain how your firm ensures that advertising is done properly, as well as how you use solicitors.
<b>Valuations</b>	Include processes to value client holdings and assess fees based on those valuations.
<b>Safeguards</b>	Describe safeguards for the privacy protection of client records and information.
<b>Business Continuity Plan</b>	Explain how you plan to minimize the impact of business interruptions on clients.
<b>Pay to Play</b>	Describe how the firm and its supervised persons will interact with elected officials who may have influence over those plans (applicable if your firm seeks to do business with certain government plans).

# CONCLUSION

The legal and regulatory considerations associated with going independent as an RIA are considerable and should be weighed carefully in consultation with your attorney, accountant, and other trusted counsel. Ultimately, the key to a successful transition lies in large part on adequate and proper planning—deciding early on what you want your firm to be and then building the infrastructure to support that vision. With a little foresight and some solid counsel, you can avoid many of the pitfalls and speed bumps that cause some firms to run afoul of regulators and can significantly impede growth.

But the benefits of going independent as an RIA can be significant—not just monetarily, but psychologically as well. The sense of ownership and personal fulfillment can be invigorating. And that, combined with the pride that comes with building and operating a firm that's consistent with the best interests of your clients, can truly be rewarding.

# APPENDIX

## **Additional Resources**

U.S. Securities and Exchange Commission (SEC)  
[sec.gov](http://sec.gov)

North American Securities Administrators Association (NASAA)  
[nasaa.org](http://nasaa.org)

FINRA Broker Check  
[finra.org/investors/toolscalculators/brokercheck](http://finra.org/investors/toolscalculators/brokercheck)

Investment Adviser Public Disclosure  
[adviserinfo.sec.gov](http://adviserinfo.sec.gov)

## **About MarketCounsel, LLC**

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