

South Carolina Securities Division

Investment Adviser Examination Program Overview

The Securities Division of the South Carolina Office of the Attorney General (the "Securities Division") conducts examinations of state-registered investment advisers and of their offices both within South Carolina and outside of the state. We hope that this summary will provide investment advisers with an insight into our examination procedures and spotlight some of the deficiencies frequently observed during our examinations.

How Will Advisers be Selected for Examinations?

Advisers may be selected randomly or for cause. The examination may be conducted at the adviser's place of business, or through a "desk audit" where certain records are required to be provided to the Securities Division.

Are Advisers Notified In Advance of Examinations?

If your firm is to be examined, the Securities Division staff may either schedule an appointment in advance or arrive at your place of business unannounced. If advance notice is given, it is typically provided several days prior to the exam with a list of documents to have ready.

Examinations may last from one day to a couple of weeks and will normally be performed by one or two examiners. If the location also serves as a broker-dealer main or branch office, the staff may examine the records of that entity as well.

What Should I Expect During An Examination?

During an examination, staff will review books and records to determine compliance with relevant laws and regulations and to detect any potential issues. As part of the examination process, staff may also interview employees regarding the operations of the investment adviser.

What Records Are Reviewed?

The Securities Division may review all records pertaining to an investment adviser's business during an examination, including but not limited to the following items:

1. Accounting journals and auxiliary records such as cash/check receipts and disbursement records.
2. Checkbooks, bank statements, canceled checks, credit card statements and cash reconciliation documents.
3. Unpaid and paid bills and documents pertaining to the expenses of the firm.
4. Trial balances, financial statements and internal audit working papers.
5. List of current clients under contract and the type of service that you provide to them. Accounts where you have discretionary authority should be clearly marked.
6. Client contracts, customer information documents, broker-dealer new account forms, trading authorizations, power-of-attorney forms (if applicable), and suitability information.
7. Client brokerage statements, trade confirmations and file-order memoranda.
8. Billing invoices sent to clients.
9. All incoming and outgoing correspondence, including written and electronic mail messages.
10. Complete complaint, arbitration and litigation files.
11. Advertising file including web sites, pamphlets, brochures, newsletters, radio ads, seminar materials, etc.
12. Compliance manual, including written supervisory policies and procedures.
13. List of personnel, including names, titles, CRD numbers, professional designations and employment dates, along with their business cards.
14. Personal securities transactions for all employees.
15. Form ADV, Part 1 and Part 2 for firm, and Form U4 for representatives.
16. The firm's "brochure", if used in lieu of ADV Part 2.
17. Privacy statements provided to client initially, and any updates.
18. Solicitor agreements, disclosures and delivery procedures.

Rule 13-408 of the South Carolina Code of [Regulations](#) should be consulted for further guidance regarding record keeping requirements for registered investment advisers.

Types of Deficiencies Often Found

- ***Outdated or inaccurate Forms ADV and U4.*** Advisers are required to keep an updated copy of their Form ADV in their office for review. An examiner will request a copy of this form for his/her examination file. Inconsistencies between the responses to Parts 1A and 2 are frequently noted. Questions asked in Part 1 and 2 are similar and must be answered consistently.

The Forms ADV and U4 require disclosure of financial industry affiliations and other business activities. This information may identify areas in which conflicts of interest may occur between you and your clients. Inaccurate, misleading or omitted disclosures of such relationships are a common finding in our examinations.

In addition to your annual updating amendment, you must amend your Form ADV by filing additional amendments for material changes within 30 days of the date of the change. Please follow the instructions to the Form.

Within 30 days of any changes to a representative's Form U4, an amendment must be filed. Within 30 days of termination of an investment adviser representative, a Form U5 is to be filed.

- ***Failing to keep accurate records of client billing.*** All billing invoices should show how fees are calculated and indicate which specific periods bills cover. Advisers should ensure that fee calculations are consistent with Form ADV and client contracts. All client-billing invoices must be retained.
- ***Lack of, missing or incomplete client contracts.*** All clients should have an executed contract on file with the adviser for our review. The contract should have a description of the services offered, the term of the contract, a fee schedule, how prepaid or unearned fees will be returned in the event of termination or nonperformance, whether the contract grants discretionary power to the adviser or its representatives, and a non-assignment clause. The contract should not have termination fees, or require a termination notice period that is unreasonably long. Advisory contracts should not contain "hedge clauses" that could in any way constitute a waiver or limitation of any rights which the client may have under any state and federal securities laws. With limited exceptions, contracts cannot include provisions for the adviser's compensation to be based on the performance of the client's account. The contract cannot contain unreasonable arbitration clauses and should not have arbitration venues that would be detrimental to the client.

The examiner will review the investment advisory contract and compare the contract with the activity the examiner observes in the office and with the contents of the Form ADV.

- ***Misleading business cards and letterhead.*** The use of professional designations can be confusing to the public. The designation "Registered Investment Adviser" can only be used by a properly registered investment adviser firm, not by investment adviser representatives. The use of the designation "RIA" is improper since it is not a designation approved by any professional organization. The misleading use by any person of senior and retiree designations that incorrectly imply expertise in the financial needs of seniors is prohibited. Also, affiliations with broker-dealer firms must properly be disclosed on the adviser's business cards and letterhead.
- ***Advertising file deficiencies.*** Advertising must not be false or misleading, must not contain any untrue statements, and must not omit to state a material fact.

Further, advisers should not make reference to a past, specific, profitable recommendation without the advertisement setting out a list of all recommendations made by the adviser within the preceding period of not less than one year, and the advertisement must comply with other specific conditions.

- ***Missing documentation regarding discretionary authority over a client's account.*** An adviser should have the brokerage new account form and any related trading authorizations that show that the adviser has the authority to trade for the client. The adviser's contract should clearly show that the client has granted the adviser discretionary authority.

For non-discretionary accounts, procedures must be put in place to obtain client approval of proposed transactions.

- ***Inadequate financial records.*** All advisers are required to maintain financial records for their business, including journals for cash receipts and disbursements, and ledgers reflecting asset, liability, capital, income and expense accounts. These records should be maintained in a manner that can be produced in a written form for an examiner to review. All records should be kept in accordance with generally accepted accounting principles. Some sole proprietors use their personal checkbook to record all of their advisory business' expenses and income. The adviser should keep in mind, however, that the examiner(s) will review all entries made in the checkbook, including entries that have been made for the adviser's "personal" use.

Unless an adviser posts a bond, the adviser must maintain a minimum net worth at all times of \$35,000 if the adviser has discretionary authority over, but not custody of, client funds or securities, and \$50,000 if the adviser has custody of client funds or securities. Adequate financial records must be maintained to monitor the adviser's net worth.

- ***Inadequate documentation of compliance/supervision.*** If the adviser has employees, the manager/principal will have supervisory duties over those individuals. Further, if the adviser is a one-person operation, it will still have compliance responsibilities. These duties and responsibilities should be documented in a written compliance/supervision manual. The manual should encompass all aspects of the business such as the review of incoming and outgoing correspondence, the review of customer financial plans, determining and documenting suitability, the review of new account documentation, the disclosure of any conflicts of interest, the review of personal securities transactions, complaint review and handling, privacy issues and any other items that are necessary to have procedures that ensure compliance with the various securities laws.

Currently South Carolina law does not contain a specific requirement that state registered advisers adopt and implement a code of ethics, but such a code is a

logical extension of the adviser's fiduciary duty and is certainly a recommended best practice. It should set the tone for the conduct and professionalism of the adviser's employees, officers and directors. The [SEC code of conduct rules](#) provide a template that may be helpful for South Carolina advisers as they develop a code of ethics, but a code of ethics must be tailored to the business, structure, clientele and nature of the advisory firm.

Although the [SEC rule for proxy voting policies](#) does not apply to state-registered advisers, a state-registered adviser that does vote proxies should have a policy in place because such voting is subject to anti-fraud standards and the adviser's fiduciary obligations.

- ***Records maintained in an electronic format.*** Records will be examined in the format in which they are maintained. Therefore, if the records are maintained on a personal computer, that computer's hard drive will be examined. All records should be stored in a secure manner, and appropriate backups maintained.
- ***Inadequate or outdated client information.*** The adviser should maintain written information about each advisory client that is the basis for making any recommendation or providing any investment advice to such client. This may take the form of a client information document that contains the client's age, annual income, net worth (exclusive of home, furnishings and automobiles), the client's investment objective, the name of the person who solicited the account, and the prior investment activity of the client. It is suggested that the above information be supplemented by other information such as client liabilities, expenses, financial goals, risk tolerance, marital status, number of dependents, health issues, and insurance coverage. All of this information should be kept current. Out-of-date client information is a common exam finding.
- ***Consistency of records.*** Examiners will compare the customer new account information, client contract, and customer information document with the services or advice actually provided to its clients. An adviser must maintain adequate information on its customers to document the suitability of the recommendations made. Examiners will also look thoroughly at the recommendations made where the client has granted discretionary authority to the investment adviser.
- ***Representative not registered.*** Registration is required for any person who receives any compensation or other remuneration, directly or indirectly, from the investment adviser in connection with the solicitation or referral of a client for the adviser and/or prepares or offers investment advice to a client.

PLEASE NOTE: Under our prior securities act, S. C. Code Ann. (1976) 35-1-10 *et seq.*, Section 35-1-470 provided that “registration of an investment adviser or a notice filing by a federal covered adviser automatically constitutes registration of any investment adviser representative who is a partner, officer, or director, or a person occupying a similar status or performing similar functions.” However,

Section 35-1-101 *et seq.* of the South Carolina Uniform Securities Act of 2005 eliminated this provision so that, with limited exceptions, it is now necessary for all persons with an investment advisory firm who provide investment advice to clients in South Carolina to register with the Securities Division.

Potential Problems Areas

- ***Use of a brochure.*** An examiner will request and review an investment adviser's brochure. As a best practice, the brochure or ADV Part 2 should be offered to a prospective client 48 hours before entering into any written contract or at the time of entering into any contract as long as the client is given 5 days to terminate the contract without penalty. Investment advisers must comply with the terms of [SEC Rule 204-3\(b\)](#) of the Investment Adviser Act of 1940 regarding the delivery of brochures and brochure supplements. The adviser must keep some form of record to indicate when it was offered or given.
- ***Conflicts of interest.*** Generally, if an adviser is acting in more than one capacity, more opportunity exists for conflicts of interest to arise. Investment advisers have a fiduciary duty to put the client's interest before their own.
- ***Custody.*** An adviser has custody if it directly or indirectly has authority to obtain possession of customer funds, or can appropriate customer funds. An investment adviser who is also an issuer of securities is deemed to have custody of client funds unless an independent custodian is utilized and the custodial agreements include provisions that define the method by which the adviser receives payment and has access to withdraw funds. Further, if a client wishes for the adviser to become a trustee of a trust, it may trigger the requirements under securities law regarding "custody."
- ***Best execution.*** As a fiduciary, an adviser has an obligation to obtain "best execution" of clients' transactions. In meeting this obligation, an adviser must execute securities transactions for clients in such a manner that the clients' total cost or proceeds in each transaction is the most favorable under the circumstances. In assessing whether this standard is met, an adviser should consider the full range and quality of a broker's services when placing transactions, including, among other things, execution capability, commission rates, financial responsibility, responsiveness to the adviser, and the value of any research services provided. In addition, whenever trading may create a conflicting interest between the adviser and its clients, the adviser has an obligation, before engaging in the activity, to obtain the informed consent from its clients after providing full and fair disclosure of all material facts. The adviser must periodically evaluate the execution performance of the broker-dealers used to execute clients' transactions.

- **Recidivism.** Examiners closely review the actions that advisers have taken to remedy deficiencies cited during previous examinations. Examiners have found instances where advisers have failed to correct violations cited during previous examinations, after the adviser represented to the Securities Division, in writing, that the violations would be corrected.

Concluding An Examination

After completion of the examination, Securities Division staff may sit down with the adviser or call the adviser to discuss any problems and issues that may have been uncovered. This is also an opportunity for the adviser to ask any questions of staff. After the examiner leaves, if deficiencies or potential problems were discovered, a follow-up letter will be sent to the adviser. This letter will require an adviser to respond to the department in writing by stating how the deficiencies will be corrected. The adviser usually has a two-week period in which to respond. If no deficiencies or issues are noted during an examination, the Securities Division will issue a letter to that effect and the examination file will be closed.

What Happens If A Problem Is Discovered?

The resolution of problems discovered during an examination will be contingent on their severity. Resolution may range from correcting the issue(s) at the time of the examination to cases where the Securities Division may conduct a follow-up examination.

In cases where more severe violations have occurred, an adviser may be subject to administrative orders, fines and civil penalties. Where the Securities Division becomes aware of potential criminal conduct, the matter may be referred for further review and action.

Disclaimer

This discussion of the Securities Division's examination process has been provided as a courtesy to industry. It should not be considered a complete guide to the Securities Division's regulatory program, nor should the information provided be considered a substitute for the official statutes and regulations that pertain to investment advisers. Do not rely solely upon this discussion for guidance! If you have specific questions, please call the Securities Division at (803) 734-9916. Thank you.