Adviser recordkeeping requirements

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Abstract

Purpose – *The purpose of this paper is to summarize record-keeping requirements for Securities and Exchange Commission (SEC)-registered advisers of private investment companies, especially hedge funds.*

Design/methodology/approach – *Summarizes the important record-keeping provisions of Rule 204-2 under the Investment Advisers Act of 1940 (the Advisers Act) in categories including accounting records; records of orders to purchase and sell securities; written communications; documents supporting performance information; lists of discretionary accounts; powers of attorney; written contracts; codes of ethics; personal securities transactions; disclosure documents; client solicitation agreements; written policies and procedures; records for advisers with custody; investment supervisory or management services; proxy voting records; coded designation for certain clients; the time, place, and manner for retention of records; records for advisers exiting the business; duplicate records; records for nonresident advisers; records for advisers previously registered with a state; and hedge fund records.*

Findings – *Pursuant to new Rule 203(b)(3)-2 under the Investment Advisers Act of 1940 (''Advisers Act''), most advisers of private investment companies, especially hedge funds, will be required to register with the SEC as investment advisers. Registered investment advisers must comply with the rules and regulations of the Advisers Act, including the recordkeeping requirements of Rule 204-2 under the Advisers Act. Although the subject of recordkeeping is perhaps unexciting, recordkeeping is a key area of regulatory focus for the SEC and its examiners, particularly as they seek to gauge the adequacy of adviser compliance and internal controls.*

Originality/value – *A useful summary of record-keeping requirements for hedge funds and other private investment companies.*

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Paper type *Technical*

''Roadmap'' of the Records Rule

Rule 204-2 is organized into 12 paragraphs, (a) through (l). Each paragraph concerns a different record requirement. Although Rule 204-2 covers many different records, these records fall into two groups: typical accounting records any business should keep and records required given the fiduciary nature of advisory businesses. Many of the rule's requirements do not mandate the production of additional records but, rather, the maintenance of records already prepared by an adviser.

Paragraph (a) of Rule 204-2 identifies the records relating to an investment advisory business that every adviser must keep. Paragraph (b) identifies the additional records that must be kept by an adviser with custody of client funds or securities. Paragraphs (c) and (d) concern the records an adviser rendering investment supervisory or management services must maintain for the portfolios it supervises or manages. Paragraphs (e), (f), and (g) relate to the preservation of records under Paragraphs (a) through (d) for specified time periods. Paragraph (h) permits an adviser that is also a registered broker-dealer to substitute or rely

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on records maintained under the Securities Exchange Act of 1934 for substantially similar records required to be kept by Rule 204-2. Paragraph (i) defines ''discretionary power'' for purposes of the rule. Paragraph (j) prescribes certain recordkeeping requirements for a foreign adviser. Paragraph (k) relates to the preservation of records that were required to be maintained during periods when the adviser was subject to state law. Finally, Paragraph (l) concerns the records of hedge funds managed by the adviser.

Records required of every adviser

Each of the subparagraphs of Paragraph (a) of Rule 204-2 identifies a type of record that must be maintained if it applies to an adviser's circumstances. All records must be kept on a ''current'' basis and must contain true and accurate representations of the facts. The SEC staff takes the position that the term ''current'' is not a fixed concept, but may vary with the circumstances of an advisory business and the nature of the records being kept[1].

For all advisory businesses, the primary records of transactions – such as invoices, payment vouchers, confirmations, certain journals, and order memoranda – should be created concurrently with the transactions involved or shortly thereafter. For example, the SEC instituted and simultaneously settled an administrative proceeding against the chief investment officer of an investment advisory firm for failing to keep ''current'' records because, among other things, he failed to write trade tickets until two to nine days after trades were executed[2]. For this type of record, whose purpose is to capture the specific facts about a transaction, ''current'' means up to date at all times.

On the other hand, secondary records, such as ledgers or other records to which transactional data are posted, need not be updated as transactions occur. Rather, posting may be done as is necessary for the needs of the business. Thus, for some advisory businesses, transactions may be reflected in these records no more than a few days after they occur. In other circumstances, such as a small adviser with a few clients, posting transactional data to records and keeping files of required materials current to within 30 days of transactions may be sufficient.

Accounting records

The records identified by subparagraphs (1), (2), (4), (5), and (6) of Paragraph (a) are traditional accounting records and related source documents. These records should be maintained in the ordinary course by any business and include journals, general and auxiliary ledgers, checkbooks, bank statements, bills or statements of account, trial balances, and financial statements. The rule does not dictate the format for these records. Each adviser should design and use those accounting records that suit its business so long as the records kept fit the generally recognized meaning of these terms. Paragraph (a)(2), which deals with ledgers, allows other records to be used in place of traditional ledger accounts. What this means is that a series of other records may be used in place of a separate ledger record if those other records contain information usually found in a ledger.

A few examples may illustrate the varying forms these records may take. Every business has the need to maintain a chronological list of events as they occur. Revenues from clients and other sources must be recorded as they are received, and expenses must be recorded as they are paid. Typically, a journal or journals (fees, cash receipts, cash disbursements, etc.) are kept to preserve a record of these transactions. In all but the smallest advisory businesses, these journals are computerized. In contrast, a sole proprietorship may use a checkbook to keep track of revenues and expenses and its only asset, cash. In this situation, the checkbook and its balance may constitute the business journal, ledger, and trial balance. A checkbook may be an adequate record of an adviser's cash receipts and disbursements only if all such receipts and disbursements are recorded in the checkbook. Both computerized accounting systems and checkbook systems may represent adequate accounting systems for a particular business and, thus, could meet certain of the requirements of Paragraph (a). An adviser should be aware, however, that a simple accounting system that may be adequate while a business is very small, may become inadequate quickly as the business grows or becomes more complex. If SEC examiners believe an accounting system is inadequate given the adviser's business, they may cite this as a deficiency. In this regard, SEC examiners strongly favor computerized accounting

systems that include internal control features. In addition to traditional accounting records, Paragraph (a) requires certain other records specific to different types of advisory businesses.

Cash vs accrual basis

Should an adviser's accounting records be maintained on a cash or accrual basis? The rule is silent on this. The SEC staff has taken the position that accounting records may be kept on either basis or a combination thereof. The method chosen should be reasonable given the circumstances and consistently applied. For example, a sole proprietorship with a small number of clients may find that a cash basis accounting system centered around a checkbook might be sufficient to maintain adequate control over the business's income, expenses, assets, and liabilities. Conversely, a large advisory organization with numerous clients might need to maintain a full set of accounting records on an accrual basis.

The financial statements of an advisory business may be prepared on a cash, modified accrual, or full accrual basis depending on the circumstances. The basis on which financial statements are prepared differs from the basis used to maintain accounting records. Even though accounting records may be maintained on a cash basis, financial statements may be prepared on a full accrual basis. If an adviser is required to file an audited balance sheet with the SEC under Item 14 of Part II of Form ADV, its financial statements must be prepared on an accrual basis.

Memorandum of security orders

Paragraph (a)(3) requires the preparation of a memorandum of each order given by the adviser for the purchase or sale of any security and of any instruction received by the adviser from a client concerning the purchase, sale, receipt, or delivery of a security. Typically, orders for the purchase or sale of securities are communicated orally or electronically by the adviser to a broker-dealer. Instructions received from clients may also be received orally. Paragraph (a)(3) requires an adviser to make a written record of these orders and instructions. The format of this memorandum is not specified, but it must include:

- the terms and conditions of the order, instruction, modification or cancellation;
- the identities of the person connected with the adviser that recommended the transaction and the person who placed the order;
- the account for which entered, the date of entry, and the bank or broker-dealer that executed the order; and
- if the order was entered pursuant to the adviser's discretionary power, an indication to that effect.

For a batched transaction, this memorandum should also include or be accompanied by a written statement showing how the order will be allocated across client accounts[3]. By combining these documents, a complete record of each effected transaction would exist in one place for easy future reference. The record of instructions received from clients would appear to be best maintained by filing the memoranda in clients' files. Alternatively, a trade blotter could be kept if it included all of the required information.

Written communications

Paragraphs (a)(7) and (a)(11) relate to written materials produced and distributed, or received, by an adviser. Paragraph (a)(11) pertains to ads, such as market letters, reports and other communications, that are distributed by the adviser to ten or more persons. If the ad recommends the purchase or sale of a specific security, and the basis for the adviser's recommendation is not stated in the written materials, Paragraph (a)(11) requires that a separate memorandum be prepared that memorializes the basis of the recommendation.

All other written communications sent or received by an adviser and not covered by some other paragraph of Rule 204-2 are, arguably, required to be maintained under Paragraph (a)(7). Further, the SEC takes the position that written materials include electronic mail

communications[4]. Basically, this item classifies written materials into three groups and establishes two exceptions. The three classes of written materials are those related to:

1. recommendations and advice given or proposed;
2. receipt, disbursement or delivery of client funds and securities; and
3. placement or execution of orders.

The first category – recommendations and advice – is defined very broadly to include all market letters, circulars, research reports, notices, and ads that are related to recommendations or advice given or proposed by an adviser. The recommendations and advice are not limited to recommendations about specific securities. Financial planning and asset allocation recommendations are also covered, and the corresponding records should be maintained. The need to maintain written materials relating to recommendations or advice also applies to letters received from clients inquiring about the services or advice being provided (including, of course, complaints).

In addition, unless an ad is sent to ten or more persons, Paragraph (a)(7), by implication, requires that the adviser record the names and addresses of persons receiving ads by mail. If ten or more persons are sent an ad, their names and addresses need not be maintained, but a copy of the material sent must be kept. If an ad is distributed to persons named on a list (such as a mailing list), the adviser must maintain, with the materials distributed, a memo describing the list and its source.

Paragraph (a)(7) also requires that advisers keep all materials they receive that relate to recommendations or advice given or proposed. Under this requirement, advisers should keep files for all research reports and other materials received from whatever source if they are used in the course of providing advice.

Materials should be kept whether they result in a decision to buy, sell, or hold a security or a decision to avoid a security. There are exceptions, however. An adviser is not required to keep unsolicited market letters and other similar materials of general public distribution that are not prepared by or for the adviser. Also, an adviser is not required to keep periodicals of regular public distribution, such as newspapers and magazines that the adviser may use in determining what to recommend to clients. Finally, the SEC staff has allowed research reports, available electronically to subscribers, to be maintained electronically by third parties subject to certain requirements[5].

The second category of Paragraph (a)(7) requires an adviser to keep copies of all written materials received or sent concerning the receipt or delivery of clients' funds and securities. Among these documents would be notices to custodians to receive or deliver client funds and securities and to make disbursements of client funds. Advisers must also keep copies of all written materials sent relating to the purchase and sale of securities. If an adviser deals with broker-dealers primarily over the telephone, there may be no written materials to keep relating to orders placed for buying and selling securities except for the memoranda required by Paragraph (a)(3).

Finally, the third category requires advisers to keep all written documents relating to the placing or execution of an order to purchase or sell a security of any client. The primary documents concerned are confirmations. An adviser must keep all confirmations received, whether on paper or electronically, that relate to client securities transactions[6].

To comply with the requirements of Paragraphs (a)(7) and (a)(11), an adviser should establish a filing system that provides for the appropriate grouping and classification of the written materials being maintained. Although the rule does not specify a particular filing system, these materials are generally filed by function or purpose. An adviser could have a file for all market letters, ads, circulars, etc. that were sent to more than one client. Where appropriate, a note containing a list of the clients to whom the materials were sent should be attached to the document. If individualized materials (such as periodic account evaluations or financial plans) were distributed to clients, a copy of each such document could be filed and maintained in a separate folder for each client. The various written and printed materials

received by the adviser (such as broker-dealer research reports) could be kept together in a file. Alternatively, such materials could be filed by company or by source.

Documents supporting performance information

Paragraph (a)(16) requires that advisers keep all working papers and other records ''necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations'' in any notice, circular, ad, newspaper article, investment letter, bulletin, or other communication that the adviser sends to ten or more persons (other than its associated personnel)[7]. For performance of managed accounts, these record-retention requirements may be satisfied if the advisers retain account statements that show all debits, credits, and other client transactions for the applicable period and all worksheets necessary to demonstrate the performance calculations. The SEC requires that these account statements be prepared contemporaneously with the period reported, and that all account statements for the periods for which performance is calculated be kept, not just for those accounts included in the computation of the performance figures advertised. To satisfy the recordkeeping requirements of Paragraph (a)(16), an adviser must keep records reflecting the manner in which it calculated any model fees used in ads[8] and appropriate records reflecting the performance of advised accounts of a predecessor if the performance of such accounts is included in the adviser's performance[9].

As noted above, Rule 204-2 provides that an adviser may satisfy the requirements of Paragraph (a)(16) with regard to its managed accounts if the adviser retains account statements that show all debits, credits, and other client transactions for the applicable period and all worksheets necessary to demonstrate the performance calculations. This method was set out as an alternative to requiring advisers to maintain all documentation relating to the calculation of their performance numbers. However, this method is not the exclusive means of satisfying the requirements of the rule. The SEC staff reaffirmed this position several years ago in a no-action letter to Salomon Brothers Asset Management Inc., in which it permitted the adviser to substantiate the performance of an unregistered investment company managed by a portfolio manager at another firm who subsequently joined Salomon by relying on published materials that contained the net asset values of the fund during the relevant period along with corresponding worksheets of the independent public accountants. In granting relief, the SEC staff emphasized the fact that the net asset value calculations were published by an independent third party and were accumulated contemporaneously with the management of the account.

Although Paragraph (a)(16) allows advisers to satisfy their performance recordkeeping requirements by relying on internally generated records, the SEC staff has recommended that advisers maintain third-party records, such as custodial or brokerage statements and reports prepared by independent auditors, that confirm the accuracy of the internally generated records[10]. In taking this position, the SEC staff noted an increasing number of enforcement actions in which advisers were inflating performance in both their advertising and their account statements. As a result, the SEC was unable to use the internally generated account statements to substantiate the advisers' performance claims. Based on this experience, and the availability of electronic storage technology that allows advisers to retain information in an electronic format, the SEC staff is urging advisers to maintain third-party documentation to facilitate the inspection staff's review of performance claims.

List of discretionary accounts

Paragraph (a)(8) requires that an adviser having discretionary power with respect to client funds, securities, or transactions maintain a list or other record of such accounts. Rule 204-2 does not define ''discretionary power,'' but an adviser would be viewed as having discretionary power for this purpose if, as in the definition of ''discretionary authority'' in Form ADV, it has the authority to decide which securities to purchase and sell for the client or which advisers to retain on behalf of the client. The rule does explain, in Paragraph (i), that ''discretionary power'' does not include mere discretion as to the price at which or the time when a transaction is or is to be effected if the client has directed or approved the transaction before the order is given by the adviser.

The list of discretionary accounts may be maintained in a variety of ways and may be part of some other record. For example, the list could be maintained on a computer that has the capability to sort among all clients based on the services provided. Alternatively, an adviser with relatively few clients could keep a manual or automated list of all of its clients with the nature of the services provided indicated after each client's name or account number.

Powers of Attorney

Paragraph (a)(9) concerns powers of attorney or similar papers by which clients have granted discretionary power to an adviser. Before an adviser is able to effect transactions in a client's account held by a broker-dealer, bank, or other fiduciary, it is common business practice for the adviser or the other fiduciary to obtain from the client a limited power of attorney or written evidence of the adviser's authority to act for the client. An adviser would also normally maintain such documents for its own protection. Paragraph (a)(9) merely requires that the adviser that has obtained such written powers of attorney maintain them in some orderly system. One method is to put all such documents into a single file. Alternatively, the power of attorney from each client may be filed in that client's current file along with other documents and records relating to that client.

Written contracts

Every advisory business will generally enter into a variety of contractual obligations. These include rental and service agreements, mortgages, employment contracts, and contracts with clients for investment advisory services. Paragraph (a)(10) requires that any written agreement or contract be maintained in an orderly system. This requirement merely reinforces what any prudent business person would be doing anyway. The manner in which contracts are maintained depends on the nature and preferences of the adviser. One option is to file and maintain these documents according to the subject matter covered by the agreement (e.g., leases, client agreements, solicitation agreements, and so on). A contract with a client also might be maintained with the other documents, statements, and papers that pertain to that client's account.

The Advisers Act does not require that advisory contracts be in writing. It is advisable, however, to have contracts with clients in writing in case disputes arise and to provide evidence of the adviser's authority to act for the client. If advisory agreements are oral, there may be nothing to be maintained relating to these contracts under Paragraph (a)(10).

Code of ethics

Paragraph (a)(12) requires that an adviser maintain a copy of its code of ethics, adopted pursuant to Rule 204A-1, that is currently in effect or was in effect within the last five years. Advisers must also retain records of any violations of the code and any action taken as a result of a violation. Rule 204A-1 also requires that each supervised person of an adviser acknowledge, in writing, his receipt of the code. Paragraph (a)(12) requires that the adviser retain copies of each written acknowledgment of receipt of the code. The supervised persons of an adviser are its partners, officers, directors (or other persons occupying a similar status or performing similar functions), and employees, as well as any other persons who provide advice on behalf of the adviser and are subject to the adviser's supervision and control. The SEC staff has permitted advisers that are primarily engaged in a business other than the investment advisory business to not maintain written acknowledgments from those supervised persons who are not involved in the advisory business[11].

Personal securities transactions

An adviser's code of ethics must also require the adviser's ''access persons'' to report their personal securities holdings and transactions, including those in affiliated mutual funds, and must require such persons to obtain preapproval of certain investments[12]. Paragraph (a)(13) covers records of access persons' personal trading. It requires advisers to keep a record of the names of their access persons, the holdings and transaction reports made by access persons, and records of decisions approving access persons' acquisitions of securities in IPOs and limited offerings.

Rule 204A-1 defines an ''access person'' as:

> Any of [the adviser's] supervised persons:
> (A) Who has access to nonpublic information regarding any clients' purchase or sale of securities, or nonpublic information regarding the portfolio holdings of any reportable fund, or
> (B) Who is involved in making securities recommendations to clients, or who has access to such recommendations that are nonpublic.

Disclosure documents

Paragraph (a)(14) concerns the disclosure documents (or brochures) advisers are required to give clients under Rule 204-3 of the Advisers Act, the ''brochure rule.'' An adviser is required to maintain a copy of each brochure and every amendment or revision thereof given or sent to any client. In addition, advisers must maintain a record of the dates that each brochure (and each amendment and revision thereof) was given or offered to any client or prospect who later becomes a client. One of the more frequent deficiencies found during SEC inspections is the failure by advisers to keep this record of the dates on which brochures were given or offered.

There are a variety of methods that may be used to maintain this record. One method, assuming an adviser has a listing of all clients, is to indicate the necessary dates on this list. Another method would be to have each new client sign and date an acknowledgment that the client has received the brochure and to incorporate such an acknowledgment into the adviser's standard advisory contract. Then, on an annual basis, the adviser could include in a mailing to its clients an offer of its current brochure. By maintaining a copy of this annual mailing to clients, an adviser could comply with Paragraph (a)(14) without recording a date for each individual client.

Advisers managing accounts in wrap fee programs may delegate to program sponsors the responsibility to give or offer brochures and to create required records of brochure delivery. Any such delegation does not relieve an adviser of any legal obligations or immunize the adviser from possible sanctions if its brochure is not delivered. Also, the adviser is still required to obtain and preserve in its own offices the required records of brochure delivery. As a result, an adviser in a wrap program should consider seeking contractual or other assurances from a wrap program sponsor that the sponsor will make available a report that lists the dates on which clients whose accounts are managed by the adviser received or were offered the adviser's brochure.

Client solicitation agreements

Paragraph (a)(15) pertains only to advisers that are parties to solicitation agreements. These agreements are covered under Rule 206(4)-3. This rule requires, among other things, that solicitation agreements be in writing and that each client obtained, as a result of the payment of a solicitation fee, receive a copy of the adviser's brochure and, in most cases, a special written disclosure document of the solicitor. The adviser must get from every client obtained through a solicitor a signed and dated acknowledgment that both disclosure statements were received. Paragraph (a)(15) of Rule 204-2 requires that these acknowledgments and copies of the solicitor's disclosure documents be maintained by the adviser. The written solicitation agreement between the adviser and the solicitor must be maintained pursuant to Paragraph (a)(10).

While the actual recordkeeping system used by an adviser to maintain the documents specified in Paragraph (a)(15) may vary depending on the circumstances, it would appear that the best approach is to keep the acknowledgment signed by a client in the client's file along with the contract and other client documents. A copy of the disclosure document used by every solicitor may be maintained in a file established exclusively for that purpose.

Written policies and procedures

Rule 206(4)-7 requires an adviser to adopt and implement a comprehensive compliance program. Paragraph (a)(17) requires advisers to maintain copies of all written policies and procedures that are in effect or were in effect at any time during the last five years. Advisers

are also required to keep any records documenting their annual reviews of such policies and procedures. This assists the SEC examination staff in determining whether an adviser is adhering to Rule 206(4)-7 and in identifying weaknesses in the compliance program.

Records for advisers with custody

Paragraph (b) of Rule 204-2 specifies additional record requirements for advisers that have custody or possession of client funds or securities. Paragraph (b)(1) requires the maintenance of a journal or other record showing all purchases, sales, receipts, and deliveries of securities, including certificate numbers, and all other debits and credits. Presumably, the ''other debits and credits'' refers to all cash receipts to and payments from client funds of which the adviser has custody, as well as the receipt and delivery of all other assets that might be in clients' accounts. This requirement seeks to ensure that an adviser maintains a chronological record or log of all movements of assets into and out of custody accounts in sufficient detail so that there will be a complete daily record of the movements of all client assets of which the adviser has custody.

The format of this journal is not specified, so an adviser has a degree of freedom in its design. A separate journal does not have to be maintained for each client. Several records, such as confirmations and bank statements, may be used to form the substance of this chronological record. It may also be possible to develop a chronological history of asset movements in custody clients' accounts through the use of computer software that can accumulate and sort information in a database. The key is to maintain the required information so it can be obtained readily and arrayed in a chronological format.

Paragraph (b)(2) requires that a separate ledger account be maintained for each custody client. The ledger account must show all purchases, sales, receipts, and deliveries of securities, the date and price of each such purchase and sale, and all debts and credits. The purpose of this record is to develop a complete history for each custody client of all movements of its assets. The ledger account should begin with an entry showing the initial receipt of cash and securities from the client. Subsequent entries would record the receipt and disposition of these initial and all other assets of the client of which the adviser has custody. The entries in these accounts are useful to the adviser's independent auditor when performing the annual surprise review and count of custody client assets.

Paragraph (b)(3) requires an adviser to maintain copies of confirmations received for all transactions effected by or for the account of any custody client. This file could be organized in a variety of ways, but it may make the most sense to keep the documents in chronological order so that the information they contain can be compared easily to the journal record required by Paragraph (b)(1). It may be possible, assuming the confirmations contain all of the required information, either as they are received from the broker-dealer or as supplemented by the adviser, for this to be an ''other record'' and also fulfill the requirements of Paragraph (b)(1).

Paragraph (b)(4) requires an adviser with custody clients to establish and maintain on a current basis a separate record for each security in which any such client has a position. In essence, this item requires the creation of a ledger account, by security, for each security in which any custody client has a position. The purpose of this record is to enable the adviser, as well as SEC examiners, to readily determine certain information about each such security. It would be good business practice for an adviser to reconcile periodically the security positions of each client as indicated in the record maintained in Paragraph (b)(2) to the overall position of all clients in a security as indicated in the (b)(4) record. This record must contain the name of each custody client having an interest in each security, the amount or interest of each client, and the physical location of each security.

The record required by this item could be prepared by using software to extract the necessary information from a database. That is, if the data for each transaction in a security recorded in the chronological record required by Paragraph (b)(1) were sufficient to meet the requirements of Paragraphs (b)(2) and (b)(4), the information could be entered into the database once. Then the necessary information could be extracted, as needed, to create the separate ledger account for each client required by Paragraph (b)(2) and the separate record for each security required by Paragraph (b)(4).

Investment supervisory services

Paragraph (c) of Rule 204-2 specifies two additional records that must be kept by an adviser that renders investment supervisory or management services to any client. The Advisers Act defines ''investment supervisory services'' to mean ''the giving of continuous advice as to the investment of funds on the basis of the individual needs of each client.'' The additional requirements of Paragraph (c) apply only to the clients receiving investment supervisory or management services.

The two additional records required are:

1. records showing, separately for each such client, the securities purchased and sold, and the date, amount, and price of each such purchase and sale; and
2. for each such security in which any such client has a current position, information from which the adviser can promptly furnish the name of each such client, and the current amount or interest of each such client.

To comply with the first of these requirements, the adviser should establish a journal or other form of chronological record with a separate section for each client in which all purchases and sales of securities are recorded. The information to be recorded includes the name and description of each security, the date of the transaction, whether it was a purchase or sale, the total amount paid for the security for purchases or the total amount received for sales, and the per share or unit price paid.

The second requirement asks only that the adviser have information available from which it can furnish promptly for each security the name of each client that has an interest in the security and the amount or interest of each client. Thus, an adviser does not have an ongoing requirement to maintain a separate record with this information so long as it can be obtained promptly when requested. If a manual recordkeeping system is used and there are a large number of clients, it may be necessary to maintain this information in a separate record to be able to furnish it promptly. In a computerized system that has been designed to produce this record on request, the only requirement is that the underlying database be maintained on a current basis. If an adviser has custody or possession and furnishes investment supervisory services, the record maintained in compliance with Paragraph (b)(4) of the rule would also suffice for the information required by Paragraph (c).

Proxy voting records

Paragraph (c) addresses proxy voting. Specifically, under the rule, advisers that exercise voting authority with respect to client securities must retain their proxy voting policies and procedures, proxy statements received regarding client securities, records of votes they cast on behalf of clients, records of client requests for proxy voting information, and any documents prepared by the advisers that were material to making decisions on how to vote or that memorialized the basis for those decisions. Paragraph (c) also permits an adviser to rely on proxy statements filed on the SEC's EDGAR system instead of keeping its own copies, and to rely on proxy statements and records of proxy votes cast by the adviser that are maintained with a third party (such as a proxy voting service), so long as the adviser has obtained an undertaking from the third party to provide copies of the documents promptly upon request.

Coded designation for certain clients

Paragraph (d) permits the use of a numerical or alphabetical code or designation in place of the name of any client to whom the adviser renders investment supervisory services. The intent of this provision is to permit an adviser to keep the names of its clients receiving investment supervisory services confidential. In order for an adviser to take advantage of this provision, it must use the coding system in its daily operations. A coding system used only at the time of an inspection by the SEC staff does not meet the requirements of this paragraph.

Time, place and manner for retention

Paragraph (e) addresses the amount of time the records required to be made under Rule 204-2 are required to be retained and where they may be retained. All records required to be made under Paragraphs (a) to (c)(1)(i) of the rule (except for records required to be made under the provisions of Paragraphs (a)(11), (12)(i), (12)(iii), (13)(ii), (13)(iii), (16) and (17)(i) of the rule) are to be retained for at least five years from the end of the fiscal year in which the last entry in the records was made. Records required to be made under the provisions of Paragraphs (a)(11) and (16) of the rule are to be retained for five years from the end of the fiscal year during which the adviser last published or disseminated the ad or other communication. During the first two years of these five-year periods, the records should be stored in the adviser's offices. During the remaining three years, the records should be preserved in an easily accessible place. This easily accessible place can be an appropriate facility away from the adviser's offices such as a public records storage building.

Paragraph (e)(3)(ii) also provides that hedge fund advisers required to register with the SEC pursuant to Rule 203(b)(3)-2 are permitted to market their performance records for periods prior to registration with the SEC, even if they do not have the level of documentation otherwise required by Paragraph (a)(16). Hedge fund advisers are, however, required to retain whatever records they do have that support the performance they earned prior to their registration with the SEC, but are excused from the requirements of Paragraph (a)(16) to the extent that those records are incomplete or otherwise do not meet the requirements of Rule 204-2.

Paragraph (e)(2) specifies a different preservation requirement for organizational documents, such as partnership articles and amendments, articles of incorporation, charters, minute books, and stock certificate books of an adviser and any predecessor. All of these documents must be maintained in the principal office of the adviser and preserved until at least three years after termination of the enterprise. Prior to termination of an adviser, keeping minute books at the offices of its legal counsel does not comply with the requirements of Paragraph (e).

Originally, Paragraph (g) of the rule required all records to be stored in a hard copy form for the first two years. The SEC amended the rule in 1985 to allow records to be stored on photographic film and, for records created or received in electronic form, on electronic media. In 2001, the SEC amended the rule to allow advisers to maintain records electronically – regardless of the form in which the records were created or received – subject to certain conditions.

Today, where an adviser uses photographic or electronic storage, the adviser must:

- arrange and index the records in a way that permits easy location, access, and retrieval of any particular record;
- provide to the SEC promptly, on request, a legible, true, and complete copy of the record in the medium and format in which it is stored (i.e. a computer file for electronically stored records), a print-out of the record or a means to access, view, and print the record; and
- separately store, for the time required for preservation of the original record, a duplicate copy of the record on any medium allowed by the rule.

For electronically stored records, an adviser must also establish and maintain procedures (i) to safeguard the records from loss, alteration, or destruction; (ii) to limit access to the records to authorized personnel and the SEC; and (iii) to ensure that electronic copies of nonelectronic originals are complete, true, and legible when retrieved.

Advisers exiting the business

Paragraph (f) of the rule establishes procedures for the preservation of records by an adviser that is discontinuing business as an adviser. An adviser in this situation, before it ceases to conduct business, must arrange and be responsible for the preservation of its records for the remainder of the period specified in the rule. This means that an adviser contemplating exiting the advisory business must arrange for the preservation and storage of its records, including the payment of any fees and charges in accordance with the

preservation requirements of the rule. After the retention periods specified in the rule have passed, the records can be destroyed. An adviser must also notify the SEC of the exact address where its records will be maintained during this period.

Duplicate records

In order to avoid needless duplication, the first part of Paragraph (h) of the rule permits any records that are preserved under Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934, which are substantially the same as the records required to be preserved under Rule 204-2 of the Advisers Act, to be deemed preserved under Rule 204-2. This paragraph does not, however, cover a registered representative who is also separately registered as an adviser. Such a representative, as an adviser, would have to keep all of the applicable records under Rule 204-2 and could not rely on any records he maintained as a registered representative of a broker-dealer.

The second part of Paragraph (h) provides simply that a record made and kept pursuant to any provision of Paragraph (a) of Rule 204-2 that contains all of the information required under any other provision of Paragraph (a) need not be maintained in duplicate to meet the requirements of such other provision of Paragraph (a). This means, in essence, that if a record is kept to meet the requirements of one item of Paragraph (a) and the information in that record also meets the requirements of another item of Paragraph (a), two copies of the record do not have to be kept and preserved to meet all the requirements of Paragraph (a). For example, if the cash receipts and disbursements information entered into a record such as a checkbook together with the balance of the checking account entered in the checkbook could fulfill the requirements for both a cash journal and a cash ledger account, the single checkbook would suffice for both records. It is not necessary to make and retain a copy of the checkbook to meet separately the journal and ledger requirements of Paragraph (a).

Nonresident advisers

Paragraph (j) of the rule addresses the record requirements for nonresident advisers that are registered with the SEC. Although the paragraph requires that the records kept by non-resident advisers be the same as those required of all registered advisers, the SEC staff has, by no-action letter, applied this strict standard only to transactions involving, or representations made, to US resident clients[13]. However, because the adviser's business is not located in the USA, this paragraph gives a non-resident adviser two options for how it will make its records available to the SEC.

The first option is that such an adviser may preserve in the USA a complete and current set of copies of all records that are required under the Advisers Act. An adviser adopting this option must notify the SEC in writing of the US location where such copies of its records will be preserved. Because a requirement to keep current copies of all required records in the USA entails a significant burden, most nonresident advisers registered with the SEC elect to follow the second option.

The second option allows the adviser to maintain its records wherever it wants but requires that the adviser agree to furnish the SEC on demand with all of the records required to be maintained or those specified in the demand by the SEC. An adviser has 14 days after the written demand to furnish such records to the SEC at its own expense. The written undertaking to furnish records on demand must be filed with the adviser's application for registration with the SEC.

Because the SEC staff believes that investment advice provided by a nonresident adviser to foreign clients should not be governed by the substantive provisions of the Advisers Act, the SEC staff has issued several no-action letters limiting the recordkeeping requirements of nonresident advisers with respect to their dealings with foreign clients. Under the terms of these no-action letters, a nonresident adviser need not comply with the following items of Rule 204-2 with respect to the adviser's foreign clients: (i) subparagraphs (3) and (7) of Paragraph (a) with respect to transactions involving foreign clients that do not relate to advisory services performed by it on behalf of US clients or to related securities transactions; and (ii) subparagraphs (8), (9), (10), (11), (14), (15) and (16) of Paragraph (a) and all of

Paragraph (b) with respect to transactions involving, or representations or disclosures made to, foreign clients.

Advisers previously registered with a state

Paragraph (k) provides that any records that were maintained pursuant to state law requirements, prior to an adviser's registering with the SEC, must continue to be maintained and preserved as if they had been maintained pursuant to Rule 204-2.

Hedge fund records

Paragraph (l) clarifies that, for purposes of Section 204 of the Advisers Act, the books and records of a registered hedge fund adviser include the records of the private funds for which the adviser acts as investment adviser and the adviser or a related person acts as general partner, managing member, or in a similar capacity. This provides SEC examiners with access to these records to determine whether a hedge fund adviser is meeting its fiduciary obligations to a private fund under the Advisers Act. The rule applies to related-person general partners only when the adviser has an advisory relationship with the private fund in question. It does not apply to every related-person general partnership in a large financial complex.

Notes

1. See, e.g. *American Asset Management Company*, SEC No-Action Letter (July 23, 1987); *William P. Frankenhoff*, Inc., SEC No-Action Letter (Aug. 24, 1987).
2. *In the Matter of Michael L. Smirlock*, Advisers Act Release No. 1393 (Nov. 29, 1993). See also *Pretzel & Stouffer*, SEC No-Action Letter (Dec. 1, 1995) (trade tickets completed and delivered no later than close of business on trade date).
3. See *SMC Capital, Inc.*, SEC No-Action Letter (Sept. 5, 1995) (adviser's records to separately reflect for each client account the orders of which are aggregated, the securities held by, and bought and sold for, that account).
4. *In the Matter of Banc of America Investment Services* et al., Advisers Act Release No. 2396 (June 15, 2005).
5. See *Disclosure Incorporated*, SEC No-Action Letter (Aug. 22, 1996); *First Call Corporation*, SEC No-Action Letter (Sept. 6, 1995).
6. The SEC staff has provided no-action guidance permitting advisers to receive electronic confirmations via the Depository Trust Company's ID system. See., e.g. *Depository Trust Company*, SEC No-Action Letters (Sept. 4, 1992 & Apr. 17, 2001).
7. Paragraph (e), however, provides an exception for a hedge fund manager that had a performance history that predates the adviser's being subject to Rule 204-2.
8. See *J.P. Morgan Investment Management, Inc.*, SEC No-Action Letter (pub. avail. May 7, 1996).
9. See *Great Lakes Advisers, Inc.*, SEC No-Action Letter (pub. avail. Apr. 3, 1992); *Taurus Advisory Group, Inc.*, SEC No-Action Letter (July 15, 1993).
10. See *Jennison Associates LLC*, SEC No-Action Letter (pub. avail. July 6, 2000).
11. *Prudential Insurance Company of America*, SEC No-Action Letter (Mar. 1, 2005).
12. Rule 204A-1(b)(1)-(3).
13. See, e.g. *Mercury Asset Management plc*, SEC No-Action Letter (Apr. 16, 1993).

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