



# PROPOSED RULE MAKING

## CR-102 (August 2017) (Implements RCW 34.05.320) Do NOT use for expedited rule making

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STATE OF WASHINGTON  
FILED

DATE: November 09, 2018

TIME: 12:00 PM

WSR 18-23-017

**Agency:** Department of Financial Institutions

**Original Notice**

**Supplemental Notice to WSR** \_\_\_\_\_

**Continuance of WSR** \_\_\_\_\_

**Preproposal Statement of Inquiry was filed as WSR** 18-07-024 ; or

**Expedited Rule Making--Proposed notice was filed as WSR** \_\_\_\_\_; or

**Proposal is exempt under RCW 34.05.310(4) or 34.05.330(1).**

**Proposal is exempt under RCW** \_\_\_\_\_.

**Title of rule and other identifying information:** (describe subject) The Securities Division proposes to amend the investment adviser rules in Chapter 460-24A WAC. The amendments would update various provisions of the investment adviser rules, including the rules regarding examination and registration requirements, advertising, custody, advisory contracts, performance compensation arrangements, books and records, and unethical business practices. The amendments would add new rule sections or subsections addressing physical and cybersecurity policies and procedures, code of ethics, business continuity and succession plans, and policies and procedures regarding the misuse of material nonpublic information.

**Hearing location(s):**

**Date:**                      **Time:**                      **Location:** (be specific)                      **Comment:**

January 9, 2019	10:00am	Dept. of Financial Institutions 150 Israel Rd SW Tumwater, WA 98501	
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**Date of intended adoption:** January 10, 2019 (Note: This is **NOT** the effective date)

**Submit written comments to:**

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Other:  
By (date) January 8, 2019

**Assistance for persons with disabilities:**

Contact Carolyn Hawkey  
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By (date) January 8, 2019

**Purpose of the proposal and its anticipated effects, including any changes in existing rules:**

The Securities Division proposes to amend the rules in Chapter 460-24A WAC in order to address changes in federal law and updates to NASAA Model Rules, and to implement necessary protections for the investing public who may use the services of investment advisers. The proposed rules would make the following changes:

- Amend the definitions section at WAC 460-24A-005 to alphabetize the section; add definitions for "assignment," "chief compliance officer," and "supervised person"; and revise the definitions of "advertisement," "custody," "CRD," "IARD," "qualified custodian," and "qualifying private fund";
- Revise WAC 460-24A-040 to clarify that additional combinations of terms may be deemed similar to "financial planner" and "investment counselor" for the purposes of RCW 21.20.040(4);
- Revise WAC 460-24A-047, -060, and -205 to specify that certain application materials must be filed by email or through a state electronic filing system to be developed in the future;

- Revise the examination requirements at WAC 460-24A-050 to incorporate FINRA's new Securities Industry Essentials Exam;
- Revise the registration requirements at WAC 460-24A-050 and -205 to require investment advisers to file a complete list of all custodians of the adviser's separately managed accounts;
- Revise the renewal application provisions at WAC 460-24A-057 to specify that the deadline for renewal applications is the deadline set by FINRA;
- Revise the private fund adviser exemption at WAC 460-24A-071 and the venture capital fund adviser exemption at WAC 460-24A-072 to remove a reference to disqualification under Rule 505 and replace it with a reference to disqualification under Rule 506;
- Revise the advertising rule at WAC 460-24A-100 to specify that it applies to written client communications, and to codify Securities Act Interpretive Statement 21;
- Revise the custody requirements at WAC 460-24A-105 to prohibit advisers from making recommendations of independent representatives to clients;
- Revise the additional custody requirements at WAC 460-24A-106 to add additional information to be disclosed on the fee invoice;
- Revise the compliance policies and procedures rule at WAC 460-24A-120 to clarify the role of the chief compliance officer;
- Add a new section at WAC 460-24A-122 regarding policies and procedures to prevent the misuse of material non-public information consistent with federal rules;
- Add a new section at WAC 460-24A-126 to adopt the NASAA Model Rule on Business Continuity and Succession Planning;
- Revise the advisory contracts rule at WAC 460-24A-130 consistent with current agency practices;
- Create a new section at WAC 460-24A-135 to codify Securities Act Policy Statement 21;
- Revise the brochure rule at WAC 460-24A-145 to reflect current SEC rules and guidance;
- Revise the performance fee rule at WAC 460-24A-150 to update the definition of "qualified client" and revise the requirements for the compensation formula;
- Add a new section at WAC 460-24A-190 to remind advisers of the requirement under RCW 74.34.220 to train employees regarding the financial exploitation of vulnerable adults;
- Add a new subsection at WAC 460-24A-200(1)(aa) to require a code of ethics;
- Add a new subsection at WAC 460-24A-200(1)(bb) to require physical and cybersecurity policies and procedures;
- Revise the books and records requirements at WAC 460-24A-200 to require advisers to retain documentation of client authorization for non-discretionary transactions; to require advisers to attempt to update client profile information annually; and to clarify recordkeeping requirements;
- Revise the unethical business practices rule at WAC 460-24A-220 to add additional items;
- Make Plain English updates, such as eliminating the use of the word "shall" in the Chapter; and
- Make additional updates, amendments, and clarifications.

**Reasons supporting proposal:** The proposed amendments should be adopted in order to reflect changes in federal law which impact the state regulation of investment advisers. The amendments will incorporate provisions from updated NASAA Model Rules which will help create uniformity among the states. In addition, the Securities Division believes the amendments should be adopted because they will provide necessary protections for members of the investing public who use the services of investment advisers or invest in pooled investment vehicles managed by investment advisers.

**Statutory authority for adoption:** RCW 21.20.005; RCW 21.20.020; RCW 21.20.030; RCW 21.20.040; RCW 21.20.050; RCW 21.20.060; RCW 21.20.070; RCW 21.20.080; RCW 21.20.090; RCW 21.20.100; RCW 21.20.330; RCW 21.20.340; RCW 21.20.450; RCW 21.20.702

**Statute being implemented:** RCW 21.20

**Is rule necessary because of a:**

- |                         |   |  |
|-------------------------|---|--|
| Federal Law?            | <input checked="" type="checkbox"/> Yes | <input type="checkbox"/> No            |
| Federal Court Decision? | <input type="checkbox"/> Yes            | <input checked="" type="checkbox"/> No |
| State Court Decision?   | <input type="checkbox"/> Yes            | <input checked="" type="checkbox"/> No |

If yes, CITATION:

**Agency comments or recommendations, if any, as to statutory language, implementation, enforcement, and fiscal matters:**

**Name of proponent:** (person or organization) Department of Financial Institutions  Private  
 Public  
 Governmental

**Name of agency personnel responsible for:**

	Name	Office Location	Phone
Drafting:	Jill Vallely	150 Israel Rd SW, Tumwater, WA 98501	(360) 902-8760
Implementation:	Joanne Jones	150 Israel Rd SW, Tumwater, WA 98501	(360) 902-8760
Enforcement:	Bill Beatty, Director, Securities	150 Israel Rd SW, Tumwater, WA 98501	(360) 902-8760

**Is a school district fiscal impact statement required under RCW 28A.305.135?**  Yes  No

If yes, insert statement here:

The public may obtain a copy of the school district fiscal impact statement by contacting:

- Name:
- Address:
- Phone:
- Fax:
- TTY:
- Email:
- Other:

**Is a cost-benefit analysis required under RCW 34.05.328?**

Yes: A preliminary cost-benefit analysis may be obtained by contacting:

- Name:
- Address:
- Phone:
- Fax:
- TTY:
- Email:
- Other:

No: Please explain: The Department of Financial Institutions is not one of the agencies listed in RCW 34.05.328.

**Regulatory Fairness Act Cost Considerations for a Small Business Economic Impact Statement:**

This rule proposal, or portions of the proposal, **may be exempt** from requirements of the Regulatory Fairness Act (see chapter 19.85 RCW). Please check the box for any applicable exemption(s):

This rule proposal, or portions of the proposal, is exempt under RCW 19.85.061 because this rule making is being adopted solely to conform and/or comply with federal statute or regulations. Please cite the specific federal statute or regulation this rule is being adopted to conform or comply with, and describe the consequences to the state if the rule is not adopted.

Citation and description:

This rule proposal, or portions of the proposal, is exempt because the agency has completed the pilot rule process defined by RCW 34.05.313 before filing the notice of this proposed rule.

This rule proposal, or portions of the proposal, is exempt under the provisions of RCW 15.65.570(2) because it was adopted by a referendum.

This rule proposal, or portions of the proposal, is exempt under RCW 19.85.025(3). Check all that apply:

- |   |  |
|---|--|
| <input type="checkbox"/> RCW 34.05.310 (4)(b)<br>(Internal government operations) | <input type="checkbox"/> RCW 34.05.310 (4)(e)<br>(Dictated by statute)   |
| <input type="checkbox"/> RCW 34.05.310 (4)(c)<br>(Incorporation by reference)     | <input type="checkbox"/> RCW 34.05.310 (4)(f)<br>(Set or adjust fees)  |
| <input type="checkbox"/> RCW 34.05.310 (4)(d)<br>(Correct or clarify language)    | <input type="checkbox"/> RCW 34.05.310 (4)(g)<br>((i) Relating to agency hearings; or (ii) process requirements for applying to an agency for a license or permit) |

This rule proposal, or portions of the proposal, is exempt under RCW \_\_\_\_\_.

Explanation of exemptions, if necessary:

**COMPLETE THIS SECTION ONLY IF NO EXEMPTION APPLIES**

If the proposed rule is **not exempt**, does it impose more-than-minor costs (as defined by RCW 19.85.020(2)) on businesses?

No Briefly summarize the agency's analysis showing how costs were calculated. \_\_\_\_\_

Yes Calculations show the rule proposal likely imposes more-than-minor cost to businesses, and a small business economic impact statement is required. Insert statement here:

**Small Business Economic Impact Statement**

Chapter 460-24A WAC  
Investment Advisers

**Introduction**

The Department of Financial Institutions, Securities Division has prepared this Small Business Economic Impact Statement (SBEIS) in support of proposed amendments to the rules pertaining to investment advisers in Chapter 460-24A WAC.

The Securities Division conducts periodic reviews of the investment adviser rules in Chapter 460-24A WAC. Since the Securities Division last amended the rules in 2014, the financial industry and the laws regulating investment advisers have continued to develop. In addition, in the course of our examination, licensing, and enforcement activities, the Securities Division has identified certain rules the revision of which would increase investor protection, reduce the potential for fraud, or enhance the clarity of the rules. Accordingly, the proposed rule amendments incorporate updates to federal law and to NASAA Model Rules. The proposed amendments also codify several interpretive statements and policy statements previously promulgated by the Securities Division. Finally, the proposed amendments revise the rules to reflect the Securities Division's current licensing procedures and practices. We describe the proposed rule amendments in greater detail within this Small Business Economic Impact Statement.

Throughout the rulemaking process, the Securities Division has involved its registered investment advisers, exempt reporting advisers, and noticed filed investment advisers. The Securities Division took into consideration the comments and feedback received, and where appropriate the Securities Division revised the initial draft of the rules. The Securities Division finds that the proposed rule amendments should be adopted in order to better protect the clients and prospective clients of investment advisers in Washington.

### **Procedural Background**

On March 9, 2018, the Washington Securities Division filed a CR-101 Preproposal Statement of Inquiry with the Code Reviser's Office stating that the Division was considering possible amendments to the investment adviser rules in Chapter 460-24A WAC. The Securities Division subsequently prepared a draft of amendments to its investment adviser rules and distributed the draft to interested persons in a mailing on or about June 20, 2018. The Securities Division also posted the draft on its website. At the same time, the Securities Division conducted a survey of state-registered investment advisers, exempt reporting advisers, and notice-filed federal-registered investment advisers to determine the costs associated with the rule amendments.

Following the survey and the distribution of the initial draft, the Securities Division revised the draft amendments in response to feedback received from investment advisers and interested persons. The Securities Division now intends to proceed with the rulemaking to amend WAC 460-24A by formally proposing the draft amendments in a CR-102 filing with the Code Reviser.

### **Summary of Proposed Rule Amendments**

The proposed rule amendments would amend 30 rule sections under WAC 460-24A and create 4 new sections.

The amendments would update the rules to add new definitions; to alphabetize the definitions section; to provide for electronic filing and electronic records storage; to revise the examination requirements to incorporate the new Securities Industry Essentials exam; to require the filing of a list of custodians for separately managed accounts; to revise the advertising rule; to codify Interpretive Statement 21; to expand the information that advisers must disclose on fee invoices; to revise the compliance policies and procedures rule; to create a separate rule section relating to policies and procedures regarding the misuse of nonpublic information; to adopt the NASAA Model Rule Regarding Business Continuity and Succession Planning as a separate rule; to codify Policy Statement 21; to revise the advisory contract rule; to update the definition of "qualified client" consistent with the federal definition; to revise the compensation formula in the performance fee rule; to revise the books and records rule to require updates to client profiles and documentation of client authorization for non-discretionary transactions; to adopt a requirement to maintain a code of ethics; to adopt a requirement to maintain cybersecurity policies and procedures; and make other clarifications, updates, or corrections. Many of these changes would make Washington's rules consistent with current federal law and NASAA Model Rules. We describe the proposed amendments in greater detail below:

#### *Definitions*

The proposed rule amendments would make various updates to the definitions rule at WAC 460-24A-005. First, the proposed amendments alphabetize the definitions section for ease of use. Next, the proposed amendments add definitions for "assignment," "Chief Compliance Officer," and "supervised person" consistent with SEC definitions. Our rules currently use these terms, but we have not previously defined them. In addition, the proposed rules would move the definition of "advertisement" from its current location in WAC 460-24A-100 to the definitions section.

The amendments would revise the definition of “advertisement” to include a business card among the items identified as advertisements. In addition, the amendments would revise the definition of “qualifying private fund” for clarity by incorporating the language from the definition of “private fund” in Section 202(a)(29) of the Investment Advisers Act of 1940 and the definition “qualifying private fund” from SEC Rule 203(m)-1 adopted thereunder. The current definition merely refers to SEC Rule 203(m)-1. Finally, the proposed amendments would make minor clarifications to the definitions of “CRD,” “custody,” “IARD,” and “qualified custodian.”

#### *Terms Deemed Similar to “Financial Planner” and “Investment Counselor”*

The rule amendments would revise WAC 460-24A-040, which sets forth terms deemed similar to “financial planner” and “investment counselor,” in order to add language to clarify that any combination of terms similar to the terms in WAC 460-24A-040 may be deemed similar to “financial planner” and “investment counselor” if such terms are used to imply that the person is in the business of providing investment advisory or financial planning services. The Securities Division proposes this change in order to clarify that the list of similar terms in WAC 460-24A-040 is not exclusive.

#### *Electronic Filing*

The rule amendments would revise WAC 460-24A-047, WAC 460-24A-060, and WAC 460-24A-205 to provide that any application materials or other required documents (such as annual balance sheets) which cannot be filed on IARD must be filed with the Securities Division by email, or through a state electronic filing system to be developed in the future. The Securities Division proposes this change to eliminate paper filings.

#### *Examination Requirements*

The rule amendments would revise the examination requirements in WAC 460-24A-050 in order to incorporate FINRA’s new Securities Industry Essentials (SIE) exam. Persons who satisfy the examination requirements by passing the Series 65 would not need to pass the SIE exam. However, persons who satisfy the examination requirements by passing the Series 7 and the Series 66, would now need to pass the SIE examination in addition to the other two exams. This requirement would not apply if a person is currently registered as an investment adviser or investment adviser representative, or has been registered within the two-year period prior to the date of application.

#### *List of Custodians*

The rule amendments would revise WAC 460-24A-050 and WAC 460-24A-205 in order to require investment advisers who provide supervisory or management services to separately managed accounts to file with the Securities Division a list of *all* custodians that hold their client funds or securities. The Securities Division proposes this amendment as this information may be essential to the Division in the event of an unexpected business disruption of a state-registered investment adviser.

Section 5.K.(3) of Schedule D of Form ADV Part 1A currently requires investment advisers who provide supervisory or management services to separately managed accounts to disclose the custodians who hold 10% or more of the adviser’s aggregate separately managed account regulatory assets under management. Advisers may satisfy the new requirement to provide a list of custodians by disclosing *all* custodians on Schedule D of Form ADV Part 1A (regardless of the percentage of the adviser’s aggregate separately managed account regulatory assets under management held by the custodian), or by separately submitting a complete list of custodians to the Securities Division.

#### *Renewal of Applications*

The proposed rules would revise the renewal provisions in WAC 460-24A-057 to clarify that investment advisers and investment adviser representatives must submit renewal applications on IARD or CRD no later than the renewal application deadline set by FINRA each year. Currently, the rule does not specify a deadline.

#### *Disqualification for Private Fund Adviser and Venture Capital Fund Adviser Exemptions*

The proposed rules amend the private fund adviser exemption at WAC 460-24A-071 and the venture capital fund adviser exemption at WAC 460-24A-072 in order to replace references to the disqualification provisions under WAC 460-44A-505 with references to the disqualification provisions under Regulation D Rule 506. After the U.S. Securities and Exchange Commission repealed Regulation D Rule 505 in 2017, Washington subsequently repealed its corresponding exemption at WAC 460-44A-505. The rule amendments remove this obsolete reference.

#### *Advertising*

The proposed rules would amend the advertising provisions in WAC 460-24A-100 to promote investor protection and to provide guidance to investment advisers regarding advertising and client communications. This rule section identifies certain practices in advertising by investment advisers that constitute fraudulent or misleading practices under RCW 21.20.020. The amendments would clarify that the fraudulent or misleading practices described in the rule are also considered fraudulent or misleading practices in the context of written client communications (even if such communications do not otherwise meet the definition of an advertisement). The amendments would codify Securities Division Interpretive Statement 21 but modify the Interpretive Statement consistent with current SEC guidance regarding the use of past performance information in advertising by investment advisers. The proposed rules would relocate the definition of “Advertisement” from WAC 460-24A-100 to the definitions section at WAC 460-24A-005.

Finally, the amendments would specify that advertisements and written client communications must do the following:

- Contain the full legal name of the adviser;
- Provide a citation for any data or information referenced from outside sources;
- Refrain from including information inconsistent with the information provided on Form ADV or Form U4;
- Refrain from using the acronyms IA, IAR, and RIA unless the terms are defined; and
- Refrain from using senior designations in a manner inconsistent with Chapter 460-25A WAC.

#### *Custody*

The proposed rules would amend WAC 460-24A-105, which specifies the requirements for investment advisers who have custody. WAC 460-24A-105 contains a provision that states that a client may designate an independent representative to receive the client’s account statements for him or her. Due to potential conflicts of interest, the proposed rules state that an investment adviser may not recommend a person to serve as an independent representative for a client.

#### *Additional Custody Requirements*

The proposed rules would amend WAC 460-24A-106, which establishes additional custody requirements for investment advisers who directly deduct fees from client accounts. The Securities Division proposes to amend this rule in order ensure that essential information is provided to investors regarding fees.

The proposed amendments would require the client fee invoice to include the following additional information:

- The fee calculation;

- The name(s) of the custodian; and
- For advisers who charge performance fees:
  - The client’s cumulative net investment gain or loss; and
  - The amount of cumulative net investment gain above which the adviser will receive performance compensation (high-water mark).

*Compliance Policies and Procedures*

The proposed rules would amend the compliance policies and procedures rule at WAC 460-24A-120 in order to clarify the role of the Chief Compliance Officer. Currently, WAC 460-24A-120(3) states that Chief Compliance Officer must administer the compliance policies and procedures required to be adopted pursuant to WAC 460-24A-120(1). The amendments would clarify that the Chief Compliance Officer must also administer the adviser’s policies and procedures adopted with respect to material nonpublic information pursuant to WAC 460-24A-122; proxy voting pursuant to WAC 460-24A-125; business continuity and succession plans pursuant to WAC 460-24A-126; supervision pursuant to WAC 460-24A-200(1)(t); code of ethics pursuant to WAC 460-24A-200(1)(aa); and physical and cybersecurity pursuant to WAC 460-24A-200(1)(bb).

*Material Non-Public Information Policies and Procedures*

The proposed rules would create a new section, WAC 460-24A-122, which would require investment advisers to adopt written policies and procedures designed to prevent the misuse of material non-public information by the investment adviser or any associated person of the adviser. Currently, WAC 460-24A-220(17) states that it is an unethical practice for an adviser to fail to establish, maintain, or enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information contrary to the provisions of Section 204A of the Investment Adviser’s Act of 1940. The creation of a separate rule would highlight the existing requirement and more closely mirror the federal requirement.

*Business Continuity and Succession Plan*

The proposed rules would create a new section, WAC 460-24A-126, which would require investment advisers to adopt a written business continuity and succession plan. Currently, the recordkeeping rule at WAC 460-24A-(1)(y) requires an adviser to keep records relating to a business continuity plan. The new rule conforms to the NASAA Model Rule on Business Continuity and Succession Planning adopted by NASAA in 2015.

*Advisory Contracts*

The proposed rules would revise the investment advisory contract rule at WAC 460-24A-130 in order to make clarifications and to reflect the standards applied by our licensing unit during its review of advisory contracts. The proposed rules specify that an adviser must have a written advisory agreement with each client, and the agreement must include the full legal name of the investment adviser. In addition, the proposed rules add that the advisory contract must include the following statements:

- The adviser may not assign a contract through implied or negative consent;
- The adviser will deliver the brochure 48 hours before the client signs the advisory agreement, or alternately provide that the client has a right to terminate the contract within 5 business days;
- The adviser must obtain the consent of the client to revise material terms of the contract;
- The adviser owes the client a fiduciary duty; and if the investment adviser manages a pooled investment vehicle, each investor in the pooled investment vehicle is a client; and
- The contract may not waive the adviser’s compliance with any rule adopted under the Securities Act of Washington.



## *Dissemination of Advisory Fee Billing Information for Advisers Who do Not Directly Deduct Fees*

The proposed rules would create a new section, WAC 460-24A-135, which codifies Securities Act Policy Statement 21. This Policy Statement specifies that advisers who do not directly deduct fees (and are therefore not subject to the fee invoice requirements in WAC 460-24A-106) must deliver written billing information to clients. The rule clarifies that fee invoices that comply with WAC 460-24A-106 would satisfy the requirement for written billing information. The proposed rule modifies Policy Statement 21 slightly by requiring additional information to be disclosed on the fee invoice consistent with information required by the proposed amendments to WAC 460-24A-106.

### *Brochure Rule*

The proposed rules would amend the investment adviser brochure rule at WAC 460-24A-145 to reflect current SEC rules and guidance. Consistent with SEC Rule 204-3(b)(4), the amendments address when the adviser must provide other-than-annual delivery of the brochure. The amendments further specify that if the adviser delivers the brochure by means of a passive delivery system, such as a website or portal, the adviser must notify clients by email when the brochure becomes available on the system.

### *Performance Compensation Arrangements*

The proposed rules would amend the performance fee rule at WAC 460-24A-150. Consistent with the current federal definition of “qualified client,” the proposed amendments update the definition to raise the net worth requirement for a natural person from \$2 million to \$2.1 million.

In addition, in the interest of investor protection, the proposed amendments would revise the provisions at WAC 460-24A-150(3) concerning the performance compensation formula as follows:

- The amendments remove the requirement that prohibited the adviser from calculating performance fees for a period of less than one year. The amendments substitute a requirement that the adviser not calculate the fee more frequently than once per quarter.
- The amendments add a statement to the effect that when a client invests mid-period in a pooled investment vehicle managed by the adviser, the adviser may apply the compensation formula to that client for the partial period; and
- The amendments add a requirement for a high-water mark.

### *Books and Records*

The rulemaking would amend the books and records rule at WAC 460-24A-200 as follows:

- Remove the requirement that the adviser retain “original” records of written client communications and instead specify that the adviser must retain “physical or electronic” records;
- Add a requirement that the adviser retain documentation of the client’s authorization for each non-discretionary transaction;
- Specify the type of client profile information the adviser must maintain in order to determine suitability, and state that the adviser must make a reasonable effort to update this information annually;
- Specify that the adviser retain written fee billing information and a written record of the services provided to clients during the billing period;
- Clarify that the adviser must provide state examiners access to electronic records and data;
- Add a requirement to maintain a code of ethics (discussed below); and
- Add a requirement to maintain physical and cybersecurity policies and procedures (discussed below).

### *Code of Ethics*

The proposed rules would create a new subsection at WAC 460-24A-200(1)(aa) which would require investment advisers to adopt a written code of ethics that establishes standards of business conduct which reflect the fiduciary obligations of the investment adviser and its supervised persons. This requirement promotes investor protection and is consistent with the code of ethics required of federal advisers at SEC Rule 204A-1.

### *Physical and Cybersecurity Policies and Procedures*

The proposed rules would create a new subsection at WAC 460-24A-200(1)(bb) to require investment advisers to maintain written cybersecurity policies and procedures that are reasonably designed to ensure the security and integrity of the adviser's physical and electronic records. Currently, all investment advisers must maintain compliance policies and procedures pursuant to WAC 460-24A-120, and must maintain policies and procedures regarding misuse of material nonpublic information pursuant to WAC 460-24A-220(17). Advisers also owe a fiduciary duty to clients. The creation of a separate rule for physical and cybersecurity policies in the recordkeeping rule would highlight the need for advisers to address cybersecurity in the conduct of their advisory business.

### *Additional Provisions*

In addition to the changes discussed above, the rulemaking would:

- Revise the unethical business practices in WAC 460-24A-220 to add that it is an unethical practice to access a client's account using the client's own unique identifying information (such as username and password);
- Revise the unethical business practices in WAC 460-24A-220 to add that it is an unethical practice to fail to provide advisory fee billing information pursuant to the proposed new requirement in WAC 460-24A-135;
- Revise the unethical business practices in WAC 460-24A-220 to add that it is an unethical business practice to fail to establish, maintain, and enforce policies and procedures pursuant to WAC 460-24A-120, WAC 460-24A-122, WAC 460-24A-125, WAC 460-24A-126, WAC 460-24A-200(1)(t), WAC 460-24A-200(1)(aa), and WAC 460-24A-200(1)(bb);
- Add a new section at WAC 460-24A-190 to remind advisers of the existing requirement under RCW 74.34.220 to provide training to employees concerning financial exploitation of vulnerable adults. In addition, the rulemaking would add a corresponding unethical business practice to WAC 460-24A-220 for failure to provide this training;
- Revise Chapter 460-24A WAC to make Plain English changes and promote clarity and uniformity. For instance, the amendments eliminate the use of "shall" in the rules. The amendments also revise the rules to use consistent terminology throughout and to use active voice when feasible; and
- Make additional updates, amendments, and clarifications.

### **Need for Economic Impact Statement**

RCW 19.85.030 provides that an agency must prepare a small business economic impact statement if the agency proposes rules that would impose more than minor costs on businesses in an industry. RCW 19.85.020 defines a "minor cost" as a cost per business that is less than three-tenths of one percent of annual revenue or income, or

one hundred dollars, whatever is greater; or one percent of annual payroll. The Securities Division determined that a small business economic impact may be required for this rulemaking.

### **Survey of Investment Advisers**

In order to gather the information to prepare a Small Business Economic Impact Statement, RCW 19.85.040 provides that an agency may survey a representative sample of affected businesses to assist in the accurate assessment of the costs of a proposed rule. To that end, the Securities Division prepared a Small Business Economic Impact Survey to survey its state registered investment advisers, exempt reporting advisers, and a representative sample of federal registered advisers that are notice filed in the state of Washington.

At the time of the survey, the Securities Division had 754 state registered investment advisers, 41 exempt reporting advisers, and 1,952 federal registered notice-filed advisers. In general, investment advisers doing business in Washington with assets under management of less than \$100 million must register with the state. Investment advisers in Washington with assets under management of \$100 million or more must register with the SEC and make a notice filing with the Securities Division. Investment advisers that are exempt pursuant to WAC 460-24A-071 or WAC 460-24A-072 must file as exempt reporting advisers.

The Securities Division prepared an online survey designed to determine the economic impact of the proposed amendments on small businesses. On or about June 20, 2018, the Securities Division sent an e-mail containing a link to the online survey to all Washington-registered investment advisers, all exempt reporting advisers filed in Washington, and approximately 10% of the federal-registered investment advisers notice filed in Washington. The Securities Division selected the 10% sample of notice-filed advisers by focusing on advisers who had a place of business in Washington and an email address available on IARD. If a state-registered investment adviser did not have an email address available on IARD, the Securities Division sent a letter by regular mail. Both the letter and the emails explained the reasons for conducting the survey, requested that recipients complete the survey by following the link provided, and provided a link to the draft rule amendments.

The online survey consisted of 22 questions. Each question in the survey focused on a proposed rule amendment and provided a background statement briefly explaining the amendment. The survey asked whether proposed changes to a rule section would cause increased costs. The survey then requested information on the additional costs of complying with each rule change in the categories of professional services, equipment, supplies, labor, and administrative costs. Each question also allowed a free-form response for survey takers to explain any additional costs. The survey also gathered data on the number of employees each investment adviser had, and questioned whether the rulemaking as a whole would cause a loss of revenue or the loss or addition of any jobs.

The survey period lasted from June 20, 2018 until July 15, 2018. The Securities Division received 107 unique responses, although some respondents did not complete all of the questions in the survey. The Securities Division received responses or partial responses from 94 state registered investment advisers, 1 exempt reporting adviser, and 12 federal registered advisers notice filed in Washington. All the respondents are small businesses as defined by RCW 19.85.020(3) of the Regulatory Fairness Act because each respondent has less than 50 employees. We discuss the results of the survey below.

### **REQUIRED ELEMENTS OF SMALL BUSINESS ECONOMIC IMPACT STATEMENT**

**A brief description of the reporting, record keeping, and other compliance requirements of the proposed rules and of the kinds of professional services that a small business is likely to need in order to comply with the requirements. An analysis of the costs of compliance for identified industries, including costs of equipment, supplies, and increased administrative costs.**

The proposed rule amendments would make a variety of changes to the existing investment adviser rules, some of which would create new recordkeeping, reporting, or compliance requirements for licensees. Registered investment advisers already maintain certain records required of investment advisers under WAC 460-24A-200. As they do currently, investment advisers registered in Washington would need to demonstrate compliance with the amended rules by providing required records during periodic examinations of the investment adviser by the Securities Division.

The rulemaking creates certain new recordkeeping and compliance requirements. Compliance with the proposed rules would require the following: revising and executing advisory contracts to meet new requirements; drafting and adopting cybersecurity policies and procedures; drafting and adopting a code of ethics; revising compliance policies and procedures; revising fee invoices (if applicable); reviewing advertising for compliance; revising business continuity plans; maintaining written documentation of client authorization for non-discretionary transactions; and making a reasonable attempt to update client profiles annually.

As a result of the rule amendments, investment advisers may incur expenses relating to the need to review existing procedures, documents, and agreements to ensure compliance with the new rules. Though not required to do so by the proposed rules, investment advisers may choose to hire professionals to assist them in complying with the new rules. Investment advisers may hire legal or other professionals to create or revise advisory agreements, cybersecurity policies and procedures, a code of ethics, compliance policies and procedures, fee invoices, and other documents and agreements used in the investment adviser’s business. Investment advisers may also consult professionals for advice on establishing systems or methods to ensure compliance, particularly with respect to cybersecurity. Investment advisers may need to establish new procedures with respect to updating client profile information and documenting client authorization for non-discretionary transactions.

In addition, the proposed rulemaking may have an economic impact on investment advisers in the form of increased equipment, supplies, labor, and administrative costs. These costs may relate to postage and other mailing costs, copying expenses, computer or software expenses, and expenses associated with recordkeeping and record retention. The rulemaking may cause investment advisers to hire additional employees or outside consultants to ensure compliance, or to devote additional employee time to compliance tasks that otherwise would have been spent on non-compliance matters.

The Securities Division surveyed investment advisers to determine if the new requirements would add costs to their business, and if so, how much. The survey provided a summary of the rule changes by section, and asked first whether the proposed changes to each section would create any additional costs for the investment adviser. The following chart provides the responses from the survey question regarding whether compliance with the proposed changes to each rule section would create any additional costs.

<b>Whether Rule Changes Would Create Additional Costs</b>		
<b><u>Rule Provision</u></b>	<b><u>Yes</u></b>	<b><u>No</u></b>
<b>Electronic Filing:</b> WAC 460-24A-047, -060, -205	18%	81%
<b>Examination Requirements:</b> WAC 460-24A-050	5%	95%
<b>List of Custodians:</b> WAC 460-24A-050, -205	16%	86%
<b>Advertising:</b> WAC 460-24A-100	27%	73%
<b>Custody Requirements:</b> WAC 460-24A-105	3%	97%

<b>Additional Custody Requirements:</b> WAC 460-24A-106	25%	75%
<b>Compliance Policies and Procedures:</b> WAC 460-24A-120	20%	80%
<b>Material Non-Public Information:</b> WAC 460-24A-122	18%	82%
<b>Business Continuity and Succession:</b> WAC 460-24A-126	35%	65%
<b>Advisory Contracts:</b> WAC 460-24A-130	25%	75%
<b>Advisory Fee Billing Information:</b> WAC 460-24A-135	9%	91%
<b>Brochure Rule:</b> WAC 460-24A-145	14%	86%
<b>Performance Compensation:</b> WAC 460-24A-150	4%	96%
<b>Books and Records:</b> WAC 460-24A-200	38%	62%
<b>Code of Ethics:</b> WAC 460-24A-200(1)(aa)	22%	78%
<b>Cybersecurity:</b> WAC 460-24A-200(1)(bb)	33%	67%

Where the survey takers indicated that the rule changes in a particular section would create additional costs, the survey requested information regarding the amount of increased costs of professional services, equipment, supplies, labor, and administrative costs attributable to each section of the rules. Each survey taker provided information regarding its number of employees, which allowed the Securities Division to calculate the average cost per employee for each investment adviser. These costs per employee were then averaged together.

The following chart provides the average cost increase per employee for each rule change for *all* survey respondents.

<b>Average Cost Increase (All Respondents)</b>					
<b>Rule Provision</b>	<b>Prof'l Services</b>	<b>Equipment</b>	<b>Supplies</b>	<b>Labor</b>	<b>Admin</b>
<b>Electronic Filing:</b> WAC 460-24A-047, -060, -205					
	\$325.10	\$167.71	\$45.00	\$447.67	\$97.79
<b>Examination Requirements:</b> WAC 460-24A-050					
	\$24.18	\$ -	\$1.37	\$17.86	\$7.69
<b>List of Custodians:</b> WAC 460-24A-050, -205					
	\$76.85	\$ -	\$2.17	\$39.33	\$56.92
<b>Advertising:</b> WAC 460-24A-100					
	\$278.24	\$ -	\$1.12	\$84.14	\$136.34
<b>Custody Requirements:</b> WAC 460-24A-105					
	\$23.42	\$ -	\$1.16	\$14.45	\$0.83

<b>Additional Custody Requirements:</b>					
<b>WAC 460-24A-106</b>					
	\$309.17	\$ -	\$8.99	\$91.92	\$255.51
<b>Compliance Policies and Procedures:</b>					
<b>WAC 460-24A-120</b>					
	\$148.91	\$ -	\$ -	\$55.00	\$19.74
<b>Material Non-Public Information:</b>					
<b>WAC 460-24A-122</b>					
	\$67.50	\$ -	\$0.06	\$14.80	\$75.09
<b>Business Continuity and Succession:</b>					
<b>WAC 460-24A-126</b>					
	\$226.85	\$11.63	\$5.81	\$140.76	\$56.30
<b>Advisory Contract:</b>					
<b>WAC 460-24A-130</b>					
	\$187.60	\$ -	\$1.00	\$101.42	\$103.14
<b>Advisory Fee Billing Information:</b>					
<b>WAC 460-24A-135</b>					
	\$6.29	\$ -	\$ -	\$3.65	\$32.06
<b>Brochure Rule:</b>					
<b>WAC 460-24A-145</b>					
	\$21.48	\$ -	\$ -	\$20.63	\$35.85
<b>Performance Compensation:</b>					
<b>WAC 460-24A-150</b>					
	\$5.88	\$ -	\$ -	\$ -	\$ -
<b>Books and Records:</b>					
<b>WAC 460-24A-200</b>					
	\$343.95	\$ -	\$1.79	\$280.28	\$224.02
<b>Code of Ethics:</b>					
<b>WAC 460-24A-200(1)(aa)</b>					
	\$67.73	\$ -	\$ -	\$45.93	\$64.83
<b>Cybersecurity:</b>					
<b>WAC 460-24A-200(1)(bb)</b>					
	\$143.20	\$58.62	\$ -	\$107.89	\$104.50

The following chart provides the average cost increase per employee only for those investment advisers who indicated that a particular rule change would create additional costs.

<b>Average Additional Costs (Respondents With Increased Costs Only)</b>					
<b>Rule Provision</b>	<b>Prof'l Services</b>	<b>Equipment</b>	<b>Supplies</b>	<b>Labor</b>	<b>Admin</b>
<b>Electronic Filing:</b>					
<b>WAC 460-24A-047, -060, -205</b>					
	\$1,835.35	\$4,025.00	\$1,440.00	\$2,685.08	\$670.58
<b>Examination Requirements:</b>					
<b>WAC 460-24A-050</b>					
	\$1,100.00	\$ -	\$125.00	\$812.50	\$350.00
<b>List of Custodians:</b>					
<b>WAC 460-24A-050, -205</b>					
	\$785.56	\$ -	\$100.00	\$301.55	\$56.92

<b>Advertising:</b>					
<b>WAC 460-24A-100</b>					
	\$1,650.87	\$ -	\$100.00	\$680.79	\$1,011.20
<b>Custody Requirements:</b>					
<b>WAC 460-24A-105</b>					
	\$402.86	\$ -	\$100.00	\$414.29	\$35.71
<b>Additional Custody Requirements:</b>					
<b>WAC 460-24A-106</b>					
	\$1,965.41	\$ -	\$800.00	\$818.07	\$2,067.27
<b>Material Non-Public Information:</b>					
<b>WAC 460-24A-122</b>					
	\$494.98	\$ -	\$5.00	\$325.63	\$600.73
<b>Compliance Policies and Procedures:</b>					
<b>WAC 460-24A-120</b>					
	\$1,042.36	\$ -	\$ -	\$770.00	\$331.67
<b>Business Continuity and Succession:</b>					
<b>WAC 460-24A-126</b>					
	\$975.44	\$1,000.00	\$500.00	\$756.56	\$484.17
<b>Advisory Contract:</b>					
<b>WAC 460-24A-130</b>					
	\$1,138.98	\$ -	\$42.50	\$783.70	\$1,252.38
<b>Advisory Fee Billing Information:</b>					
<b>WAC 460-24A-135</b>					
	\$133.75	\$ -	\$ -	\$155.00	\$681.25
<b>Brochure Rule:</b>					
<b>WAC 460-24A-145</b>					
	\$307.94	\$ -	\$ -	\$295.71	\$440.48
<b>Performance Compensation:</b>					
<b>WAC 460-24A-150</b>					
	\$500.00	\$ -	\$ -	\$ -	\$ -
<b>Books and Records:</b>					
<b>WAC 460-24A-200</b>					
	\$1,605.08	\$ -	\$50.00	\$1,307.98	\$1,254.52
<b>Code of Ethics:</b>					
<b>WAC 460-24A-200(1)(aa)</b>					
	\$582.50	\$ -	\$ -	\$564.29	\$619.44
<b>Cybersecurity:</b>					
<b>WAC 460-24A-200(1)(bb)</b>					
	\$778.65	\$1,020.00	\$ -	\$722.05	\$699.36

*Analysis of Increased Costs*

The survey results indicated that certain rule changes would create greater costs than others. These were the rule amendments regarding electronic filing, examination requirements, advertising, additional custody requirements, compliance policies and procedures, business continuity plans, advisory contracts, books and records, cybersecurity policies and procedures, and code of ethics. We describe the survey results in further detail below.

*Electronic Filing – WAC 460-24A-047, -060, -205*

The survey results indicated that approximately 18% of survey respondents believed that the proposed amendments to WAC 460-24A-047, WAC 460-24A-060, and WAC 460-24A-205 to require the electronic filing of certain documents would increase costs. These costs would include an average of \$325.01 per employee for professional services, \$167.71 for equipment, \$447.67 for labor, and \$97.79 for administrative costs. Of the 18% of survey respondents who indicated that the rule amendments would increase costs, those costs include an average cost increase per employee of \$1,835.35 for professional services, \$4,025.00 for equipment, \$1,440.00 for supplies, \$2,685.08 for labor, and \$670.58 for increased administrative costs.

The proposed amendments specify that if an adviser cannot file a required document electronically through IARD or CRD, the adviser must file it with the Securities Division by email or through a state electronic filing system to be deployed in the future. The Securities Division proposed these rule changes in order to eliminate paper filings. The Securities Division currently accepts the filing of supplemental materials by email, and the proposed rule amendments merely formalize the practice. In our experience, most filers prefer to submit documents in electronic format rather than by postal mail.

In addition, we believe paper filings are inefficient both for filers and for the Securities Division in terms of the expenses related to mailing, copying, and scanning physical documents. To that end, the Securities Division is currently developing an online filing system for the submission of annual financial statements. The proposed rule amendments would enable the Securities Division to require online filings through the system when it is operational. The Securities Division would not charge a fee to make filings through the online system. However, investment advisers may expend time learning how to navigate a new online filing system and updating their internal procedures.

To the Securities Division's surprise, advisers anticipated relatively high cost increases as a result of the proposed rule amendments. We found this especially surprising because investment advisers already file most application materials (such as Form ADV) electronically through IARD. The survey question regarding the electronic filing amendment was the first substantive question of the survey. Based on the free-form answer responses for this question, it appears that several respondents provided comments related to other rule subsections. For instance, several comments in response to this question expressed concern regarding the cost of complying with the new requirement for cybersecurity policies and procedures. In addition, several comments referred to the expense of hiring compliance consultants. While advisers may retain compliance consultants to implement certain of the proposed rule amendments, we do not believe the need for a compliance consultant reasonably relates to the electronic filing provisions. Therefore, we conclude that some survey respondents may have provided in response to this question information regarding the economic impact of the rulemaking as a whole. The Securities Division reasonably believes that the proposed amendments to facilitate electronic filing would not significantly increase expenses for advisers. Rather, we anticipate that advisers may save costs in postage, office supplies, and administrative time.

#### *Advertising – WAC 460-24A-100*

The survey results indicated that approximately 27% of the survey respondents believed that the proposed amendments to the advertising rule at WAC 460-24A-100 would result in increased expenses. These expenses would include an average of \$278.24 per employee for professional services, \$84.14 per employee for labor, and \$136.34 per employee for increased administrative expenses. Of the 27% of who anticipated that the amendments would increase costs, those costs included an average per employee of \$1,650.87 for professional services, \$680.79 for labor, and \$1,011.20 for administrative costs.

As a result of the amendments to WAC 460-24A-100, advisers may incur expenses associated with reviewing and revising existing advertising materials, revising compliance manuals regarding advertising practices and



procedures, and training employees regarding policies relating to advertising and written client communications. While not required, advisers may enlist the services of outside compliance consultants to complete these tasks.

Survey respondents generally expressed concern about the application of the advertising rule to written client communications such as emails. They opined that the amount of disclosure required was excessive and would result in additional time spent on compliance. Specifically, survey respondents indicated that it would be burdensome to require the adviser to provide citations to outside sources referenced in client emails. They also expressed concern that the rule might apply to account statements provided by the custodian. Survey respondents also commented that the amendments as drafted appeared to prohibit the provision of a client's personal performance results on a quarterly basis without extensive disclosures. We speculate that the uncertainty survey respondents expressed regarding the application of the rule amendments likely influenced their view that the amendments would tend to increase costs.

#### *Additional Custody Requirements for Advisers Who Deduct Fees – WAC 460-24A-106*

The proposed amendments would revise WAC 460-24A-106 to require the disclosure of additional information on the client fee invoice, including the fee calculation, the name of the custodians, and information pertinent to the calculation of performance fees. According to the survey, 25% of respondents believed that proposed amendments to the additional custody requirements at WAC 460-24A-106 for advisers who directly deduct fees would increase costs. The survey found that there would be an average cost increase for all respondents of \$309.17 per employee for professional services, \$91.92 per employee for labor, and \$255.51 per employee in increased administrative costs. For the 25% of survey respondents who expected an increase in costs, the costs per employee included \$1,965.41 for professional services, \$800.00 for supplies, \$818.07 for labor, and \$2,067.27 in increased administrative costs.

In order to comply with the rule amendments, advisers may incur expenses to engage outside service providers to revise their fee invoices, to modify software, to purchase additional software licenses, and to conduct administrative tasks related to the proposed fee invoice requirements. Survey respondents indicated that the proposed rule change would necessitate working with software vendors and/or custodians to provide compliant fee invoices, and paying the associated fees for such professional services. Several respondents indicated that their current software does not allow the addition of the names of the custodian, and questioned how to comply with the proposed requirements.

#### *Compliance Procedures and Policies – WAC 460-24A-120*

The survey results indicated that approximately 20% of survey respondents believed that the amendments to compliance policies and procedures rule at WAC 460-24A-120 would result in increased expenses. The survey found that the average cost increases included \$148.91 per employee for professional services, \$55.00 per employee for labor, and \$19.74 per employee in increased administrative costs. For the 20% of survey respondents who anticipated that the new rule would create additional costs, there was an average increase of \$1,042.36 per employee for professional services, \$770.00 per employee for labor, and \$331.67 per employee in increased administrative costs per employee.

In order to comply with the proposed rule amendments, investment advisers may incur labor and administrative expenses as a result of reviewing and revising their compliance policies and procedures. In addition, advisers may incur costs if they retain professional service providers to update their policies. Advisers may also incur expenses by providing training to employees regarding their revised policies, or by updating their compliance manuals or internal procedures.

#### *Material Nonpublic Information Policies and Procedures – WAC 460-24A-122*

The survey results indicated that approximately 18% of survey respondents believed that the adoption of a new section at WAC 460-24A-122 would result in increased expenses. The new section would require investment advisers to adopt written policies and procedures designed to prevent the misuse of material non-public information by the investment adviser or any associated person of the adviser. The survey found that the average cost increases included \$65.20 per employee in professional services, \$14.80 per employee in labor, and \$74.01 in increased administrative costs per employee. For the 18% of survey respondents who expected that the new rule would create additional costs, those costs included an average cost increase of \$498.98 for professional services, \$325.63 for labor, and \$600.73 in increased administrative costs per employee.

Though the rulemaking would create a new section addressing the requirement for policies and procedures regarding the misuse of material nonpublic information, advisers effectively must meet this requirement now. Currently, WAC 460-24A-220(17) states that it is an unethical practice for an adviser to fail to establish, maintain, or enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information contrary to the provisions of Section 204A of the Investment Adviser's Act of 1940. In the view of the Securities Division, the new rule would not change the substance of this existing requirement. Regardless, as a result of the rulemaking, advisers may elect to undertake a review of their existing policies and procedures to ensure compliance. Advisers may choose to use the professional services of attorneys or consultants to complete this task. Advisers may also determine that it is necessary to train employees regarding compliance with these policies and procedures, thereby incurring additional labor and administrative expenses.

#### *Business Continuity and Succession Plan – WAC 460-24A-126*

The proposed rules create a new section at WAC 460-24A-126 that adopts the NASAA Model Rule on Business Continuity and Succession Planning. The survey results indicated that approximately 20% of survey respondents believed that the adoption of WAC 460-24A-126 would result in increased expenses. The survey found that the average cost increases included \$226.85 per employee for professional services, \$140.76 per employee for labor, and \$56.30 per employee in increased administrative costs. For the 20% of survey respondents who indicated that the new rule would create additional costs, there was an average increase of \$975.44 per employee for professional services, \$1,000 per employee for equipment, \$500.00 per employee for supplies, \$756.56 per employee for labor, and \$487.17 per employee in increased administrative costs.

Currently, the recordkeeping rule at WAC 460-24A-(1)(y) requires an adviser to keep records relating to a business continuity plan, but this existing rule provides little guidance regarding the contents of the business continuity plan. Advisers would need to conduct a review of their existing business continuity and succession plans in order to ensure compliance with the provisions of the NASAA Model Rule on Business Continuity and Succession Planning. Advisers may need to update their business continuity plans, and may elect to hire attorneys or consultants to assist with this. However, we anticipate that many advisers already have a business continuity plan that satisfies the requirements of the proposed rule.

#### *Advisory Contracts – WAC 460-24A-130*

The survey results indicated that 25% of survey respondents believed that the proposed amendments to the advisory contract rule at WAC 460-24A-130 would increase expenses. The survey found that the average cost increases included \$187.60 per employee for professional services, \$101.42 per employee for labor, and \$103.14 per employee in increased administrative expenses. Of the 25% of survey respondents who anticipated that the rule amendments would increase their costs, those costs included an average cost increase of \$1,138.98 per employee for professional services, \$783.70 per employee for labor, and \$1,252.38 per employee in increased administrative expenses.

Advisers may choose to use the professional services of an attorney or consultant to ensure that their advisory contracts comply with the rule. There may also be administrative, copying, and recordkeeping expenses associated with any revision to advisory contracts. However, we note that the majority of the proposed amendments to WAC 460-24A-130 merely formalize the requirements the Securities Division routinely imposes on advisory contracts during the investment adviser licensing process. Therefore, the advisory contracts of most Washington-registered advisers currently meet these requirements. In addition, we note that the amendments would only apply to new or amended contracts entered into by the adviser after the date of the rule adoption.

#### *Books and Records – WAC 460-24A-200*

The survey results indicated that 38% of the survey respondents believed that the revisions to the books and records rule at WAC 460-24A-200 would increase costs. This survey question did not include the proposed subsections of WAC 460-24A-200 regarding cybersecurity policies and procedures or code of ethics, as we surveyed those provisions separately. The survey indicated that the expenses associated with the amendments to WAC 460-24A-200 would include an average of \$343.94 per employee for professional services, \$280.28 per employee for labor, and \$224.02 per employee for administrative costs. Of the 38% of survey respondents who indicated the rule changes would increase their costs, the average cost increases per employee were \$1,605.08 for professional services, \$1,307.98 for labor, and \$1,254.52 for increased administrative costs.

The proposed amendments to the books and records rule would increase the number of records that investment advisers must keep. As a result, advisers may incur additional expenses related to record retention. Advisers may need to devote additional employee time to managing and storing these additional records. Advisers may also incur expenses in developing new recordkeeping procedures and practices with respect to client profile information and client authorization for non-discretionary transactions. Advisers may also incur expenses if they elect to revise their compliance policies to reflect new recordkeeping procedures. However, we note that many investment advisers currently maintain the records that satisfy the proposed amendments.

#### *Code of Ethics – WAC 460-24A-200(1)(aa)*

The rulemaking would add a new provision at WAC 460-24A-200(1)(aa) to require investment advisers to adopt a written code of ethics that establishes standards of business conduct which reflect the fiduciary obligations of the investment adviser and its supervised persons. The survey results indicated that approximately 22% of survey respondents believed that the adoption of code of ethics requirement would result in increased expenses. The survey found that the average cost increases included \$66.95 per employee for professional services, \$45.40 per employee for labor, and \$64.08 per employee in increased administrative costs. For the 20% of survey respondents who indicated that the new rule would create additional costs, those costs included an average cost increase of \$582.50 per employee for professional services, \$564.20 per employee for labor, and \$619.44 per employee in increased administrative expenses.

Adopting a code of ethics requirement promotes investor protection and uniformity with SEC Rule 204A-1. While some state-registered advisers already maintain a code of ethics, we anticipate that most state-registered advisers would adopt one for the first time as a result of the rulemaking. Currently, state advisers must review transactions of their supervised persons pursuant to WAC 460-24A-200(1)(l) and (m). These existing recordkeeping requirements resemble many of the requirements of SEC Rule 204A-1. However, we note that a code of ethics must contain provisions governing adviser conduct. As a result, advisers would likely incur expenses in the drafting and implementation of the code of ethics. Advisers may elect to retain professional service providers to create the code of ethics. Advisers may also incur expenses relating to recordkeeping requirements, the training of employees, and the revision of existing compliance policies and procedures.

#### *Cybersecurity Policies and Procedures – WAC 460-24A-200(1)(bb)*

The rulemaking would add a new provision at WAC 460-24A-200(1)(bb) to require investment advisers to adopt policies and procedures regarding physical and cybersecurity. The survey results indicated that approximately 33% of survey respondents believed that the requirement for cybersecurity policies and procedures would result in increased expenses. The survey found that the average cost increases included \$143.20 per employee for professional services, \$58.62 per employee for equipment, \$107.89 per employee for labor, and \$104.50 per employee in increased administrative costs. For the 33% of survey respondents who indicated that the new requirement would create additional costs, there was an average increase of \$778.65 per employee for professional services, \$1,020.00 per employee for equipment, \$722.05 per employee for labor, and \$699.36 per employee in increased administrative costs.

Advisers must maintain physical and cybersecurity of client records, data, and sensitive personal information in order to fulfill their fiduciary duties to clients. Advisers are currently subject to WAC 460-24A-220(17), which states that it is an unethical practice to fail to maintain, establish, and enforce policies and procedures designed to prevent the misuse of material nonpublic information. In addition, pursuant to WAC 460-24A-120, advisers must maintain compliance policies and procedures to prevent the violation of securities laws. For these reasons, most advisers in Washington have implemented at least some cybersecurity protections and procedures. In addition, some advisers may have established policies relating to cybersecurity.

Advisers who do not have formal cybersecurity policies and procedures would likely incur expenses in order to comply with the new requirement. In order to comply, advisers may engage outside cybersecurity experts or IT consultants to assist them in implementing and maintaining reasonable cybersecurity measures. Advisers would likely need to assess the cybersecurity risks specific to the adviser's business. Advisers may need to purchase additional equipment, such as secure hard drives, encryption software, and the like, in order to implement security measures. Advisers may need to subscribe to services that provide electronic file backup, anti-virus programs, or a security alarm system. Advisers may incur expenses in training employees regarding cybersecurity practices. Advisers may also incur expenses in providing training on the use of newly acquired software, hardware, or subscription services. Finally, advisers may incur expenses if they choose to hire attorneys or compliance consultants to assist in the drafting of cybersecurity policies and procedures.

#### **Whether compliance with the proposed rule will cause businesses to lose sales or revenue.**

The proposed rules may result in investment advisers losing sales or revenue. The Securities Division's survey revealed that 17% of respondents believed that compliance with the rule changes would result in lost sales or revenue. In contrast, 83% of respondents did not believe the rule changes would cause lost sales or revenue. The 17% who believed the changes would lead to lost sale or revenue estimated they would lose \$9,641.86 in revenue per employee.

The survey requested a free-form answer regarding which specific provisions in the proposed rules would cause lost sales or revenue. Most of the answers did not directly address the potential cause of lost sales or revenue, but instead focused on the increased costs created by the proposed rule amendments. At least two survey respondents mentioned that increased time spent on compliance matters would leave less time for advising clients. Presumably, this could lead to a decrease in revenue as a result of providing advice to fewer clients. Additionally, advisers may lose revenue if they limit the type of services they provide due to the costs of compliance.

#### **An estimate of the number of jobs that will be created or lost as a result of compliance with the proposed rule**

The Securities Division surveyed its state registered investment advisers, exempt reporting advisers, and federal notice-filed investment advisers to determine whether the proposed rulemaking could result in the addition or elimination any jobs.

Approximately 6% of survey takers anticipated that the rulemaking would cause them to eliminate jobs. These respondents variously commented that the rule changes might cause them to eliminate one job, forego pay increases, or go out of business entirely. Approximately 94% of survey takers did not anticipate that they would need to eliminate any jobs.

Approximately 7% of respondents indicated that the rule changes would cause them to add jobs. One respondent commented that an additional employee may be needed to assist with compliance matters. Approximately 93% of survey takers did not anticipate adding any jobs.

Based on the survey results, the Securities Division estimates that the average investment adviser will neither add nor eliminate any jobs as a result of the rule amendments.

**A comparison of compliance costs for the small business segment and the large business segment of the affected industries, and whether the impact on small business is disproportionate.**

RCW 19.85.040 requires that the Securities Division determine whether compliance with the proposed rules would have a disproportionate impact on small businesses by comparing the cost of compliance for small business with the costs of compliance for the ten percent of businesses that are the largest businesses required to comply with the proposed rules.

The Securities Division categorized each survey response based on whether it came from a small business or whether it represented the ten percent of businesses that were the largest businesses that responded. The two categories were then compared to each other. The survey results tended to show that the increased costs per employee of small businesses were disproportionately greater than the increased costs per employee of the largest businesses.

We note, however, that all the investment advisers who responded to the survey qualified as small businesses under RCW 19.85.020(3) of the Regulatory Fairness Act. Many of the smallest businesses have only one employee, which magnifies any expenses calculated on a per-employee basis, especially with respect the expenses incurred in creating new policies and procedures. The largest advisers typically offer more complicated products and services, have been in business longer, and may employ in-house compliance persons. As a result, many of the largest businesses in the survey group may already have adopted cybersecurity policies and procedures, code of ethics, and business continuity plans that meet the requirements of the proposed rule amendments. Consequently, they may see less of an increase in professional services, labor, and administrative costs than smaller advisers. In any event, all advisers, large and small, provide investment advice to members of the public. It is imperative that we regulate investment advisers effectively in order to protect the public from financial fraud.

The following chart compares the average cost increase associated with the proposed changes to the rule provision for both the largest 10% of businesses required to comply and small businesses. Small businesses are defined as 50 or fewer employees. The largest 10% of business were likewise determined by the number of employees.

Average Cost Increase – Comparison of Small Business and Largest 10% of Businesses					
Rule Provision	Prof'l Services	Equipment	Supplies	Labor	Admin
Electronic Filing: WAC 460-24A-047, -060, -205					

Small Businesses	\$323.03	\$167.71	\$45.00	\$444.49	\$96.38
Largest 10%	\$21.16	\$ -	\$ -	\$33.86	\$15.08
<b>Examination Requirements: WAC 460-24A-050</b>					
Small Businesses	\$23.66	\$ -	\$1.34	\$17.47	\$7.53
Largest 10%	\$ -	\$ -	\$1.00	\$ -	\$ -
<b>List of Custodians: WAC 460-24A-050, -205</b>					
Small Businesses	\$76.85	\$ -	\$1.09	\$37.00	\$53.51
Largest 10%	\$ -	\$ -	\$12.50	\$26.79	\$39.29
<b>Advertising: WAC 460-24A-100</b>					
Small Businesses	\$271.28	\$ -	\$1.12	\$78.66	\$134.87
Largest 10%	\$77.38	\$ -	\$ -	\$61.01	\$16.37
<b>Custody Requirements: WAC 460-24A-105</b>					
Small Businesses	\$15.78	\$ -	\$1.16	\$10.71	\$0.42
Largest 10%	\$82.14	\$ -	\$ -	\$40.18	\$4.46
<b>Additional Custody Requirements: WAC 460-24A-106</b>					
Small Businesses	\$304.14	\$ -	\$8.89	\$89.31	\$252.67
Largest 10%	\$17.86	\$ -	\$ -	\$17.86	\$ -
<b>Compliance Policies and Procedures: WAC 460-24A-120</b>					
Small Businesses	\$148.91	\$ -	\$ -	\$55.00	\$19.74
Largest 10%	\$ -	\$ -	\$ -	\$ -	\$ -
<b>Material Non-Public Information: WAC 460-24A-122</b>					
Small Businesses	\$65.30	\$ -	\$0.06	\$14.80	\$74.01
Largest 10%	\$25.30	\$ -	\$ -	\$ -	\$11.90
<b>Business Continuity and Succession Plan: WAC 460-24A-126</b>					
Small Businesses	\$224.77	\$11.63	\$5.81	\$138.68	\$56.30
Largest 10%	\$ 22.32	\$ -	\$ -	\$22.32	\$ -
<b>Advisory Contract: WAC 460-24A-130</b>					
Small Businesses	\$183.56	\$ -	\$1.00	\$99.74	\$103.14
Largest 10%	\$42.86	\$ -	\$ -	\$17.86	\$ -
<b>Advisory Fee Billing Information: WAC 460-24A-135</b>					
Small Businesses	\$6.29	\$ -	\$ -	\$3.65	\$32.06
Largest 10%	\$ -	\$ -	\$ -	\$ -	\$ -
<b>Brochure Rule: WAC 460-24A-145</b>					
Small Businesses	\$17.33	\$ -	\$ -	\$16.48	\$35.85
Largest 10%	\$44.64	\$ -	\$ -	\$44.64	\$ -
<b>Performance Compensation: WAC 460-24A-150</b>					
Small Businesses	\$5.88	\$ -	\$ -	\$ -	\$ -
Largest 10%	\$ -	\$ -	\$ -	\$ -	\$ -
<b>Books and Records: WAC 460-24A-200</b>					
Small Businesses	\$333.66	\$ -	\$1.19	\$265.82	\$221.64
Largest 10%	\$108.04	\$ -	\$6.25	\$151.79	\$25.00
<b>Code of Ethics: WAC 460-24A-200(1)(aa)</b>					
Small Businesses	\$66.95	\$ -	\$ -	\$45.40	\$64.08
Largest 10%	\$ -	\$ -	\$ -	\$ -	\$ -
<b>Cybersecurity: WAC 460-24A-200(1)(bb)</b>					
Small Businesses	\$141.57	\$52.27	\$ -	\$95.30	\$102.18
Largest 10%	\$ -	\$62.50	\$ -	\$125.00	\$12.50

*Comparison of lost sales or revenue*

The largest 10% of businesses indicated in their survey responses that they would not lose any revenue. The small businesses estimated that they would lose an average of \$813.25 in revenue per employee, with 14 small businesses reporting that they expected to lose revenue because of the rule changes.

#### *Comparison of addition or elimination of jobs*

Approximately 7% of respondents indicated that the rule changes would cause them to add jobs. These represented 6 small businesses plus two businesses that were in the 10% of the largest businesses.

Approximately 6% of respondents indicated that the rule changes would cause them to eliminate jobs. These responses represented 3 small businesses and one business that was in the largest 10% of businesses.

#### **Steps taken by the Department under RCW 19.85.030(2) to reduce the costs of the proposed rule on small businesses, or reasonable justification for not doing so, addressing the specified mitigation steps.**

#### *Investor Protection Purpose*

In drafting the rule amendments, the Securities Division attempted to balance the business concerns of registered investment advisers with the Securities Division's mission to protect the investing public and to promote confidence in the capital markets. While the proposed rule changes may increase costs to licensees, the Securities Division believes the increased investor protection outweighs the cost increase to licensees. In addition, we note that certain rule proposals create uniformity with federal law and NASAA Model Rules.

As a result of feedback received from affected businesses, the Securities Division made certain clarifications to the initial draft of the rule amendments in order to reduce the cost of compliance for small businesses. These changes are detailed below. In addition, the Securities Division outlines below additional mitigation steps it intends to take to reduce the burden of compliance. The Securities Division does not believe that it can reduce costs further and still accomplish the investor protection purpose of the rulemaking.

#### *Reducing, modifying, or eliminating substantive regulatory requirements*

The Securities Division received several comments in its economic impact survey which indicated that the proposed amendments to the advertising rule at WAC 460-24A-100 would be burdensome and increase costs. Among the changes to the advertising rule, the Securities Division codified Interpretive Statement 21, which concerns the use of past performance information in advertisements. This policy has been in existence since 1999. However, commenters expressed concern that its addition to the advertising rule would impact the presentation of actual client performance information in written client communications such as account statements. In addition, commenters also expressed concern regarding the scope of material market or economic conditions that advisers must disclose along with any past performance data. Commenters also expressed that the disclosure requirements the rule imposed for written client communications were burdensome and unworkable.

In response to these concerns, the Securities Division revised the proposed amendments to the advertising rule in order to clarify the rule consistent with current SEC guidance regarding advertising by investment advisers. Further, the Securities Division revised the proposed rule amendments to clarify that the disclosure requirements apply only to the presentation of outside performance data, and not to the actual performance of the client's account in an account statement provided by a qualified custodian. In addition, the Securities Division intends to prepare an FAQ addressing compliance questions regarding the advertising rule. Among other items, the FAQ will clarify that documents supplied to clients directly from the custodian, such as account statements, do not have to meet the disclosure requirements for past performance information.

The Securities Division also received feedback in the survey requesting guidance on how to create cybersecurity policies and procedures and a code of ethics. Commenters requested that the Securities Division provide a template that satisfied the new requirements. The Securities Division intends to issue an FAQ that highlights existing resources available to assist advisers in developing their policies and procedures. The FAQ will highlight available resources such as the NASAA Cybersecurity Checklist for Investment Advisers.

#### *Simplifying, reducing, or eliminating record keeping and reporting requirements*

The Securities Division received several comments regarding revisions to the books and records requirements. For instance, the proposed revisions to WAC 460-24A-200(1)(r) require the adviser to update or attempt to update the client's suitability profile on an annual basis. Commenters expressed concern regarding the cost of updating client profiles annually, including the expense of conducting a mailing to request updated information. Commenters also questioned what type of documentation would satisfy the new requirement in WAC 460-24A-200(1)(dd) to maintain records of the client's written authorization for each non-discretionary transaction. In response to these concerns, the Securities Division intends to prepare an FAQ addressing recordkeeping matters. In the FAQ, the Securities Division will suggest that the use of email and other electronic means may reduce the costs associated with obtaining information to update client profiles. In addition, the FAQ will note that a reasonable attempt to update the profile annually will suffice to satisfy the requirement. The adviser can still satisfy the requirement even if a client fails to respond.

Finally, as a potential offset to cost increases attributable to the proposed rule amendments, we note that the Securities Division proposed amendments to WAC 460-24A-047, WAC 460-24A-060, and WAC 460-24A-205 to mandate electronic filing of documents with the Securities Division. We also amended WAC 460-24A-200(1)(g) to eliminate the requirement to maintain original records (as opposed to electronic copies) of client communications. We believe these changes will decrease costs and increase efficiencies, which may help offset costs increases elsewhere.

#### *Delaying compliance timetables*

The Securities Division will allow investment advisers adequate time to adjust to the rule changes through existing processes. In particular, the Securities Division understands that the creation or revision of policies and procedures takes time, and may require input from outside attorneys or compliance consultants.

Through the exam and deficiency letter process, the Securities Division will allow reasonable time for investment advisers to fix any deficiencies related to the new rules that the exam staff identifies during examinations of investment advisers that occur in the period immediately following enactment of the rules. The Securities Division will also continue to provide technical assistance visits to newly registered investment advisers to provide feedback on recordkeeping and other compliance matters.

#### *Other mitigation techniques*

The Securities Division will develop a Frequently Asked Questions ("FAQ") publication for distribution upon the adoption of the rule amendments. The Securities Division intends to provide guidance through the FAQ to explain how to comply with the rule amendments. The Securities Division has determined that in many cases, the nature of the compliance envisioned by the Securities Division is less burdensome than that imagined by the investment advisers taking the small business economic impact survey.

The Securities Division intends to address the following topics in the FAQ:



- The Securities Division will provide additional guidance regarding the information that must now be included on fee invoices pursuant to WAC 460-24A-106 and WAC 460-24A-135, and may develop a sample fee invoice. The FAQ will clarify that the fee invoice must only include the name of the custodian if there is more than one custodian.
- The Securities Division will provide links to existing resources regarding the development of cybersecurity policies and procedures. These resources may assist advisers in conducting a cybersecurity risk assessment and drafting cybersecurity policies and procedures.
- The Securities Division will provide links to a model code of ethics that will satisfy the code of ethics requirement in WAC 460-24A-200(1)(aa). This may assist advisers in preparing their own code of ethics.
- The Securities Division will provide additional guidance regarding the scope of the revised advertising rule at WAC 460-24A-100.
- The Securities Division will provide guidance on compliance with the revised books and records requirements at WAC 460-24A-200. The FAQ will address the annual update to the client profile and the type of documentation required for client authorizations of non-discretionary transactions.

In addition to the assistance provided in the anticipated FAQ, the Securities Division may conduct informational sessions for investment advisers to provide an overview of the rule changes.

#### **How the Department will involve small business in rule development**

Since the beginning of the rulemaking process, the Securities Division has involved its registered investment advisers and interested persons in the rulemaking process.

On March 9, 2018, the Securities Division filed a Preproposal Statement of Inquiry (CR-101) concerning the possible amendment of the investment adviser rules. The Securities Division distributed the CR-101 notice to its interested persons list for securities registration matters and to all state registered advisers. This group of recipients included many small businesses and those that advise small businesses.

The CR-101 notice invited interested persons to participate in the rulemaking process by submitting comments to the Securities Division. The Securities Division took the feedback received into account when preparing the initial draft of the rule amendments. Once a draft was prepared, it was distributed to the interested persons list on or about June 20, 2018 and posted on the Securities Division's website.


The Securities Division next prepared a survey to determine the economic impact of the proposed rulemaking on investment advisers. The survey, along with a copy of the draft rule amendments, was sent to all state registered investment advisers and a representative sample of federal notice-filed investment advisers. Based on the results received, the Securities Division made changes to its proposed draft as detailed above, and undertook to provide an FAQ. The Securities Division will continue to seek the feedback of interested parties as the rulemaking process continues.

#### **A list of the industries that will be required to comply with the rule**

Investment advisers doing business in Washington will be required to comply with the amended rules.

The public may obtain a copy of the small business economic impact statement or the detailed cost calculations by contacting:

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Other:

<b>Date:</b> 11/9/2018	<b>Signature:</b> 
<b>Name:</b> Charles Clark	
<b>Title:</b> Deputy Director	