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ELECTRONIC RECORDKEEPING UNDER THE INVESTMENT ADVISERS ACT OF 1940

Investment advisors registered with either the United States Securities and Exchange Commission ("SEC") or state securities bureaus must maintain certain books and records pertaining to their clients, investment advisory practices, and operations. The recordkeeping requirements of SEC-registered investment advisors are set forth in Rule 204-2 of the Investment Advisers Act of 1940 ("Advisers Act"), and the vast majority of states have substantively adopted the requirements found within this rule. Compliance with the advisor's recordkeeping responsibilities has grown less onerous through the advent of technology that affords great administrative flexibility. Through regulatory amendments, advisory firms may retain records in an electronic format and may also utilize the same recordkeeping mechanism to satisfy other fiduciary obligations owed to clients.

Historically, the Advisers Act placed limitations upon the maintenance of records, permitting electronic storage only under very stringent conditions and only for certain categories of records. Applicable rules and SEC No-Action Letters on the topic distinguished documents generated in electronic format by the advisor from documents received in hard copy that were sought to be retained in electronic format. Such distinctions were ultimately eliminated through regulatory amendments to the Advisers Act, which resulted in an expansion of investment advisors' abilities to utilize electronic storage media to satisfy their regulatory obligations.

The acceptance of electronic storage by state and federal regulatory bodies has occurred concurrently with the progression of technological advances, which makes the recordkeeping duty less onerous. However, as technology progresses, members of the investment advisory industry must remain cognizant that the advisor's statutory responsibility lies neither with the custodian who may provide information on compact disc nor with an outside record retention company, but with the advisory firm itself. Compliance matters of this nature are non-delegable, and insufficient or inadequate compliance may be the subject of regulatory citation.

In order for an advisory firm to reap the benefits of electronic recordkeeping, procedures should be established for maintaining, preserving, and accessing the records so as to ensure that these records are accurate, complete, and safe from loss, destruction, or tampering. Compliance with Rule 204-2(g) requires that records stored in electronic format be maintained on micrographic media (e.g., microfilm, microfiche, etc.) or other electronic storage media (e.g., tape backup, compact disc, etc.). Although the SEC has not endorsed any particular method as superior, the advisory firm should strive to utilize a medium that does not allow the information to be altered or edited in any capacity. [Editor's note: There is much confusion as to whether this "WORM" requirement applies equally to independent, SEC-regulated RIAs and NASD-regulated reps. For further information, see the VON collection of compliance articles on this subject at...

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http://www.davidddrucker.com/Upload_OrderByDate.aspSPID=17577&Title=Information+on+Electronic+Compliance&OrgID=431].

In addition, the information contained in the medium must be organized in a manner that permits easy location, access, and retrieval. An advisory firm is required to be capable of producing legible copies of any particular record in response to regulatory requests in a short period of time. In addition, a firm may be required to produce the means by which records are accessed in their digital or film format. For example, firms that prepare microfilm versions of their records must have the facilities to access the microfilm and be capable of producing legible reproductions of firm records. As such, it may be beneficial for the advisory firm to retain the recordkeeping infrastructure on site.

Any record retained electronically must also be retained in duplicate form and stored in a separate location from the original. This duplicate can serve two purposes. It can act as a backup from which information can later be retrieved should questions arise concerning the original. It can also be utilized as a component of a larger contingency plan should the advisor's office become affected as a result of an emergency situation. Advisory firms should view their electronic storage as part of a greater disaster preparedness policy. Such policies are commonly requested during regulatory examinations and are part of the advisory firm's fiduciary duty to, and the expectations of, its clients. As such, disaster planning is a key element in fulfilling this duty.

In light of recent global and domestic events, the SEC has placed emphasis upon business continuity planning. In fact, regulatory examiners frequently request the advisory firm to produce their written business continuity plan in order to assess its adequacy. The plan should focus on the types of events that could impact the advisory firm's ability to service clients. It is important to account for a wide range of contingencies spanning from the technical (e.g., destruction of original records) to the personal (e.g., disability to firm personnel), and the policy should present the advisor's reasonable efforts in minimizing the effects of an emergency situation. To that end, electronic recordkeeping should constitute a portion of that plan and can aid the firm in its efforts to continue servicing clients through the emergency's resolution in an effective and efficient manner.

As with all regulatory requirements, it is extremely important for the readers of this column to consult with the Advisers Act directly and/or obtain counsel competent in this area. The investment advisory atmosphere has become exceedingly litigious, and it is absolutely imperative that registered investment advisors understand and satisfy their regulatory obligations.

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