



Compliance Deficiencies for IARs



A close-up photograph of a person's hands sorting through a large stack of papers on a desk. The papers are organized into several distinct stacks, some of which are bound with orange rings. In the background, a laptop is visible on the desk, and the scene is softly lit, suggesting an office or study environment. A semi-transparent purple rectangular overlay is positioned in the center-left of the image, containing the text.

Topics We'll Cover

1. Overview of SEC's Role and Examination Objectives

- Purpose of SEC examinations
- Importance of compliance to investment advisers

2. Common Focus Areas in SEC Examinations

- Overview of typical areas of scrutiny

3. Fiduciary Obligations

- Explanation of fiduciary duty

4. Disclosure and Transparency

- Common pitfalls and how to avoid them
- Importance of accurate and clear disclosures
- Case studies on disclosure-related deficiencies

5. Compliance Programs and Policies

- Best practices for developing and maintaining compliance programs
- Identifying and managing conflicts of interest

6. Custody and Safeguarding Client Assets

- Custody rule requirements
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7. Implementing Effective Compliance Controls

- Techniques for monitoring and reviewing compliance
- Role of compliance officers and staff training

8. Preparing for an SEC Examination

- Steps for a successful examination process
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Overview of SEC's Rule and Examination Objectives

Purpose of SEC Examinations

The Division of Examinations conducts the SEC's National Exam Program. The Division's mission is to protect investors, ensure market integrity and support responsible capital formation through risk-focused strategies that:

1. Improve Compliance
2. Prevent Fraud
3. Monitor Risk
4. Inform Policy

The results of the Division's examinations are used by the SEC to inform rule-making initiatives, identify and monitor risks, improve industry practices and pursue misconduct.

Overview of SEC's Rule and Examination Objectives

Importance of Compliance to Investment Advisers

While investment advisers are required to pass an exam to secure their registration as an advisor or their license, maintaining that license is considered a privilege rather than right.

There are a multitude of errors that you could commit that would lead a regulator to suspend or revoke your license.

Compliance is a path to following the rules and regulations and avoiding such an outcome.

SEC examinations are designed to make sure you are on the right track and following all the rules and regulations that apply to your business.

Common Focus Areas in SEC Examinations

Overview of Typical Areas of Scrutiny

Each year, the SEC publishes a list of examination priorities. It is important to continuously review the agency's priorities to make sure you are on track with:

- Marketing
- Compensation Arrangements
- Illiquid Investment Evaluations
- Safeguard to Protect Clients' Non-Public Information
- Disclosures
- Accuracy and Completeness of Regulatory Filings

Fiduciary Obligations

Explanation of Fiduciary Duty

Investment advisor representatives have a fiduciary responsibility to their clients. This includes both a duty of loyalty and duty of care. Under your duty of loyalty, you must not put your needs above the needs of your clients. Under your duty of care, you must act as you would if you were in your client's position while maintaining your own knowledge and experience of the financial markets and investing.

Documenting and disclosing your adherence to these duties is accomplished through disclosures and regulatory filings.

This includes properly disclosing all conflicts of interest and carefully disclosing your process to understand your client's investor profile.

Disclosure and Transparency

Common Pitfalls and How to Avoid Them

The most common finding for SEC registered firms in the past few years has been errors with the Form CRS:

1. Reg BI requires form CRS to be prominently displayed on the homepage of a website. Firm was cited for having the CRS behind a “Disclosures” link. The link must take customers directly to the CRS. The customers must not have to scroll through other disclosure to get to it.
2. The CRS must display the effective date prominently at the beginning of the summary may be in the header or footer of the first page. The date must meet this requirement in all formats, including electronic. Each time the CRS is reviewed or modified; the date must be updated.
3. There must be a record of each time a CRS is delivered to a customer. The record must include how the delivery was made, on what date, and which version. This includes a record of the annual delivery.
4. A copy of the CRS must be maintained in the customer file as evidence of which version the customer received.
5. Policies & Procedures must include who at the firm is responsible for updates and timely filings of the CRS.

Disclosure and Transparency

6. Additional Information section must not refer back to other sections of the CRS, it must reiterate any information that belongs in that section. For example, if in the Fees section, the document directs customers to look at the ADV Part 2A, in the Additional Information section, rather than state look at the Fee section above (which sends the customer to the ADV Part 2A), just state see the ADV Part 2A.
7. All required verbiage must be in the CRS. Specific “Conversation Starters” are provided in the instructions, all of them must be included verbatim.
8. All incentives must be disclosed, this includes non-cash compensation such as sales meetings or trainings where travel and lodging is covered for some top performers but not for all advisors.
9. On the CRS, all questions must be clearly and accurately responded to with definitive answers. For example, In item 4 “Do you or your financial professionals have legal or disciplinary history?” if the firm has history, the response must be “Yes.” Firm was cited for stating “Does have disciplinary history.” The “yes” was missing. (See instructions for Item 4.B)
10. The CRS must be readable and contain white space. The deficiency the firm received stated “jumbled, tightly spaced, with little to no design or change in font structure or spacing.”
11. The Fee schedule on ADV 2A must match the fee schedule on the CRS. Whenever fee schedules change, the firm must be diligent to update all disclosures.

Disclosure and Transparency

Common Pitfalls and How to Avoid Them

Another common deficiency recently has been errors with the Marketing Rule.

- All tables and hypotheticals displayed on the firm's website must be clear and accurate, and proper disclosures must be prominently displayed with the hypothetical. Example, website contained hypothetical fee structures comparing the difference between a tiered flat fee structure and a 1% fee structure. Firm was cited for methodological errors in the calculations including, cherry picking the initial value and time frame displayed without disclosing that other assumptions would lead to differing results and that competitor firms may use a variety of other methods of calculation. Further, the hypothetical fees published did not align with the firm's policies and procedures for charging fees.
- Third Party Ratings must follow the Marketing Rule. Firm failed to disclose the criteria for the rating, the category for which the rating was determined, the number of advisors surveyed, the number of advisors that received the rating, and that rating is not indicative of the advisor's future performance.

Disclosure and Transparency

Common Pitfalls and How to Avoid Them

Best Execution is yet another common deficiency.

- Mutual Fund Share class selection must be the best option for the individual client's needs and financial profile. The firm must have policies and procedures to ensure that firm recommends the most advantageous mutual fund share class for each account. The firm must monitor mutual fund trades for compliance with the policies.

Disclosure and Transparency

Importance of Accurate and Clear Disclosures

SEC examiners focus on information that is disclosed in each part of your ADV Brochure. It is important that you complete each item accurately and keep them updated. While clients may or may not rely on these documents, the position of the Agency is that these documents are of the utmost of importance and are the foundation for your Firm's disclosures.

When the SEC is performing an exam, before they request documents for their review, the Staff carefully combs over each of your documents looking for items that are unclear or potentially omitted.

Disclosure and Transparency

Case Studies on Disclosure-Related Deficiencies

Advisor A: This advisor had a client who was in her 80's who requested that he be trustee on her revocable trust as she had no family or friends whom she felt like she could rely on. He wanted to help. By becoming the trustee on this client's trust, he inadvertently took custody of her assets. He did not update his ADV to reflect that his firm takes custody of client assets. This resulted in the examiner requiring audits of the past two years of her accounts and a deficiency that led to a small fine.

Advisor B: This advisor provided his clients with a tiered fee schedule based on the assets that he managed for them. In addition, he offered financial planning services at an hourly rate. His exam revealed that for a few clients who had less than \$50,000 under management with his firm, which put them in his 2% tier on his fee schedule, he also had charged them to develop a financial plan. For these clients, when the planning service fee was added to the management fee, the total annual fee was greater than 2.5% of assets managed. The Staff determined that these fees were excessive. The exam resulted in an order to refund fees with interest and to immediately cease this billing practice.

Compliance Programs and Policies

Best Practices for Developing and Maintaining Compliance Programs

In order to develop an effective compliance program, it is important to understand the:

- Services that you will offer
- How you will charge for those services
- Any conflicts of interest that must disclosed and mitigated

And then you must develop policies and procedures that help you to best provide your services within the rules and regulations of the SEC and State Securities Divisions.

Then you must test the policies and procedures regularly to ensure that they are helping you effectively meet the regulatory requirements.

Finally, you must document these tests.

Compliance Programs and Policies

Identifying and Managing Conflicts of Interest

Conflicts of interest can come from a variety of business and financial activities.

- Are you investing in the same investments as your customers?
- Do you own a building and one of your clients leases an office from you?
- Do you also sell fixed insurance for a commission to your clients?
- Are you a member of an LLC with one of your customers who is also a member?
- Are you referring clients to a tax preparation firm that you own?
- Are you receiving referrals from a trust company owned by your spouse?

Custody and Safeguarding Client Assets

Custody Rule Requirements

An adviser has custody if it holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them.

If you have custody of client accounts, among other requirements, you are required to have an annual surprise audit by a PCAOB (Public Company Accounting Oversight Board) registered accounting firm. (CHECK this)

Ways that you may take custody of client assets:

- By being the trustee of a client's trust
- By being the named executor in a client's will
- By putting in place a standing letter of authorized (SLOA) where monies are sent to a third-party account
- By logging into a client's 401(K) using the client's credentials (username and password)
- By having a client write a check to your firm for deposit into their brokerage account
- By accepting a stock certificate and holding it for more than 24 business hours prior to depositing into the client's account

Custody and Safeguarding Client Assets

Common Custody-Related Issues and How to Address Them

Often times a firm for an advisor is designated as an executor as a client's will without the firm or individual's knowledge. If a client has informed you that they have made you the executor of their will, you must decline and ask them to change the document. If the client has already passed and you were named the executor, you must decline the appointment.

Another common form of inadvertent custody is putting in place a SLOA to a third party without considering the custody implications to the firm.

Implementing Effective Compliance Controls

Techniques for Monitoring and Reviewing Compliance

Rather than waiting for your annual review, it is a best practice to review individual compliance activities on a more frequent basis.

While some tasks such as email review and trade review should be done weekly, others may only require quarterly review. For example, if you bill your clients quarterly, it is important to identify any errors in billing on a quarterly basis.

Keeping your ADV and all U4s up to date should not be left to annual review. If you are offering a new product or service mid-year, you must update your documents. If you move your office to a new location, you must timely update your ADV. A quarterly review of your documents helps to avoid long periods of noncompliance.

Implementing Effective Compliance Controls

Role of Compliance Officers and Staff Training

Compliance is too important to be left as a side job to your top producer. Finding the right people to help keep your advisor representatives on track and your disclosures properly filed and up to date is a difficult task. It is important.

Once you have the right compliance staff, it is important that they provide proper training and support to each member of your team.

Industry-wide, it is standard to spend approximately 5% of your gross revenue on Compliance.

Regulators require that your compliance program is tailored to meet your business' needs.

Firm management must lead a culture of compliance, it starts at the top.

Preparing for an SEC Examination

Steps for a Successful Examination Process

1. Design an effective compliance program
1. Continuous and effective compliance reviews
 1. Be organized
 1. Document EVERYTHING
 1. Be organized
1. Provide clear and accurate responses to each item requested by the SEC

Once the examiners are in your office, you cannot hide the ball – it is too late. Be prepared ahead of time, focus on compliance, don't let it be an afterthought.

Preparing for an SEC Examination

Documentation and Record-Keeping Best Practices

Have a thorough and complete system for filing and achieving each section of your compliance manual that requires documentation. Make sure you date everything appropriately and ensure that you have a filing system that makes sense to you and is easily accessible.

The easiest way to achieve this is to work through your compliance manual and confirm that for each item that begins with “CCO shall,” you have a way to evidence your reviews of that item.



Questions?

