



AdvisorLaw®

Common Compliance Deficiencies for IARs

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The background is a close-up, slightly blurred image of a document. It features a blue arrow-shaped graphic pointing to the right, which serves as a backdrop for the title text. Faint, illegible text from the document is visible in the background, including the word "Assignment" and the word "SIGNATURE".

Overview of the SEC's Role and Examination Objectives

Polling Question

**Are you a
Registered
Investment Adviser
registered with one
of the following?**

- Yes, I am registered with the SEC
- Yes, I am a state registered RIA
- No, I am not a Registered Investment Adviser

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 adviser or their license, maintaining that license is considered a privilege rather than a 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 while avoiding such an outcome.

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

A hand with a watch points to a document containing a pie chart and bar graphs. A blue arrow graphic points from left to right across the center of the image, containing the text.

Common Focus Areas in SEC Examinations

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
- Safeguards to Protect Clients' Non-Public Information
- Disclosures
- Accuracy and Completeness of Regulatory Filings

Common Focus Areas in SEC Examinations

- Adherence to Fiduciary Standards of Conduct
- Effectiveness of Advisers' Compliance Programs
- Examinations of Advisers to Private Funds
- Never Examined Advisers, Recently Registered Advisers, and Advisers Not Recently Examined
- Cybersecurity
- Regulation S-ID and Regulation S-P
- Shortening of the Settlement Cycle
- Emerging Financial Technologies
- Crypto Assets
- Regulation Systems Compliance and Integrity
- Anti-Money Laundering



Fiduciary Obligations

Fiduciary Obligations

Explanation of Fiduciary Duty

Investment Advisor Representatives have a fiduciary responsibility to their clients. This includes both a duty of loyalty and a 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.

A photograph of a business meeting. In the foreground, a person's hand holds a pen over a document with financial text. Another person's hand points at a bar and line chart on a tablet. A third person's hand points at the same chart. The background shows three people in business attire. A blue semi-transparent banner is overlaid across the middle of the image.

Disclosure and Transparency

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 the Form CRS to be prominently displayed on the homepage of a website. A 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 disclosures to get to it.
2. The CRS must display the effective date prominently at the beginning of the summary and it may be in the header or footer of the first page. The date must meet this requirement in all formats, including electronically. 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 was provided. 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 and Procedures must specify who at the firm is responsible for updating and timely filing of the CRS.

Disclosure and Transparency

6. The 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 the document directs customers to look at the ADV Part 2A in the Fees section, rather than stating “look at the Fee section above” in the Additional Information section, instead say, “see the ADV Part 2A.”
7. All required verbiage must be in the CRS. Specific “Conversation Starters” are provided in the instructions and 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 advisers.
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.” A 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 a firm received stated “jumbled, tightly spaced, with little to no design or change in font structure or spacing.”
11. The fee schedule on the ADV 2A must match the fee schedule on the CRS. Whenever fee schedules change, the firm must be diligent to update all disclosures.

Polling Question

**Which area
is your
biggest
concern with
compliance?**

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

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. For example, a firm's website contained hypothetical fee structures comparing the difference between a tiered flat fee structure and a 1% fee structure. The firm was cited for methodological errors in its calculations, including cherry-picking the initial value and time frame displayed, without disclosing that other assumptions could lead to different results or that competitor firms may use various other calculation methods. 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. A firm failed to disclose the criteria used for the rating, the category in which the rating was given, the number of advisers surveyed, the number of advisers who received the rating, and the fact that the rating is not indicative of the adviser'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 represent the best option for each client's individual needs and financial profile. The firm must have policies and procedures in place to ensure that it recommends the most advantageous mutual fund share class for each account. Additionally, the firm must monitor mutual fund transactions to ensure compliance with these 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 to look for items that are unclear or potentially omitted.

Disclosure and Transparency

Case Studies on Disclosure-Related Deficiencies

Adviser A: This adviser had a client who was in her 80's and requested that he be trustee on her revocable trust as she had no family or friends 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 her account within the the past two years and a deficiency that led to a small fine.

Adviser B: This adviser 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.

Polling Question

**How often do
you review your
Part 2A of your
form ADV?**

- Rarely
- Annually
- I don't

A close-up photograph of two hands holding two interlocking puzzle pieces. The hands are positioned on the left and right sides of the frame. The puzzle pieces are light gray. A semi-transparent blue banner with a right-pointing arrow shape is overlaid across the center of the image, containing the text 'Compliance Programs and Policies' in white. The background is a blurred image of a person in a dark suit and a striped tie.

Compliance Programs and Policies

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

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.

You must test these 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

SIGNATURE

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.

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, a firm for an adviser is designated as an executor of 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 update your ADV in a timely manner. 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 adviser 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.

Polling Question

**Do you
serve as
Trustee for
any clients?**

- Yes
- No
- No, but I would consider it
- No, and I never will

Preparing for an SEC Examination

Steps for a Successful Examination Process

1. Design an effective compliance program
2. Continuous and effective compliance reviews
3. Be organized
4. Document EVERYTHING
5. Organize even more
6. 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 already too late. Be prepared ahead of time, focus on compliance, and 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 archiving 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.

A hand with a watch points towards the right, overlaid with a large blue arrow pointing right. The background is a blurred office scene with a laptop and documents. The text 'Preparing for an SEC Examination' is written in white, italicized font across the blue arrow.

Preparing for an SEC Examination

Preparing for an SEC Examination

The Examination Process Typically Unfolds in Several Stages, Outlined as Follows:

1. **Introduction to Examiners:** You will meet with the examiners to establish rapport and provide an overview of your firm's operations.
2. **Receipt of Request Letter:** Following the initial meeting, you will receive a formal request letter outlining the specific documents and information required for the examination. It is encouraged for you to reach out to your Compliance team or legal counsel with any questions or concerns regarding the request letter.
3. **Provision of Documents:** You will promptly gather and provide the requested documents to the examiners for their review. Keeping organized and meeting the requested turnaround time is important. If you need more time to complete a request, you may ask for an extension.
4. **Response to Additional Requests:** In some cases, the examiners may request additional information or clarification. You should cooperate fully and address any additional requests in a timely manner.
5. **Receipt of Deficiency Letter:** Upon completion of their review, the examiners may identify deficiencies or areas for improvement within the firm's compliance program. It's important to note that deficiencies are a common occurrence since each office/examiner may have their own priorities and concerns.
6. **Correction of Deficiencies:** In the event that deficiencies are identified, you will need to address them and formulate a comprehensive response to the deficiency letter.

Preparing for an SEC Examination

Legal Considerations and Compliance Strategies in a Rapidly Evolving Tech Landscape

We live in an evolving environment as it relates to digital currencies and technologies available for your firm to use. The most important thing is to do proper due diligence for any new products or technologies that you plan to use. Once the due diligence is complete, you must draft proper disclosures and procedures. The final step is training all advisers of the firm on the new products and procedures.

It is critical to prevent jumping to new technologies or product lines before completing these steps.

Preparing for an SEC Examination

Strategic Compliance and Risk Management Future Trends and How to Prepare for Potential Regulatory Changes

Pay attention to the Federal Register for new regulations that have been announced and their implementation schedules. This can be a challenge, and you may want to hire a compliance consultant to stay on top of the rapidly changing regulatory requirements.

Q&A





AdvisorLaw®



11001 W 120th Avenue, Suite 100, Broomfield, CO 80021

advisorlawllc.com | (303) 952-4025

