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# ***Investment Adviser Compliance Developments***

**SEC's 2020 Examination Priorities for Investment Advisers**

**Presented by Bryan Hill**

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# Presentation Agenda

- SEC's 2020 Exam Priorities (Curated)
- Common Exam Deficiencies in 2019
- Compliance Tips for COVID-19

# Slides Available

<https://www.ria-compliance-consultants.com/wp-content/uploads/2020/04/SEC-2020-Exam-Priorities-COVID-19-Compliance-Tips.Schwab.04.02.2020-4823-8029-7401.pdf>

# SEC Examined 15% of Federal RIA Population in FY2019

*Examinations of registered investment advisers (RIAs) in FY 2019 remained strong at approximately 2,180, covering 15 percent of this population.*

## Custody = SEC Exam of Investment Adviser

*When RIAs have access to client funds or securities, OCIE prioritizes examination for compliance with the Custody Rule (Rule 206(4)-2 under the Investment Advisers Act of 1940 (Advisers Act)), which includes important client safeguards like third party audits and surprise examinations.*

## **SEC Uses Risk-Based Analysis for Selecting RIAs to Examine - Potential Risk Factors Can Include**

- Products and services offered, including certain products identified as higher risk;
- Compensation and funding arrangements;
- Prior examination observations and conduct;
- Disciplinary history of associated individuals and affiliates of a registered firm;
- Changes in firm leadership or other personnel; and,
- Whether a firm has access to investor assets, i.e., custody.



# Disclosures

- Fees & Expenses
  - Whether investment adviser aggregated certain accounts for purposes of calculating fee discounts in accordance with its disclosures
- Conflicts of Interest
- Undisclosed or Inadequately Disclosed Compensation Arrangements
  - Revenue Sharing Arrangements
  - Direct or Indirect Compensation to Supervised Persons for Executing Client Transactions

# Advice Given to Retail Investors

- Seniors
  - Including Retirement Communities
- Investors Saving for Retirement
- Teachers
- Military Personnel

# Higher Risk Products

- Complex & Non-Transparent
- Private Placements & Issuers in New Risk Areas
- High Fees & Expenses
- Where Issuer of Product Is Affiliated or Related to RIA or Its Supervised Persons

# Fiduciary Duty

- Whether fulfilled duty of care and loyalty?
- Whether investment adviser provide advice in the best interests of their clients and eliminate, or at least expose through full and fair disclosure, all conflicts of interest which might incline an RIA, consciously or unconsciously, to render advice which is not disinterested?
- Is the investment adviser meeting its contractual duties?

# Mutual Funds

- Examination of financial incentives that may influence the selection of particular mutual fund share classes
- Review for mutual fund fee discounts that should be provided to investors as a result of policies, contractual or disclosed breakpoints, such as discounts provided based on achieving managed investments of a specific size

# Cybersecurity – Investment Advisers

- Focus on investment adviser's protection of clients' personal financial information
- Governance and risk management;
- Access controls;
- Data loss prevention;
- Vendor management;
- Training; and
- Incident response and resiliency.

# Cybersecurity - Third-Party and Vendor Risk Management

- Focus on oversight practices related to use of third-party service providers including networks and cloud-based storage.
- Review whether third-party service provider arrangement comply with Regulations S-P and S-ID
- Focus on controls surrounding online access and mobile application access to customer brokerage account information.
- Examine safeguards around the proper disposal of retired hardware that may contain client information and potential network information that could create an intrusion vulnerability

# Digital Assets

- Risk - investors who may not adequately understand the differences between these assets and more traditional products.
- SEC will assess following with respect to digital assets:
  - Investment suitability,
  - Portfolio management and trading practices,
  - Safety of client funds and assets,
  - Pricing and valuation,
  - Effectiveness of compliance programs and controls, and
  - Supervision of employee outside business activities.



## Electronic Advice via Robo-Advisor

- SEC Registration Eligibility
- Cybersecurity Policies & Procedures
- Marketing Practices
- Adherence to Fiduciary Duty – Adequacy of Disclosures
- Effectiveness of Compliance Program

# Compliance Program

Whether policies and procedures reasonably designed, implemented and maintained

# Dual RIA/BD & Dual IAR/RR

- Prioritize exams of dual RIA/BD or RIA with dual IAR/RR
  - Best Execution
  - Prohibited Transactions
  - Fiduciary Advice
  - Disclosure of Conflicts

# Using Third-Party Asset Managers

Assess, among other things, the extent of these RIA's due diligence practices, policies, and procedures

# Environmental, Social & Governance ("ESG") - Disclosures

- Accuracy and adequacy of disclosures provided by RIAs offering clients new types or emerging investment strategies, such as strategies focused on sustainable and responsible investing, which incorporate environmental, social, and governance (ESG) criteria

# ESG Investing

- SEC Does Not Offer Specific Safe Harbor for Using ESG
- If Using ESG for U.S. Clients, Need to Make Sure Meet Requirements under Investment Advisers Act of 1940 as amended
  - Federal Fiduciary which Consists of Duty of Loyalty (i.e., Disclose All Conflicts) & Duty of Care (i.e., Act in Client Best Interest, Obtain Best Execution, Provide Advice & Monitor Over Course)
  - Full Disclosure in Writing of All Material Facts – For Example, Differences Between Using ESG Factors or Metrics versus Not Using Such on Investment Performance
  - Add Disclosures to Item 8 of Form ADV Part 2A Regarding ESG Factors/Metrics and Risks Associated with Such
  - Utilize Best Practices or Guidance of CFA Institute & Other Professional Organization About When/How to Use ESG in Investment Advice and Selection. See <https://www.cfainstitute.org/-/media/documents/article/position-paper/esg-issues-in-investing-a-guide-for-investment-professionals.ashx>
  - Carefully Document Client's Desire, Requirements and Instructions to Use ESG Factors/Metrics

## Actual Examination Findings

- Advertising - Portfolio Review Report
  - Failed to Disclose Re-Investment of Dividends & Returns
  - Failed to Disclose that Client May Experience Losses
- Best Execution
  - Failed to Conduct Best Execution
  - Compliance Manual Failed to Identify Frequency of Review and How to Conduct Review
- Client Communications
  - Failed to Take Notes or Send Confirming Email/Letter of Client Meetings/Calls

## Examination Findings

- Custody
  - After Obtaining Surprise Annual Custody Verification Exam for Trustee, Bill Pay and SLOA Activities, SEC Found Failed to Obtain Exam in 3 Previous Years and Required Mitigation of Deficiency
- Financial Statements
  - Not Accurate & Not Sufficiently Detailed
  - Value of Fixed Assets Inaccurate – Depreciation Not Included
  - Used Cash Basis Accounting Instead of GAAP (Accrual Basis)



# Examination Findings

- Portfolio Management
  - No Client Suitability Info
  - No Due Diligence on Private Placement
  - No Basis for Investment Recommendations/Decisions – No Research/Notes/Analysis
  - No Evidence of Review of Position
  - No Evidence of Subsequent Inquiry About Client's Suitability After First Year
  - Investment Objective Moderate & No Disclosure in ADV 2A Item 8 that Client Investing in Highly Concentrated, Diversified Portfolio in Oil & Gas Industry
  - Elderly Client Invested in Speculative/Volatile Investments – Inconsistent with Investment Objectives
  - Excessive Short-Term Trading – Adversely Effecting Clients Returns

## Examination Findings

- Trade Allocation - Cherry Picking
  - Block Trade Sent in Morning But Allocation Instructions Sent Late Afternoon to QC
  - Profitable Allocations Favored Larger Clients for Adviser
- PST
  - IAR Failed to Report PST Holdings & Quarterly Reports
  - IAR's PST Received More Favorable Prices than Client Trades on Same Day

# Examination Findings

- Compliance Manual
  - Incomplete – Never Finalized
  - Inapplicable – Procedures Not Applicable to Business Model & Practices
  - Inadequate – Procedures that Aren't Enough
  - Inconsistent – Not Consistent with Actual Practices
- Vulnerable/Senior Client – No Policy for Abuse
- Annual Review - SEC
  - Lost Risk Assessment/Re-Completed During Exam and Then No Changes to Policies Is Inadequate Due to No Corrective and Failure to Demonstrate Completed and No Records of Review
- CCO - Statements by CCO Indicates Lack of Competence
  - Doesn't Keep PST Records
  - Unsure How to Review Advertising
  - Unsure How to Review or Oversee Financial Planning

## Examination Findings

- Form ADV Part 2A – Inaccurate Statements
  - Waiving of FP Fees
  - Tax Harvesting Services
  - Failed to Accurately Describe Investment Strategies & Risks in Item 8
  - Failed to Identify Conflict of Interest
  - Inadequate Acknowledgement & Description of Conflicts of Interest
  - Inconsistencies with Client Agreements
  - No Log or Other Evidence Showing Delivery of ADV 2A

# Examination Findings

- Private Fund
  - Failed to Address/Mitigate Conflict of Using an Affiliates for Services to Client
  - Failed to Allocate Expenses between Investment Adviser & Private Fund
  - Failed to Make Sure Fund's Investments Consistent with Fund Documents
  - Allocation of Co-Investments between Clients/Fund and Affiliates
  - Failure to Have Valuation Policy for Illiquid Hard-to-Value Assets

# Examination Findings

- Fees
  - No Testing of Calculations
  - Failure to Provide Refunds Upon Client Termination for Fees Paid in Advance
  - Fee Schedules Need to Clarify if One Rate Is Applied or Tiered/Blended Rate – Need to Provide Examples of Fee Calculations
  - Fee Schedule – Need to Include Whether Includes Household Accounts or Single Account
  - Wrong Fee Rate Charged Due to Mis-Classification of Assets
- Succession Plan – None

# Compliance Tips Related to COVID-19

Notice of Office Closure

Custody

Form ADV

PST

BCP/Succession Planning

Due Diligence

Client Communication

Cybersecurity

Financial Condition of Firm

Client Complaints

Exams & Enforcement

## Notice of Office Closure

- If Supervised Persons Are Not Working in Office and Not Available to Accept Mail or Deliveries
  - Notify Clients of Such Closing
  - Explain How Clients Can Contact the Applicable Supervised Persons
  - Remind Clients that All Securities & Checks Should Be Sent Directly to Qualified Custodian
  - Notify Applicable Vendors
  - Consider Options on How to Monitor Mail/Deliveries
    - Daily Visit to Office, Mail Pick-Up Service or Forwarding Mail



# Custody – Receipt of Client Assets

- Previous Custody Guidance
  - Inadvertently Receives Securities from Client – Must Return within 3 Days
  - Inadvertently Receives Tax Refund, Class-Action Settlement or Dividends – Must Forward within 5 Days
- Updated Custody Guidance
  - If an Investment Adviser Is Unable to Access Mail or Deliveries at an Office Location Due to BCP in Response to COVID-19, SEC Wouldn't Consider Investment Adviser to Have Received Such Assets Until Personnel Are Able to Access the Office Location.

*See Staff Responses to Questions About the Custody Rule Question II.1 (Modified March 16, 2020.)*

# Update ADV – Temporary Office

*Q: My firm has employees who are temporarily conducting investment advisory business from a temporary location other than their usual place of business (their homes, for example) as part of the firm's business continuity plan due to circumstances related to coronavirus disease 2019 (COVID-19). Item 1.F of Part 1A requires information about a firm's principal office and place of business. Section 1.F of Schedule D requires information about "each office, other than your principal office and place of business, at which you conduct investment advisory business." Is my firm required to update either Item 1.F of Part 1A or Section 1.F of Schedule D in order to list the temporary teleworking addresses of its employees?*

*A: No. As long as the employees are temporarily teleworking as part of the firm's business continuity plan due to such circumstances, staff would not recommend enforcement action if the firm does not update either Item 1.F of Part 1A or Section 1.F of Schedule D in order to list the temporary teleworking addresses. (Posted March 16, 2020)*

See <https://www.sec.gov/divisions/investment/iard/iardfaq.shtml#item1f>

## Update ADV – Other Issues

- Regulatory Contact – Verify Contact Person & Contact Information Is Current on Form ADV Part 1
- Books & Records - If Original Required Records Are Maintained at New Location - Form ADV Part 1, Schedule D, Section 1.L
- Material Information – If Impact of COVID-19 Is Material on Investment Adviser or Services, the Form ADV Part 2A Should Be Updated Promptly.

## SEC ADV Filing & Delivery Extension

- If Investment Adviser Registered with SEC or ERA Is Unable to Meet ADV Annual Amendment Filing, Form PF Filing or ADV 2A Delivery Deadline (falling 2/13/20 – 6/30/20) Due Effects of COVID-19, Investment Adviser May File/Deliver No Later Than 45 Days After the Original Due Date of the Filing/Delivery (as Applicable) If it Meets the Following Requirements:
- Provides the Commission via Email at [IARDLive@sec.gov](mailto:IARDLive@sec.gov) and Discloses on its Public Website the Following Information:
  - It is relying on this Order due to COVID-19;

## SEC – Use of Extension Is Not Risk Factor

*OCIE believes it is important to communicate to registrants that **reliance on regulatory relief will not be a risk factor utilized in determining whether OCIE commences an examination.** We encourage registrants to utilize available regulatory relief as needed.*

*See <https://www.sec.gov/ocie/announcement/ocie-statement-operations-health-safety-investor-protection-and-continued>*

## COVID-19 Updates by State Securities Regulators

- NASAA Established a Webpage of COVID-19 Updates by State Securities Regulators:

<https://www.nasaa.org/industry-resources/covid-19-updates/>

- Several States Have Announced Extensions for Annual ADV Amendments

# Business Continuity Plan

- Should Review & Update BCP in Light of Extended Work From Home Scenario
- Verify All Mission Critical Tasks Are Documented
- Cross-Train Back-Up Employee on All Mission Critical Tasks

# PST - Review

- Verify Supervised Persons Are Not Front Running Clients When Moving Out of or Into Market



# BCP

- Should Review & Update BCP in Light of Extended Work From Home Scenario
- Verify All Mission Critical Tasks Are Documented
- Cross-Train Back-Up Employee on All Mission Critical Tasks

# Succession Plan

- Multi-Rep Investment Adviser Firm - Should Review, Establish and/or Update the Following Related to Disability or Death of Owner or Key Officer
  - Limited Powers of Attorney, Corporate Resolution, Check-Writing Authority, Buy-Sell Agreement
- Single-Rep Investment Adviser Firm – Should Review, Establish and/or Update
  - Temporary Service Agreement with Limited Power of Attorney & Buy-Sell Agreements with Other Investment Adviser Firms

## Vendors – Ongoing Due Diligence

Investment Adviser Should Consider,  
Analyze or Investigate the Implications of  
COVID-19 on Critical Operational  
Relationships with Key Service Providers

# Client Communication

- Check In with All of Your Clients
- Document All Communications/Meetings
  - Have a 2<sup>nd</sup> Staff Member in Call/Meeting Taking Notes
- Utilize Agendas/Checklists, Contemporaneous Notes & Follow-Up Emails, Letters or Minutes
- Trusted Emergency Contact Authorization
  - Don't Rely Upon Merely Qualified Custodian
- Verify with Client Beneficiaries Are Correct
- Make Sure Power of Attorneys, Health Directive, Trusts and Will Up-To-Date

# Client Communications

- Text Messaging, Social Media Messaging and/or Slack to Clients
  - Does Your Investment Adviser Have Technology to Supervise & Archive Messages
  - If Yes, Need Compliance Manual Section & Training
  - If No, Remind Supervised Persons Cannot Use Text Message for Client Communication or Trading Purposes
- Email sent to Multiple Clients Should Be Reviewed as Advertising/Sales Literature

# Client Communications - Scams

- Warn Clients of COVID-19 Scams Related to Miracle Drugs/Remedies
  - Watch Out for Bogus Research Reports on Microcap Stock Fraud – Pump & Dump Schemes
  - Submit Tips & Complaints of Fraud to <https://www.sec.gov/tcr>
- Warn Clients of Stimulus Package Related Scams – Sharing SSN or Account Numbers
- Remind Supervised Persons to Watch for Diminished Capacity & Financial Exploitation – Report to CCO for Investigation
- Remind Supervised Persons to Verify 3<sup>rd</sup> Party Transfer Requests

## Working from Home – Physical Security

- Implement clean desk policy - no confidential client information or documents on unattended desk
- Implement procedures to shred immediately any discarded document with confidential client information
- Lock file cabinets and desks (or office) with confidential client documents and information

## Working from Home – Cybersecurity

- Require Supervised Person to Use Firm's Computer/Laptop & Prohibit Using Personal Computer/Laptop
  - Encrypt Computer/Laptop
  - Make Sure Firewall Turned-On & Anti-Virus/Malware Active
  - Lock Screen When Not In Use
  - Do Not Write Password Down Next to Computer/Laptop
  - Have IT Use Remote Access To Verify Set-Up Correctly If New Arrangement



## Working from Home – Cybersecurity

- If Using Personal Computer/Laptop, Recommended Mitigation:
  - Verify Operating System and Security Patches Are Current and Automatically Updated
  - Make Sure Firewall Turned-On
  - Verify Anti-Virus and Malware Software Installed/Active
    - Conduct Full Scan to Identify Any Issues
  - Create a Separate Login for Supervised Person
  - Do Not Save Passwords in Browser & Automatically Delete Browsing History
  - Use Password Manager to Login To Cloud Services & Turn On Two-Factor Authentication Wherever Possible
  - Do Not Save Documents with Confidential Information on Personal Computer/Laptop
  - Lock Screen or Log Out When Not Using
  - Recommend Requiring Supervised Person to Confirm in Writing & Have IT staff check via Remote Access

## Working from Home – Cybersecurity

- WiFi
  - Verify Not Using Public WiFi
  - Recommend Using Data When Accessing Confidential Client Info or Systems
  - Verify WiFi Is Password Protected, Only Used by Trusted Family Members/Roommates & Other Security Features Are Turned-On (e.g. Using WPA2)
- Remote Access to Server – Require VPN to Access
- Access Cloud Service Providers
  - Turn on 2FA
  - Use Unique/Complex Password

# Cybersecurity - Protecting Against Phishing

- **Stay Current.** Watch news about current developments of phishing scams.
- **Check Out Links Before Clicking.** Hover over links before clicking and verify that the links lead to where they should. It's better to go to the site than click on a link when possible.
- **Ask Others About Unexpected Emails.** If you receive an unexpected email, ask the sender or others about whether this is an expected email.
- **Double Check Website Address** – Watch out for a malicious website's use of deceptive website addresses using similar but different names with one character missing or different from a legitimate website.
- **Avoid Ads with Diagnostic Warnings, Prize Notices or Sensational Headlines.** Avoid ads on website that look like diagnostic warnings about your computer or that the user has won a prize. Also avoid pop-up windows trying to lead you to a less secure website. Avoid clickbait – sensational headlines designed to click to read more.
- **Investigate Suspicious Websites** - Search for information about the suspicious or unknown website – look for other people's experiences with the site. Run a Google safe browsing diagnostic on site.
- **Verify Site's Security.** Make sure website starts with "https" and/or includes a locked sign near the website address.
- **Secure Browser.** Utilize an open-source, secure browser like Firefox with a privacy focused extension like PrivacyBadger to protect sensitive browser and user data.

# Cybersecurity - Protecting Against Phishing

- **Install Anti-Phishing Toolbar in Internet Browser.** Run quick checks on the sites that you are visiting and compare them to lists of known phishing sites.
- **Check Online Accounts and Statements.** Regularly review online accounts and any statements to verify no unauthorized activity.
- **Change Passwords.** Regularly change the passwords for online accounts.
- **Keep Browser Updated.** Promptly download and install security patches for browser.
- **Use Firewalls.** Verify that your network has a hardware firewall and desktop has software firewall.
- **Block Pop-Ups.** Turn-on browser feature that blocks pop-up ads.
- **Utilize Anti-Virus Software.** Scan for malicious files.
- **Notify CCO and CIO of Phishing.** Encourage supervised persons to report promptly any instances of the supervised person falling victim of phishing scam.
- **Monitor Security Breaches Involving Email Address.** Subscribe to Firefox Monitor to monitor whether your email addresses have been involved in a cybersecurity breach exposing your personal information.

## Working from Home – Cybersecurity

- Educate Supervised Person on Who to Contact if Possible Cybersecurity Breach
- Maintain Copy of Cybersecurity Incident Response Plan at Home
  - Including Contact Name and Info of Various Parties Who Have To Be Contacted In Event of Breach

# To Extent COVID-19/Market Volatility Causes Investment Adviser's Financial Condition to Decline

- SEC – Must Disclose Precarious Financial Condition to Clients
- State – If State Has a Net Worth Requirement, Must Make Sure that Still Meeting State's Requirements

# Client Complaints

- Remind Supervised Person that Any Client Complaints or Potential Complaints Should Be Reported to CCO
- Review Emails/Messages/Correspondence for Complaints for Potential Complaints
  - Refine Key Words for Filters to Help Identify Complaints
- Promptly Acknowledge Receipt of Client Complaint in Writing, Conduct Investigation by Objective & Competent Party, Consult with Legal Counsel Depending Upon Circumstances, Report to E&O Carrier Depending Upon Circumstance, Provide Letter of Findings to Client.

## ADV Part 3/CRS

SEC Has Provided **No** Indication Whether It Will Postpone Requirement to File Form ADV Part 3/Client Relationship Summary with SEC (6/30/20) or Delivery to Existing Client (7/30/20).



# Upcoming Webinars

## ***Preparing Form ADV Part 3/CRS***

Wednesday, April 22, 2020 at 12:00 p.m. CDT

Complimentary

[https://zoom.us/webinar/register/WN\\_CsHILWJHRQK8YZnrutpdow](https://zoom.us/webinar/register/WN_CsHILWJHRQK8YZnrutpdow)

# Client Relationship Summary – Form ADV Part 3

Webinar Presented by Bryan Hill  
Over 30 FAQs Pertaining to Form ADV Part 3  
Form ADV Part 3 Drafting Service - \$595

<https://www.ria-compliance-consultants.com/form-adv-part-3-faqs/>

# Thank You

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