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Investment Adviser Compliance Developments

Presented by Bryan Hill

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Slides Available

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Presentation Agenda

- IAR CE Requirements
- SEC Risk Alerts (Curated)
- Marketing Rule – High Level
- SEC Tea Leaves with New Chair

IAR CE Requirement

- NASAA Passed Model Continuing Ed Rule for IAR
- If State Adopts, Reps Must Comply in 2022
- Will Apply to IARs at State & SEC Firm If Any State (Where IAR Is Licensed) Adopts
- Annual IAR CE Requirement
 - 6 Hours of Products & Practices
 - 6 Hours of Ethics & Professional Responsibility
- If IAR Doesn't Complete Annual CE Status, Marked CE Inactive on IAPD/Broker-Check and Won't Be Eligible for Renewal of Registration If Not Corrected Within Following CY

SEC Risk Alerts in 2020

- Executive Order on Securities Investments that Finance Communist Chinese Military Companies (1/6/21)
- Large Trader Obligations (12/16/20)
- **Investment Adviser Compliance Programs (11/19/20)** ←
- **Supervision, Compliance and Multiple Branch Offices (11/9/20)**
- Cybersecurity: Safeguarding Client Accounts against Credential Compromise (9/15/20)
- Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers (8/12/20)
- Cybersecurity: Ransomware Alert (7/10/20)
- Observations from Examinations of Investment Advisers Managing Private Funds (6/23/20)
- **Examinations that Focus on Compliance with Form CRS (4/7/20)**

See <https://www.sec.gov/exams> .

Risk Alert – Compliance Program Inadequate Resources

- CCO Didn't Devote Adequate Time to Responsibilities
 - Too Many Other Responsibilities
 - Didn't Have Time to Develop Knowledge of IAA'40
- Compliance Staff Didn't Have Adequate Resources
 - Lack of Training or Staff
 - Resulted In P&P Not Implemented, Lack of Annual Review, Incomplete ADV Filings & Delays in Responding to SEC Examiners
- Grew Significantly in Size or Complexity But No Additional Compliance Staff or Technology

Risk Alert – Compliance Program Insufficient Authority

- Restricted CCO from Trading Exception Reports or Advisory Agreements with Key Employees
- Senior Leaders Had Limited Interaction with CCO
- CCO Had Limited Knowledge of Firm's Leadership, Strategy, Transactions & Business Operations
- Instances Where Senior Leadership Doesn't Consult CCO About Matters with Compliance Implications

Risk Alert – Compliance Program Annual Review Deficiencies

Failed to Identify Significant Compliance/Regulatory Issues:

- Evidence of Annual Review – Could Not Provide Evidence That One Occurred
- Identification of Risks – Failed to Identify or Review Key Risk Areas Applicable to Firm
- Significant Aspects of Business – Failed to Review Key Areas of Business
 - Oversight & Review of Third-Party Money Managers, Cybersecurity & Calculations of Fees and Expenses

Risk Alert – Compliance Program

Examples of Failure in Implementing Written P&P

- Train Employee
- Implement Compliance Procedures For Trade Errors, Best Execution, Conflicts, Disclosure and Other Requirements
- Review Advertising Materials
- Follow Compliance Checklists Including Testing Fee Calculations and Business Continuity
- Review Client Accounts
 - Assess Consistency of portfolios with clients' investment objectives, on a periodic basis

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Risk Alert – Compliance Program Maintaining Reasonably Designed Written P&P

- Outdated & Inaccurate Info in Written P&P
- Off-the-Shelf Manual with Incomplete or Unrelated Info
- Failure to Tailor Written P&P
 - Cursory Review
 - Used an Affiliate's P&P Like B/D

Risk Alert – Compliance Program Observed Areas of Weakness in P&P

- Portfolio Management
 - Due diligence and oversight of outside managers
 - Monitoring compliance with client investment and tax planning strategies
 - Oversight of third-party service providers
 - Due diligence and oversight of investments, including alternative assets.
 - Oversight of branch offices and investment advisory representatives
 - Compliance with regulatory and client investment restrictions.
 - Adherence with investment advisory agreements.

Risk Alert – Compliance Program Observed Areas of Weakness in P&P

- Marketing
 - Oversight of solicitation arrangements
 - Misleading marketing presentations, including on websites
 - Oversight of the use and accuracy of performance advertising
- Trading practices
 - Allocation of soft dollars
 - Best execution
 - Trade errors
 - Restricted Securities

Risk Alert – Compliance Program Observed Areas of Weakness in P&P

- Disclosures.
 - Accuracy of Form ADV
 - Accuracy of client communications
- Advisory fees and valuation
 - Fee billing processes, including how fees are calculated, tested, or monitored for accuracy
 - Expense reimbursement policies and procedures.
 - Valuation of advisory client assets

Risk Alert – Compliance Program Observed Areas of Weakness in P&P

- Safeguards for client privacy.
 - Regulation S-P
 - Regulation S-ID
 - Physical security of client information
 - Electronic security of client information, including encryption policies
 - General cybersecurity, including access rights and controls, data loss prevention, penetration testing and/or vulnerability scans, vendor management, employee training or incident response plans

Risk Alert - Multi-Branch Offices – P&P

One-Half of Examined Firms Had One or More of the Following Issues Related to P&P

- Inaccurate Due to Outdated Information (e.g., Change of Personnel)
- Not Consistently Applied to All Branches
- Compliance Dept. Didn't Receive Records Required Under Compliance P&P
- Not Enforced

Multi-Branch Offices - Inadvertent Custody

- P&P Didn't Limit Ability to Process Withdrawals/Deposits in Client Accounts or Change Client Addresses
- Comingled Client & Investment Adviser's Assets
- Trustee of Client Accounts
- General Partner to Advised Limited Partnership
- Received Checks at Branch Which Were Deposited with Custodian
- Various Arrangements Which Gave Investment Adviser Broad Authority Over Assets

Multi-Branch Offices - Fees

- No P&P to Identify and Remediate Undisclosed Fees Charged to Clients
- Most Fee Billing Issues Due to Lack of Oversight
- Examples of Overcharging Fees to Clients
 - Inaccurate Fee Calculations – Misapplying Tiered Fee Structures & Incorrect Valuations
 - Inconsistently Fee Refunds Including 12b-1 Trail Offsets & Termination Refunds for Pro-Rated Fees Which Were Initially Paid in Advance
 - Different Rates than In Agreement or On Excluded Assets

Multi-Branch Offices - Supervision

- Disclosure of Material Discipline Events for Certain Supervised Persons
- Portfolio Management Such as Recommending MF Share Class Not in Client's Best Interest
- Trading & Best Execution

Multi-Branch Offices Advertising

- Performance Presentation Omit Material Disclosures
- Superlatives or Unsupported Claims
- Professional Experience and/or Credentials that Were Falsely Stated
- Third-Party Rankings or Award that Omitted Material Facts Regarding these Awards

Multi-Branch Code of Ethics

- Failure to Comply with Reporting Requirements of Personal Securities Transactions or Holdings
- Failure to Review Transactions and Holding Reports
- Failure to Properly Identify Access Persons
- Failure to Include Required Provisions in CoE Such as Pre-Approval of Private Placements & IPOs

Multi-Branch - Portfolio Management

- Purchased Share Classes with 12b-1 Fees Which Weren't In Client's Best Interest
- Failed to Assess Whether Wrap Fee In Best Interest of Client
 - Erroneously Charged Commissions
 - Misrepresented Wrap Fee Program (i.e., fees, trading away practices, and delegation of responsibilities)
 - Failed to Oversee Trade Away Practices of Sub-Advisers
- Automated Rebalancing Resulted in Short-Term Redemption Fees
- Trade Allocation – Favoring Proprietary Fund over Non-Proprietary Fund Clients Which Is Conflict of Interest
- Failure to Disclose Compensation Difference for IARs to Recommend Specific Investments
- Lack of Best Execution Analysis
- Principal Trades without Client Consent
- Improper Supervision of Personal Securities Trades – Allocating Block Trade Losses to Clients Rather than Supervised Person (i.e., Cherry Picking)

Multi-Branch Office - Best Practices

- Main Office to Monitor/Approve Branch's Advertising Especially When Using D/B/A
- Main Office Responsible for Billing & Utilize Uniform Billing Standards
 - Resulted in Less Errors & Reduced Risk that IAR or Branch Had Billing Exceptions that Were Inconsistent with Agreement and Disclosures
- Centralized Review/Approve Personal Trading
- Uniform P&P and Systems for Portfolio Management and Centralized Trade Desk

Multi-Branch - Best Practices

- Conduct Branch Audits At Least Annually
 - Validating Branch Undertook Supervisory Reviews of Portfolio Management Decisions
 - Designating Individuals within Branch to Provide Portfolio Management – Assess Whether Client Recommendations Were Consistent with Stated Investment Objectives
 - Consolidated Branch Trading with Firm’s Overall Testing
 - Conduct Reviews that Don’t Rely Upon Self-Disclosures
- P&P Requiring Review of Prospective IAR’s Disciplinary History When Hiring & Periodically Re-Reviewing Thereafter for Accuracy & Providing Heightened Supervision
- Compliance Training for Branch Office’s Supervised Person Twice Per Year Based Upon Branch Audit

Form ADV Part 3 Compliance

Item 4 - Disciplinary & Legal History

- Due to Time Constraints, This Presentation Isn't Covering Issues SEC May Have with Content Except for the Following:
 - Item 4 Answer on Disciplinary Question Is Required Even If No Legal/Disciplinary Issue
 - Item 4 Answer Can Explain Yes/No for Firm and Then Yes/No for Reps
 - Item 4 Answer Cannot Use Descriptive, Qualitative or Quantitative Language

Form ADV Part 3 Compliance Item 4 - Disciplinary & Legal History

*In the staff's view, it would **not** be appropriate to add descriptive or other qualitative or quantitative language. Adding such language might intentionally or unintentionally obfuscate or otherwise minimize the disciplinary history. Accordingly, based on your facts, in the staff's view, it would **not** be appropriate to respond, for example, "No for our firm. Yes for only one of our 50 financial professionals."*

See <https://www.sec.gov/investment/form-crs-faq> (emphasis added).

Form ADV 3 Compliance Undisclosed Disciplinary Events

RCC Recommends The Following:

- Run A Background Check (Civil/Criminal) on All Supervised Persons for Last 10 Years in Each County Where Person Lived/Worked
- Review CRD Report Each Supervised Person
- Compare to Form U4, Form ADV Part 1, Form ADV Part 2A, Form ADV Part 2B and Form ADV Part 3 & Reconcile/Update Any Omissions or Discrepancies

Updating Form ADV Part 3

Must Amend Form ADV Part 3 within 30 days whenever any information in the investment adviser firm's relationship summary becomes materially inaccurate by filing with the SEC an additional other-than-annual amendment or by including the relationship summary as part of an annual updating amendment.

Form ADV Part 3 Compliance Delivery of Form ADV Part 3 Updates to Clients

A SEC registered investment adviser must communicate any changes in the updated Form CRS/For ADV, Part 3 relationship summary to retail investors who are existing clients within 60 days after the updates are required to be made and without charge.

Form ADV Part 3 Compliance Showing Updates to Clients

Must include an exhibit highlighting the most recent changes when delivering the updated Form CRS/Form ADV, Part 3 relationship summary to an existing retail investor.

Form ADV Part 3 Compliance Updates – P&P

- Review an Investment Adviser Firm's P&P for Updating the Form ADV Part 3/CRS
 - Assess How & Whether Firm Updates & Files Form ADV Part 3/CRS within 30 Days of Info Becoming Inaccurate
 - Assess How & Whether Firm Communicates Changes to Retail Investors within 60 Days After Updates Are Required to Be Made
 - Assess Firm's Process for Highlighting Most Recent Changes Including an Exhibit Highlighting or Summarizing Material Changes

Form ADV Part 3 - Recordkeeping

Required to maintain for 5 years following the end of the fiscal year during which the last entry was made on such record

Form ADV Part 3 - Recordkeeping

- Review Filing of Form ADV Part 3
 - Include Proof of Filing via IARD System in Files
- Review Each Version of Form ADV Part 3
- Review Whether Updates Include Exhibit of Changes
- Review Records Related to Delivery
- Review P&P Related to Record Keeping of Form ADV Part 3 and Delivery Obligations

Form ADV Part 3 After Filing with SEC & Delivery to Clients

- Verify Posted to Website & Easily Accessible
 - Link to Form ADV Part 2A
 - Archive Webpages to Prove Posting
- Verify Updated Compliance Manual with Form ADV Part 3 Section
- Verify All Supervised Persons Trained on Form ADV Part 3 P&P
- Verify IARs Trained on Conversation Starters
- Review Update Requirements (Filing & Delivery)
- Check Recordkeeping
- Implement Testing of P&P for Form ADV Part 3

Marketing Rule - Background

- SEC's New Marketing Rule Merged Old Advertisement Rule from 1961 and Old Solicitor Rule from 1979
- With Respect to Solicitations (now known as Endorsements), New Marketing Rule Expands Coverage to
 - All Forms of Compensation Rather Than Merely Cash Compensation
 - Also Include Current & Prospective Investors in Fund
 - Eliminates Certain Requirements Such As Delivery of Form ADV Part 2A at Time of Solicitation or Separate Disclosure Statement

Overall Assessment of Advertising Component of SEC's New Marketing Rule

- Allows Client Testimonials Under Certain Conditions with Disclosures
- Changes Criteria/Disclosure for Third-Party Rating Services
- Makes Hypothetical Advertising to the Masses Not Feasible & Establishes Specific Disclosures
- Creates Standardized Disclosures for Performance Advertising
- Better Updates Rule to Present Day Technology (Electronic & Mobile)
- Codifies Many of the SEC No-Action Letter & Interpretative Releases
- Utilizes Principals & Instead of Very Specific Rules
 - This Ambiguity Is Still Very Dangerous for Investment Advisers

Advertising Prohibitions

- **Making an untrue statement of a material fact, or omitting a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading;**
- Making a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC;
- **Including information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the adviser;**
- Discussing any potential benefits without providing fair and balanced treatment of any associated material risks or limitations;
- Referencing specific investment advice provided by the adviser that is not presented in a fair and balanced manner;
- Including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced; and
- **Including information that is otherwise materially misleading.**

Effective/Compliance Date

- Passed by SEC Commissioners on 12/22/20
- Rule Isn't Effective Until 60 Days from Publication in Federal Register ("Effective Date")
- As of 3:30 p.m. Central Wednesday, February 3, 2021, the SEC's New Marketing Rule Hasn't Been Published in the Federal Register
- Marketing Rule Includes an Extended, 18-Month Transition Period after the Effective Date
 - "Compliance Date" Is 18 Months After Effective Date
- Advertising Is Required to Comply with New Marketing Rule After Compliance Date
- Risk that New Majority of Commissioners Pulls Back for Reconsideration

My Reading of SEC Tea Leaves

- More SEC Examiners
- Tougher SEC Enforcement
- Continued Focus on Fiduciary Duty/Conflicts of Interest
- Less Focus on Capital Availability
- Scrutiny of Investment Adviser's ESG Claims & Practices
- Regulation of Crypto Currency/Digital Assets
- Review of Leveraged/Inverse ETFs for Retail Investors

SEC Enforcement

- Subpoena Power Broadened Under Interim Chair Allison Lee
- Automatic Disqualification Waivers Taken Out of Enforcement Settlements
- Many Commentators Predict More Enforcement Actions Under Chair Nominee Gensler Against Investment Adviser

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

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
- Including Digital Assets as Part of PST of Supervised Persons?

Inverse & Leveraged ETFs

- SEC Investor Advocate Identified Inverse & Leveraged ETFs for Retail Investors as Problematic & Urged Commission to Mitigate Danger Facing Retail Investors

Thank You

Bryan Hill, President

RIA Compliance Consultants, Inc.

877-345-4034 x 101

bhill@ria-compliance-consultants.com

<https://www.linkedin.com/in/bryanhill/>