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SEC 2021 Exam Priorities

Presented by Bryan Hill

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Slides Available Online

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Today's Presenter

Bryan Hill

President

RIA Compliance Consultants, Inc.



Grant Parr

Director of Marketing and
Analytics

RIA Compliance Consultants, Inc.



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Presentation Agenda

- IAR CE Requirements
- SEC Risk Alerts (Curated)
- SEC 2021 Exam Priorities

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 - 2021

- Digital Asset Securities (2/26/21)
- 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

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

SEC 2021 Exam Priorities

Division of Examinations (f/k/a Office of Compliance Inspections and Examinations) of U.S. Securities and Exchange Commission
Published 2021 Examination Priorities on 03/03/2021:

<https://www.ria-compliance-consultants.com/product/2021-sec-exam-priorities/>

SEC 2021 Exam Priorities RIAs, BD & Hybrids

“[The Division of Examinations] will continue to prioritize examinations of RIAs, broker-dealers, and dually-registered or affiliated firms...”

SEC 2021 Exam Priorities Prioritize RIA Exams

- RIA That Have Not Been Examined for a Number of Years Focusing Whether Compliance Program Adequate In Light of Substantial Growth or Changes of Business Models
- RIA That Have Never Been Examined, Including New RIAs, Focusing on Compliance Programs

SEC 2021 Exam Priorities – Retail Investors

– Will Again Emphasize Protection of Retail Investors Particularly Seniors and Individuals Saving for Retirement

- Focus on Appropriateness of Recommendations & Advice Especially

SEC 2021 Exam Priorities Compliance Programs

- Assess Appropriateness of Account Selection, Portfolio Management, Custody, Best Execution, Fees & Expenses, Business Continuity, Valuation of Client Assets for Consistency and Appropriateness of Methodology
- Evaluate Whether RIA Has Sufficient Resources to Perform Core Compliance Responsibilities
- Review Whether P&P Are Reasonably Designed, Implemented and Maintained

SEC 2021 Exam Priorities – Form ADV 3

“The Division [of Examinations] will prioritize examinations of broker-dealers and RIAs to assess compliance with Form CRS.”

SEC 2021 Exam Priorities

Fiduciary Duty

- Continue to Assess Whether RIAs as Fiduciaries Have Fulfilled Their Duty of Care & Duty Loyalty
- Assess Whether RIAs Provide Advice (**Including Account or Program Type Recommendations**) Continues to Be In the Best Interests of Client Based on Client's Objectives
- Assess Whether RIAs Eliminate or Make Full & Fair Disclosures of All Conflicts Which Might Incline RIAs (Consciously or Unconsciously) to Render Advice which Is Not Disinterested
- Focus on Risks Associated with Fees and Expenses, Complex Products, Best Execution, and Undisclosed or Inadequately Disclosed, Compensation Arrangements

SEC 2021 Exam Priorities – Conflicts

- Will Review Revenue Sharing Arrangements Between RIA and Issuers, Service Providers and Others
- Will Review Direct or Indirect Compensation for Personnel for Executing Client Transactions
- Will Prioritize Examinations of RIAs Operating and Utilizing Turnkey Asset Management Platforms:

“Such platforms provide RIAs with technology, investment research, portfolio management and other outsourcing services, and the Division’s examinations will seek to assess whether such fees and revenue sharing arrangements are adequately disclosed.”

SEC 2021 Exam Priorities – Fee Errors

- Review Whether RIA Failed to Aggregate Certain Accounts for Purposes of Calculating Fee Discount Contrary to Disclosures
- Whether RIA Failed to Exclude Certain Holdings from Management Fee Calculations
- Whether RIA Inaccurately Calculated Tiered Fees, Including Failure to Provide Breakpoints and Aggregate Household Accounts
- Whether RIA Failed to Refund Prepaid Fees for Terminated Accounts

SEC 2021 Exam Priorities Leveraged ETFs

“The Division [of Examinations] will focus on financial intermediaries’ recommendations and disclosures involving ETFs, including adequacy of risk disclosure, and suitability, particularly in niche or leveraged/inverse ETFs.”

SEC 2021 Exam Priorities

ESG, Accredited Investors & Opportunity Zones

- Review Consistency & Adequacy of Disclosures Regarding Strategies
- Determine Whether RIA's Processes & Practices Match Disclosures
- Review Advertising for Misleading Statements
- Review Proxy Voting Policies & Procedures & Actual Vote Align with Strategies

ESG Investing – RCC Tips

- 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

SEC 2021 Exam Priorities – Info Security

- Review Safeguard of Accounts & Prevention of Intrusions
 - Verifying Client’s Identity
- Oversee Vendors and Service Providers
- Address Malicious Email (e.g., Phishing & Account Intrusions)
- Response to Cybersecurity Incidents Including Ransomware
- Operational Risks as Result of Work-From-Home Environment
- Controls of Mobile Application with Access to Client Info
- Controls of Electronic Storage via Cloud Service Providers

SEC 2021 Exam Priorities Business Continuity & Disaster Recover

*“The scope of these examinations will be similar to the post-Hurricane Sandy work of the Division and other regulators, with a heightened focus on the maturation and improvements to these plans over the intervening years. **As climate-related events become more frequent and more intense**, we will review whether systemically important registrants are considering effective practices to help improve responses to large-scale events.”*

SEC 2021 Exam Priorities RegTech

*“RegTech, when implemented appropriately, may increase the efficiency of compliance staff, reduce manual processes, and exponentially increase transaction review capabilities. **However, misused or improperly configured RegTech may lead to compliance program deficiencies.** Examinations will focus on the implementation and integration of RegTech in firms’ compliance programs.”*

SEC 2021 Exam Priorities RIAs Managing Digital Assets

- Whether investments are in the best interests of investors
- Portfolio management and trading practices
- Safety of client funds and assets
- Pricing and valuation
- Effectiveness of compliance programs and controls
- Supervision of outside business activities of reps

SEC 2021 Exam Priorities Dual RIA/BD Registrants

- *“[T]he Division will continue to prioritize examinations of RIAs that are dually registered as, or are affiliated with, broker-dealers, or have supervised persons who are registered representatives of unaffiliated broker-dealers.”*
- *“Areas of focus will include whether RIAs maintain effective compliance programs to address the risks associated with these business models, including **conflicts of interest that arise from certain compensation arrangements and outside business activities, best execution, and prohibited transactions.**”*

SEC 2021 Exam Priorities Mutual Fund Share Class

“The Division [of Examinations] will also continue to prioritize the examination of incentives provided to financial services firms and professionals that may influence the selection of particular higher cost mutual fund share classes when lower cost classes are available.””

SEC 2021 Exam Priorities - Adviser to Private Funds

- Focus on Liquidity, Disclosures of Risks and Conflicts of Interest
- Specific Areas of Review
 - Preferential Treatment of Certain Investors Including Imposing Gates or Suspension on Fund Withdrawals
 - Valuations of Fund Assets
 - Adequacy of Disclosures for Cross Trades, Principal Investments or Distressed Sales

SEC 2021 Exam Priorities - Adviser to Private Funds

- Conflicts Around Liquidity (Adviser Led Fund Restructuring Included Stapled Secondary Transactions Where New Investors Purchase Interests of Existing Investors while Also Agreeing to Invest in New Fund)
- Focus on Funds with Higher Concentration of Structured Products (CLO and Mortgage-Backed Securities) to Assess Whether Funds Are at Higher Risk Holding Non-Performing Loans & Having Loads with Higher Default Risk than Disclosed to Investors
- Private Funds Where Material Impacts on Portfolio Companies Owned by Fund (e.g., Real Estate) Due to Recent Economic Conditions.

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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/>