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Advisors: How to prepare for the 2015 U.S. regulatory environment

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In fiscal 2014, the Securities and Exchange Commission (SEC) filed a record 755 enforcement cases. This means that to stay ahead of the curve and take preventative steps to safeguard against regulatory scrutiny, you must know what is driving enforcement actions, what is on the horizon in 2015, and how best to prepare, particularly if you have a limited budget. This article will address what to expect from the regulators this year and how to prepare and establish an effective compliance risk management framework, particularly on a "shoestring budget".

Regulatory focus areas – what to expect in 2015

During the SEC's third- and fourth-quarter 2014 compliance conferences, officials provided guidance on the evolving regulatory focus areas and priorities for 2015. Most notably, SEC Chair Mary Jo White provided insight into the regulator's approach toward the asset management industry, which now has more than $63 trillion of assets under management, over 11,000 investment advisers, and nearly 10,000 investment companies registered with the SEC.

The SEC is looking at how firms establish controls on conflicts of interest, including the implementation of written compliance programs, appointment of chief compliance officers, and production of robust disclosure brochures that clearly explain conflicts to clients.

Next, through registration, reporting, and disclosure, the SEC is able to focus on compliance practices, business arrangements, fees, and related conflicts to monitor and regulate funds and advisers.

Finally, through review of the controls on portfolio composition risks (such as liquidity and leverage) and operational risks (such as inadequate internal processes and systems), the SEC is working to advance further investor protections. To accomplish this, expect three main initiatives in 2015:

- **Enhanced data reporting:** By collecting additional data from advisers, the SEC will be in a better position to monitor industry trends and identify potential compliance abuses. Expect additional reporting requirements for separate account managers, such as how the adviser manages assets owned by a particular client, as well as data inquiries on securities lending practices.

- **Enhanced controls on risks related to portfolio composition:** Liquidity management and use of derivatives in mutual funds and exchange traded funds (ETFs) are primary focus areas for SEC staff. Expect an emphasis on disclosures and how advisers are addressing the risks associated with diverse fund holdings and liquidity, as well as derivative risks associated with the use of particular funds, especially during redemptions.

- **Improved transition/succession planning:** Clients can be materially impacted when an adviser is unable to serve its clients due, for example, to retirement, dissolution, or departure of personnel. The SEC is looking at how advisers will face these challenges, taking into consideration the contractual or market restrictions that advisers may face when moving assets to another adviser.

- **Cybersecurity:** Cybersecurity will continue to be a priority, based on the number of breaches being detected, particularly as a result of identity theft and loose internal controls. Expect increased focus on how advisers safeguard against such attacks, especially if the adviser provides website portals to their consumers.

- **Other Initiatives:** These include: evaluation of how advisers safeguard client assets and comply with custody rules; asset verification to ensure advisers do not inflate assets or performance numbers; how advisers serve elderly clients; disclosure of fee arrangements outside the scope of asset-based fees; how advisers are marketing their services and performance; and the compliance programs of never-before-examined advisers.

Advisers should keep in mind that the SEC will heavily scrutinize compliance programs. Examiners will consider whether advisors have proactively performed risk assessments, analyzed and responded to exception reports, and made increased use of technology to gather more meaningful data to heighten self-awareness of potential compliance problems. The SEC will also scrutinize representations made in offering documents, performance reports, and marketing information and focus on any perceived problematic conduct.

Establishing a cost-effective compliance program

To establish an effective compliance risk management framework, it is important to begin by evaluating your highest levels of compliance risk and how such risks will be addressed. For example, if you have several remote branch offices, one risk would be how to supervise remote activities, which often requires the use of technology.

Once solutions are identified, prioritize projects based on a risk rating, with highest risks addressed first, keeping in mind implementation steps and budgetary considerations. When establishing risk levels, focus on identified conflicts and current regulatory "hot topics" and initiatives, as well as new business developments. To obtain essential information and internal controls while minimizing costs, consider the following resources, which are often free or have a nominal expense:

- **Network with colleagues:** Join a local compliance roundtable or establish a networking group of similarly situated firms and discuss how other advisers are addressing compliance challenges. Exchange business cards with attendees at industry conferences to expand your network.

- **Subscribe to free newsletters, blogs, and other publications:** Most securities law firms offer free resources and information on their websites.

- **Leverage technology:** Many advisers rely on key personnel who have multiple roles and perform various job functions, such as overseeing both operations and compliance. Given the increased regulatory focus on compliance awareness, it is essential for advisers to utilize technology to more effectively and efficiently assist in detecting and preventing circumvention of compliance requirements. Technology solutions provided by your vendors – particularly your electronic recordkeeping provider, custodian, and performance reporting software system – could help produce compliance surveillance reports that reveal potential red flags. Discuss technology solutions with your IT provider – current software may have capabilities of which you are not aware and which can be customized to meet your needs.

- **Rely on others within the organization to assist with compliance:** Market compliance messages internally by putting up compliance bulletins on your intranet and in break rooms and staff meetings. Emphasize that good compliance is good business – and is everyone's responsibility. Partner with other senior managers to emanate a consistent message across the organization.

- **Attend free or affordable compliance conferences sponsored by custodians, compliance consultants, and your affiliates:** Vendors often provide compliance seminars that are either free or low-cost. By attending these events, senior management can stay apprised of the latest regulatory trends and industry best practices and learn of new, innovative ways to manage the adviser's compliance program.

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