



Today's SEC Priorities and How You Can Prepare for an Examination

Presenters:

Michelle L. Jacko, CSCP
 Managing Partner, Jacko Law Group, PC
 CEO, Core Compliance & Legal Services, Inc.

Tito Pombra
 President, Core Compliance & Legal Services, Inc.

Kurt Nuñez
 Senior Compliance Consultant, Core Compliance & Legal Services, Inc.



Agenda

- ☐ 2019 SEC Examination Priorities
 - ❖ Services to Retirement Accounts
 - ❖ Aging Client Issues
 - ❖ Cybersecurity
 - ❖ Portfolio Management and Trading
 - ❖ Disclosure of Conflicts, Fees and Expenses
 - ❖ How Regulators Evaluate Sales Practices
 - ❖ The Importance of Onboarding and Succession Planning
- ☐ Tips, Exam Checklist and Other Takeaways



2019 SEC Examination Priorities

February 28, 2019

Schwab Advisor Services

3



2019 SEC Examination Priorities - Overview

- Very similar to 2018
- Primarily focused on retail investors, including seniors and those saving for retirement
 - ❖ Senior investors and retirement accounts and products
 - ❖ Portfolio management and trading
 - ❖ Never-before or not recently examined investment advisers
 - ❖ Mutual funds and ETFs
 - ❖ Municipal advisers
 - ❖ Broker-dealers entrusted with customer assets
 - ❖ Microcap securities

February 28, 2019

Schwab Advisor Services

4



2019 SEC Examination Priorities - Overview

- Digital assets
- Cybersecurity
 - ❖ Multiple branch offices
 - ❖ Recently-merged advisers
 - ❖ Governance and risk assessment
 - ❖ Access rights and controls
 - ❖ Data loss prevention
 - ❖ Vendor management
 - ❖ Training
 - ❖ Incident response
- Anti-Money Laundering Programs

February 28, 2019

Schwab Advisor Services

5



Services to Retirement Accounts

February 28, 2019

Schwab Advisor Services

6



Services to Retirement Accounts

- Regulatory Update: ReTIRE Initiative
 - ❖ Launched in 2015, its purpose is geared towards examining registrants' efforts in protecting investors saving for retirement
 - ❖ OCIE's Retirement-Targeted Industry Reviews and Examinations Initiative ("ReTIRE") focuses on the following four service areas:
 - Reasonable Basis for Recommendations
 - Conflicts of Interest
 - Supervision of Compliance Controls
 - Marketing and Disclosure

February 28, 2019

Schwab Advisor Services

7



Services to Retirement Accounts

- How to Prepare for An Exam
 - ❖ Examiners are reviewing how firms communicate to clients about retirement and evaluating what is in the client's best interest
- Initial Document Requests Frequently Ask About Retirement Accounts
 - ❖ What types of policies and procedures has the adviser developed relating to servicing retirement accounts?
 - ❖ Does the adviser provide training to its financial advisors for servicing retirement accounts?

February 28, 2019

Schwab Advisor Services

8



Services to Retirement Accounts

□ Initial Exam Document Requests (con't)

- ❖ What types of written disclosures and other information was provided to clients during the review period relating to:
 - Options available to the retiree (*e.g.*, account options, investment options, associated fees and distribution options, such as maintaining assets in a former employer's plan, IRA R/O or lump sum distribution)
 - Tax implications of available retirement options
 - Communications sent to clients related to retirement options
 - Retirement analysis / plans provided to clients
 - Education in this subject matter area

February 28, 2019

Schwab Advisor Services

9



Services to Retirement Accounts: Case Study

Wendy is the owner of Exposed Retirement Services ("Exposed"). The phone rings and it is the SEC. The Examiner identifies himself as Chuck Rhoades, and explains he'll be conducting an examination of Exposed next week. Prior to his arrival, Chuck requests any written disclosures or scripts used for clients with retirement accounts regarding distribution options, conflicts of interest that the Adviser has in recommending a specific product or services, the various types of account options available to clients (*e.g.*, IRA R/O) and investment options available to clients (*e.g.*, ETFs, mutual funds, private funds, etc.)

February 28, 2019

Schwab Advisor Services

10



Services to Retirement Accounts: Case Study

Wendy contacts the CCO, Taylor Mason, and asks him to gather this information. Taylor finds that the financial advisors' approach to such disclosures is inconsistent, and is not always documented.

Furthermore, most of the CRM notes do not discuss what was disclosed to clients about their distribution or investment options. It is further complicated by the fact that two of the financial advisors are licensed RRs with an unaffiliated broker-dealer.

Q1: What issues do you see?

Q2: What should Taylor produce to the staff?



Services to Retirement Accounts: Takeaways

- Develop a communication describing different retirement planning options available for your clients and use as a handout at the onset of retirement planning discussions
- Review your Form ADV disclosures relating to your retirement planning services and consider if you are fully disclosing investment options and associated risks with each
- Use a template to memorialize what is discussed with clients – and when
- Review your P&P Manuals to assess whether the firm has clearly articulated what should be documented and discussed when servicing retirement accounts, including conflicts of interest
- Provide training



Aging Client Issues

February 28, 2019

Schwab Advisor Services

13



Aging Client Issues

□ Regulatory Update: FINRA's New Rules

❖ FINRA adopts "Trusted Contact" Requirements (Effective Feb. 5, 2018)

➤ Rule 4512: Customer Account Information

Requires firms to make a reasonable effort to obtain name and contact information of a trusted contact; firms must collect this whenever an account is updated or as part of the 36-month confirmation

➤ Rule 2165: Financial Exploitation of Specified Adults

Applies to anyone over age 65 or under age 18 whom the firm believes has a mental/physical impairment such that they cannot protect their own interests; can hold disbursements and report to state regulatory agency

February 28, 2019

Schwab Advisor Services

14



Aging Client Issues

- Regulatory Update: Senior \$afe Act
 - ❖ May 24, 2018: President Trump signed into law S.2155, the Economic Growth, Regulatory Relief, and Consumer Protection Act, which included the Senior Safe Act of 2017 (“SSA”)
 - ❖ The SSA is intended to help protect against financial exploitation of senior citizens through the promise of immunity to “covered financial institutions” (“CFIs”) and individuals associated with a CFI who disclose suspected financial exploitation to a “covered agency,” such as the SEC, FINRA or law enforcement

February 28, 2019

Schwab Advisor Services

15



Aging Client Issues

Summary of the Senior \$afe Act

- Investment advisers, broker-dealers, credit unions, depository institutions, insurance agencies and transfer agents are CFIs
- The term “exploitation,” means, in part, the fraudulent or otherwise illegal act or process that “uses the resources of a senior citizen for monetary or personal benefit” or “results in depriving a senior citizen of rightful access to or use of benefits, resources, or assets”

February 28, 2019

Schwab Advisor Services

16



Aging Client Issues

Summary of the Senior Safe Act

- The SSA Promises Immunity
 - ❖ Includes civil or administrative proceedings
 - ❖ Extends to the disclosure of suspected financial exploitation of a senior citizen to a covered agency
 - Immunity extends as long as the CFI or individual associated with the CFI has received requisite training and the report is made in good faith and with reasonable care
- The SSA Does Not Mandate CFIs to Make Disclosures
 - ❖ But encourages CFIs to identify warning signs and common scams to help prevent senior citizens from becoming future victims

February 28, 2019

Schwab Advisor Services

17



Aging Client Issues

Summary of the Senior Safe Act

- For a CFI representative or an individual to receive immunity, the reporting individual must have:
 - ❖ Received requisite training
 - ❖ Served as a supervisor or in a compliance or legal function for the CFI or, in the case of a registered representative or investment adviser representative, was affiliated or associated with the CFI
 - ❖ Disclosed in good faith and with reasonable care

February 28, 2019

Schwab Advisor Services

18



Aging Client Issues

Summary of the Senior Safe Act

- ☐ Training to be made by the CFI and made available to the regulatory agencies and provided within 1-year of DOH
 - ❖ Content must address how to identify and report suspected exploitation both internally and externally to law enforcement
 - ❖ Emphasize the need to protect privacy and integrity of that individual
 - ❖ Customize to the job responsibilities of the individual
- ☐ Records to include employee name, who was trained, when

February 28, 2019

Schwab Advisor Services

19



Aging Client Issues

- ☐ How to Prepare for An Exam
 - ❖ Examiners are reviewing ability of firms to identify financial exploitation and supervisory internal controls employed
- ☐ Exam Request Letters Often Contain a Senior Client Section
- ☐ Typical questions include:
 - ❖ Indicate the % of clients who are 62+
 - ❖ What % of RAUM is from clients age 62+
 - ❖ What policies and procedures do you have for establishing a trusted point of contact?

February 28, 2019

Schwab Advisor Services

20



Aging Client Issues

☐ Exam Request Letters - Senior Client Section (con't)

❖ Typical questions:

- What policies and procedures do you have to address issues associated with:
 - Steps taken with client account(s) upon death?
 - Handling of client requests for changes to beneficiaries?
 - Powers of Attorney?
 - Trustees?
 - Frequency of communications with clients?



Aging Client Issues: Case Study

Chuck receives his first round of document production and sees that Exposed has a number of “Senior Clients” (i.e., who are over age 62). In reading over one of the CRM notes, he sees that one particular client, Ann Vulnerable, attended the last three client meetings with her new boyfriend, Dollar Bill. Chuck notices that Ann has been slowly withdrawing monies out of her account in increasing intervals, and in fact, the last withdrawal represented 25% of her assets. Chuck reaches out to Wendy, who serves as Ann’s financial advisor to gather more information. During the conversation, Chuck learns that Ann appeared



Aging Client Issues: Case Study

“not to be herself” at the last meeting. She was disheveled and seemed confused, and she had forgotten that she had withdrawn \$10,000 the previous month. When Wendy pressed her for why she needed this latest withdrawal request, Ann stated, “I want to get Dollar Bill a nice gift...you know dear, he is only 38-years old and he still loves his toys.”

Q1: What issues or potential issues do you see?

Q2: What should a financial advisor do if there are these signs?

Q3: What documentation would you provide to an examiner during an SEC exam related to this issue?

February 28, 2019

Schwab Advisor Services

23



Aging Client Issues: Takeaways

- Develop an escalation system for reporting elder abuse matters
- Have one person designating for assessing the potential concern
 - ❖ Determine if the Client has a power of attorney or trusted contact
 - ❖ Determine if a hold or restriction should be placed on the account
 - Look to the advisory contract for additional guidance
 - ❖ Evaluate whether the matter needs to be reported to APS, a regulator or law enforcement
- Add language to advisory contract for aging client issues

February 28, 2019

Schwab Advisor Services

24



Performance Advertising

February 28, 2019

Schwab Advisor Services

25



Performance Advertising

- Regulatory Update: NEP Risk Alert (Sep. 14, 2017) – Most Frequent Advertising and Marketing Deficiencies Found
 - ❖ Misleading Performance Results
 - ❖ Misleading 1:1 Presentations
 - ❖ Misleading Claims of Compliance with GIPS
 - ❖ Misleading Selection of Recommendations
 - ❖ Inadequate Compliance Policies and Procedures
 - ❖ Misleading Use of Third Party Rankings/Awards
 - ❖ Misleading Use of Professional Designation
 - ❖ Use of Testimonials

February 28, 2019

Schwab Advisor Services

26



Performance Advertising

- ☐ How to Prepare for An Exam
 - ❖ Examiners are focused on testimonials and how advisors are using rankings to promote themselves
 - ❖ Social media, including websites, Facebook and LinkedIn will be reviewed by the staff prior to their arrival onsite; review postings
 - ❖ Backup to performance advertising is frequently requested
- ☐ Examinations Generally Focus on Advertising Efforts
 - ❖ How many accounts are chosen to be in a composite? What is your selection criteria?
 - ❖ How are you marketing your strategies? Is a solicitor used?

February 28, 2019

Schwab Advisor Services

27



Performance Advertising: Case Study

When onsite, Chuck sits down with Lara Axelrod, the Managing Director of Sales, to learn about how Exposed is promoting its strategies. Lara explains that she primarily relies upon the sales team and social media, which they also embed into the firm's newsletter. Chuck asks to see an example, and Lara shows Chuck this clip:



February 28, 2019

Schwab Advisor Services

28



Performance Advertising Takeaways

- Who is going to receive the material?
- How will it be used and what is the intent?
- If used for social media purposes, has the firm adopted or integrated third-party videos as if to make it their own?
- Is there adequate and appropriate disclosures on risks, indices, performance numbers and consideration for past specific recommendation requirements, etc.?
- Have sources been cited and time periods stated?
- Are performance periods consistent?
- Does the material appear fair and balanced?

February 28, 2019

Schwab Advisor Services

29



Cybersecurity

February 28, 2019

Schwab Advisor Services

30



Cybersecurity

- Regulatory Update: “Cyber 3” Exam Sweep Coming from OCIE
 - ❖ On March 22, 2018, Peter Driscoll, Director of OCIE, announces its plan for a third cybersecurity sweep exam
 - ❖ The Cyber 3 Exam Sweep will have three focus areas:
 - Advisers who maintain remote offices
 - Advisers who have merged firms
 - The use of personal email and other “unregulated forms” of communications used leading up to and following a merger

February 28, 2019

Schwab Advisor Services

31



Cybersecurity

- Regulatory Update: 2018 SEC Exam Priority Letter
 - ❖ Specified that examinations will continue to focus on cybersecurity, and specifically:
 - Governance and risk assessment
 - Access rights and controls
 - Data loss prevention
 - Vendor management
 - Training
 - Incident response

February 28, 2019

Schwab Advisor Services

32



Cybersecurity

- How to Prepare for An Exam – Lessons Learned from the Sweep Exams
 - ❖ *Cyber 1* focused on how firms identify risks related to cybersecurity, governance practices (e.g., policies and procedures and oversight), protections of networks and information, vendor management and detecting unauthorized activities
 - ❖ *Cyber 2* focused on validation and testing of procedures and controls surrounding cybersecurity preparedness (e.g., access rights and incident response)

February 28, 2019

Schwab Advisor Services

33



Cybersecurity

- How to Prepare for An Exam – Lessons Learned from the Sweep Exams
 - ❖ 2017 NEP Risk Alert: Observations from Cybersecurity Examinations
 - Discussed examination observations (e.g., most conducted penetration tests and vulnerability scans)
 - Outlined issues observed (e.g., majority of policies and procedures were not reasonably tailored)

February 28, 2019

Schwab Advisor Services

34



Cybersecurity

☐ Recent SEC Cyber Document Request Letters

- ❖ Does the Adviser conduct periodic risk assessment to identify cybersecurity threats, vulnerabilities and potential business consequences. If such assessments are conducted:
 - Identify who conducts them, the month and year completed and any findings that were deemed to be a moderate or high risk
 - For any findings, describe whether risk areas have been remediated or not been fully remediated, and status
 - Provide evidence of how the firm conducted vendor due diligence on cyber controls

February 28, 2019

Schwab Advisor Services

35



Cybersecurity

☐ Recent SEC Cyber Document Request Letters

- ❖ If the Adviser provides clients with online account access, provide the following information:
 - Name of 3dp that manages the service, functionality for clients on the platform, how clients are authenticated for online access and security measures used to protect client PINs stored on the site
- ❖ Has malware been detected on one or more of the Adviser's devices? If so, describe actions taken
- ❖ Has a critical network resource been impaired by a software or malware function? If so, describe actions taken
- ❖ Has the Adviser detected an unauthorized breach of its network?

February 28, 2019

Schwab Advisor Services

36



Cybersecurity: Case Study

During the onsite portion of the exam, Chuck meets with Taylor to inquire about the firm's cybersecurity controls. Taylor appears to be nervous. Two days before the SEC exam, a client had contacted Wendy and informed her that \$25,000 was missing from her account. Upon investigation, it appears that the custodian received a wire request from a financial advisor who works remotely to wire the funds to a third-party bank account. It appears that the wire request was forged. Currently, Exposed is unsure if the funds were misappropriated by an employee or a cybercriminal.

Q1: What issues do you see?

Q2: Should Taylor disclose this event to Chuck?

Q3: What documentation would you provide to the examiner related to this issue?



Cybersecurity Takeaways

- Review Your Incident Response Plan for Thoroughness
 - ❖ Consider escalation procedures, remediation efforts and communication plans (to clients, regulators and law enforcement)
- Consider Your Vendor Management Internal Controls
 - ❖ Add cybersecurity risk provisions into servicing agreements (e.g., notification if a cyber breach and confidentiality / NDA language)
 - ❖ Develop policies and procedures and training materials related to information security procedures for vendors and business partners authorized to access the Adviser's network



Portfolio Management and Trading

February 28, 2019

Schwab Advisor Services

39



Portfolio Management and Trading

- Primary Focus on Allocations and Trading Practices (Cherry Picking)
- Consider also 2018 Best Execution Risk Alert
 - ❖ Not performing best execution reviews
 - ❖ Not considering materially relevant factors during best execution reviews
 - ❖ Not seeking comparisons from other broker-dealers
 - ❖ Not fully disclosing best execution practices
 - ❖ Not disclosing soft dollar arrangements
 - ❖ Not properly administering mixed use allocations
 - ❖ Inadequate policies and procedures related to best execution
 - ❖ Not following best execution policies and procedures

February 28, 2019

Schwab Advisor Services

40



Disclosure of Conflicts, Fees and Expenses

February 28, 2019

Schwab Advisor Services

41



Disclosure of Conflicts, Fees and Expenses

- Regulatory Update: NEP Risk Alert on Advisory Fees (Apr. 2018)
 - ❖ Fee-Billing on Incorrect Account Valuations
 - ❖ Billing Fees in Advance or with Improper Frequency
 - ❖ Applying Incorrect Fee Rate
 - ❖ Omitting Rebates and Applying Discounts Incorrectly
 - ❖ Disclosure Issues Involving Advisory Fees
 - ❖ Adviser Expense Misallocations
- Compensation Arrangements Remain a Focus Area
 - ❖ Advisers fail to disclose revenue share and solicitor arrangements

February 28, 2019

Schwab Advisor Services

42



Disclosure of Conflicts, Fees and Expenses

- How to Prepare for An Exam
 - ❖ Evaluate how you are providing “breakpoints” to your clients for additional assets under management and whether disclosures are accurate and meaningful
 - ❖ Review financials to identify fee splitting and revenue sharing arrangements, including incentive and bonus programs and payments to solicitors; be sure this is disclosed in Forms ADV
- The Staff Will Ask for Identification of Conflicts of Interest
 - ❖ Computation of advisory fees and compensation arrangements are key focus areas

February 28, 2019

Schwab Advisor Services

43



Disclosure of Conflicts, Fees and Expenses: Case Study

Chuck looks at the Form ADV and notices that Exposed provides breakpoints at \$1Mil in assets under management. In reviewing the client list, it appears that one client family, the Connerties, has a new family member, Bryan Connerty, who is located at the same address as the Connerty family, and has opened an account with Exposed approximately one-year ago valued at \$1Mil. Chuck learns that Bryan is the father to the primary account holder. According to the Form ADV, “Exposed may household certain assets in order to achieve breakpoints.” In requesting the supporting documentation for this calculation, Chuck discovers that Bryan’s account was not captured as part of the household.

Q1: What issues do you see?

Q2: What actions should Exposed take?

February 28, 2019

Schwab Advisor Services

44



Disclosure of Conflicts of Interest - Takeaways

- Review your disclosures for how you are describing compensation both received and paid from the Adviser and its personnel
- Consider outside business activities of your team and disclose as appropriate in Forms ADV and other client-facing documents
- Use a conflict inventory checklist to help identify conflicts
- Develop policies and procedures relating to how the Adviser detects, mitigates or eliminates conflicts
 - ❖ Disclosures alone are not enough!

February 28, 2019

Schwab Advisor Services

45



How Regulators Evaluate Sales Practices

February 28, 2019

Schwab Advisor Services

46



How Regulators Evaluate Sales Practices

Review Everything Holistically

- ❑ From the initial prospective client experience, to the marketing collateral and agreement execution, the staff will evaluate what is promised and stated
- ❑ Consider the client onboarding process and what you are requesting and delivering
 - ❖ Advisory contract, client objectives / IPS, financial plan data and trusted contact information will be evaluated
 - ❖ Consider how you are educating and communicating with your clients about working with YOU

February 28, 2019

Schwab Advisor Services

47



The Importance of Onboarding and Succession Planning

February 28, 2019

Schwab Advisor Services

48



The Importance of Onboarding and Succession Planning

The SEC is Concerned About Advisers Not Having a Succession Plan

- ❑ Recent deficiencies cite breach of fiduciary duty
- ❑ Must plan for the unexpected
 - ❖ Determine short-, mid- and long-term contingencies
- ❑ If exiting the business, consider the buyout and transition
 - ❖ Buyout by whom, insurance (keyman and tail coverage) and valuation
- ❑ If onboarding a new team to take over, consider:
 - ❖ Regulatory history
 - ❖ Similarity of management
 - ❖ Indebtedness (review with checklists we formulated)

February 28, 2019

Schwab Advisor Services

49



Tips, Exam Checklist and Other Takeaways on How to Prepare for the Exam

February 28, 2019

Schwab Advisor Services

50



Tips on How to Prepare for the Exam

- ❑ Organize Yourself Internally and Prepare Books and Records
- ❑ Prepare Employees for Interacting with Regulators
 - ❖ Conduct mock interviews
 - ❖ Review applicable policies and procedures and client disclosures (e.g., Forms ADV)
 - ❖ Be able to discuss exception reports and supervisory controls
 - ❖ ALWAYS be honest and forthcoming to the staff
- ❑ Explain to Management and Key Personnel What to Expect During the Exam
 - ❖ Establish who is the best contact person for each business area for both information and document gathering

February 28, 2019

Schwab Advisor Services

51



Tips on How to Prepare for the Exam

- ❑ Be Proactive Instead of Reactive
 - ❖ Prepare an “Opening Ceremonies” Presentation
- ❑ Inform the Staff
 - ❖ Who will be the Firm’s primary point person
 - ❖ Who must be present for interviews and demonstrations
- ❑ Always Make Duplicate Copies of Documents Produced
- ❑ Treat the Examiners Professionally
 - ❖ Be responsive; don’t speculate
 - ❖ Only address questions posed; don’t volunteer information

February 28, 2019

Schwab Advisor Services

52



Tips for Initial Documentation Requests

- ❑ Respond promptly and thoroughly to document requests
 - ❖ Only address the question posed; supplement if meaningful and ask for clarification when necessary
- ❑ Don't create new records without notating as such
- ❑ Emphasize your use of technology within the Compliance Program
 - ❖ To demonstrate the dynamics of your Compliance Program
 - ❖ To reduce "human errors" and oversights
 - ❖ To maximize efficiencies and manage risks
 - ❖ For testing, exception reports and internal controls

February 28, 2019

Schwab Advisor Services

53



Supplemental Materials

- ❑ 2019 SEC Examination Priorities
- ❑ Recent Risk Alerts
 - ❖ Advisory Fee and Expense Issues, Best Execution, Cybersecurity Examinations and ReTire Initiative
- ❑ Regulatory Examinations and Audits, Ch. 20 of Modern Compliance: Best Practices for Securities & Finance, by Michelle Jacko
- ❑ Compliance Program Checklist
- ❑ Risk Management Tip, 2019 SEC Exam Priorities: How To Prepare for Your Next SEC Exam, by Michelle Jacko

All materials can be uploaded by visiting:

<https://www.corecls.com/todays-sec-priorities-and-how-you-can-prepare-for-an-examination-supplemental-materials>

February 28, 2019

Schwab Advisor Services

54



Questions? Let us know how we can help!



Michelle L. Jacko, CSCP
 Managing Partner, Jacko Law Group
michelle.jacko@jackolg.com
 CEO, Core Compliance
michelle.jacko@corecls.com



Tito Pombra
 President
 Core Compliance
tito.pombra@corecls.com



Kurt R. Nuñez
 Sr. Compliance Consultant
 Core Compliance
kurt.nunez@corecls.com

Core Compliance & Legal Services, Inc.

Four Embarcadero Center, Ste. 1400

San Francisco, CA 94111

(415) 766-3599

San Diego: (619) 278-0020

www.corecls.com

Jacko Law Group, PC

(619) 298-2880

www.jackolg.com

February 28, 2019

Schwab Advisor Services

55