

**Compliance Update**

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

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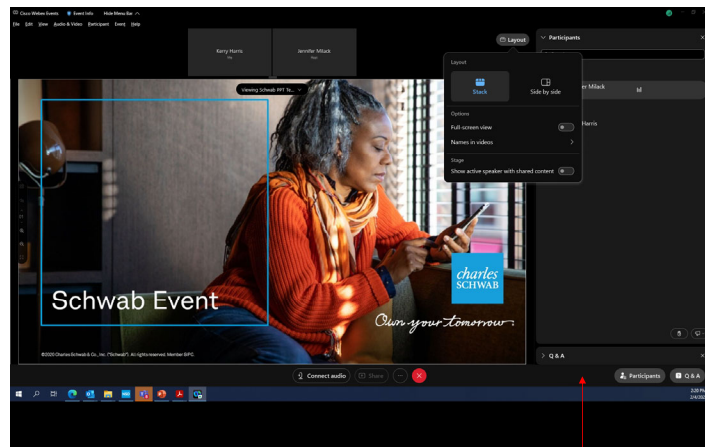
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# Be in the Know: SEC Examination Hot Topics and Compliance Expectations for 2022

Presenter:

**Michelle L. Jacko, CSCP**

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



## Agenda

- ☐ SEC Examination Hot Topics
  - ❖ Recent SEC *Risk Alerts*
  - ❖ Standards of Care
    - The DOL's Investment Advice Rule (PTE 2020-02)
    - The SEC's New Marketing Rule (Rule 206(4)-1)
  - ❖ Other Regulatory Focus Areas
- ☐ Compliance Program Tips and Operational Considerations
  - ❖ Guidance for Policy and Procedure Development
  - ❖ Customizing your Supervisory Structure
  - ❖ Using Technology to Stay Ahead
- ☐ Q&A



## SEC Hot Topics

- Exam priorities letter not yet released! Anticipated to be similar to 2021
- Focus areas continue to be retail investors, seniors, and those saving for retirement
- Current examination areas include:
  - ❖ Advisory Fees and Expenses
  - ❖ PPP Loans
  - ❖ Advisory Contract Provisions (Hedge Clauses)
  - ❖ Disclosure of Conflicts of Interest (Duty of Loyalty / Duty of Care)
  - ❖ Compliance Programs – Policies and Procedures and the Annual Review



## SEC Hot Topics

- Risk Alerts Serving as a “Call to Action”
  - ❖ There have been 10 Risk Alerts since January 2021, including:
    - Focus on Digital Asset Securities
    - ESG Investing
    - Managing Client Accounts that Participate in Wrap Fee Programs
    - Fixed Income Principal and Cross Trades by Investment Advisers
    - Registered Investment Company Initiatives
    - Advisers that Provide Electronic Advice
    - Advisory Fee Calculations
    - Private Fund Advisers
  - ❖ We will focus on the four *Risk Alerts* most likely to effect you



## SEC Hot Topics

- Why Focus on SEC *Risk Alerts*?
  - ❖ They provide insight into the most common examination deficiencies found
  - ❖ They provide best practices to consider
  - ❖ They provide areas to review for:
    - Policy and Procedure Development
    - Annual Reviews
    - Risk Mitigation
    - Potential Training Opportunities



## SEC Hot Topics

- In the Spotlight: Examinations of Private Fund Advisers (*SEC Risk Alert* - Jan. 27, 2022)
  - ❖ In the past five years, private fund assets have increased by 70%
  - ❖ The staff is finding fiduciary breaches for private fund advisers involving:
    - Failure to act consistently with disclosures
    - Misleading marketing disclosures
    - Failures relating to due diligence of investments
    - Use of misleading “hedge clauses”
    - Failure to identify risks and develop compliance policies and procedures to address risks





## SEC Hot Topics

- ☐ In the Spotlight: Examinations of Private Fund Advisers (*SEC Risk Alert* - Jan. 27, 2022)
  - ❖ Common Deficiencies Noted Include:
    - Failure to follow practices for calculation of fund-level management fee (e.g., not reducing the cost basis once the investment is sold)
    - Failure to invest in accordance with fund disclosures
    - Misleading information about a track record or performance calculation
    - Lack of reasonable investigation into underlying investments
    - Misleading hedge clauses which limit willful misconduct / fraud
  - ❖ Risk Management Tip: Review practices and procedures for these areas



## SEC Hot Topics

- ❑ EXAMS Observations: Investment Advisers' Fee Calculations (*SEC Risk Alert* Nov. 10, 2021)
  - ❖ The staff conducted 130 exams of SEC registrants with retail clients
  - ❖ EXAMS is finding issues related to:
    - Advisory Fee Calculation Errors (*e.g.*, overbilling, incorrect householding)
    - Not Crediting Certain Fees Due to Clients (*e.g.*, terminated client accounts)
    - Inadequate Fee Disclosures
    - Fee-Related Compliance Issues



## SEC Hot Topics

- ❑ EXAMS Observations: Investment Advisers' Fee Calculations (*SEC Risk Alert* Nov. 10, 2021)
  - ❖ Common Deficiencies Noted Include:
    - Advisory Fee Calculations (failure to convert all clients to updated fee schedule or charged fees different from the client's contract)
    - Householding of client accounts not correctly calculated
    - Not refunding prepaid fees for terminated clients regardless of policy
    - Misleading disclosures in Form ADV Part 2 on how fees are calculated and billed; whether fees are negotiable; values used for fee calculation (e.g., month end vs. average daily value); and extra fees (e.g., platform fees)
    - Lack of policies for computing, billing and testing advisory fees
  - ❖ Risk Management Tip: Adopt policies for advisory fee billing; centralize the process



## SEC Hot Topics

- Observations from Examinations of Investment Advisers Managing Client Accounts that Participate in Wrap Fee Programs (*SEC Risk Alert - Jul. 21, 2021*)
  - ❖ The staff conducted 100 exams of advisers with wrap fee programs
  - ❖ EXAMS observed issues related to:
    - Compliance and Oversight (*e.g.*, policies and procedures for tracking and monitoring wrap fee programs)
    - Disclosures related to conflicts, fees and expenses (*i.e.*, disclosures were inconsistent, omitted or inadequate)



## SEC Hot Topics

- ❑ Observations from Examinations of Investment Advisers Managing Client Accounts that Participate in Wrap Fee Programs (*SEC Risk Alert* - Jul. 21, 2021)
  - ❖ Common Deficiencies Noted Include:
    - Recommendations not made in clients' best interest (lack of monitoring and no reasonable basis for going into/remaining in)
    - Inadequate disclosures related to fees, brokerage commissions, householding discounts and impact and effect of bundled fees
    - Weak policies for determining suitability of wrap fee accounts, conducting best execution analysis and due diligence of TPAMs
  - ❖ Risk Management Tip: Conduct and document best interest reviews when recommending wrap fee accounts to clients



## SEC Hot Topics

- ❑ EXAMS' Review of ESG Investing (*SEC Risk Alert* - Apr. 9, 2021)
  - ❖ Concerns focus on disclosures, marketing claims and internal controls
  - ❖ EXAMS to focus on due diligence efforts for selecting, investing in and monitoring ESG investments
  - ❖ Staff Observations During Investment Adviser Exams:
    - Evidence of misleading statements regarding ESG investment processes
    - Lack of adherence to global ESG frameworks when claiming adherence (*e.g.*, only investing in companies with "high employee satisfaction")
    - Inadequate controls to maintain, monitor and update clients' ESG mandates (*e.g.*, prohibitions on certain industries such as alcohol or tobacco)
    - Proxy voting was inconsistent with advisers' stated approaches
  - ❖ Risk Management Tip: Customize ESG policies and procedures for oversight and review of ESG investing practices and disclosures



## SEC Hot Topics

- Standards of Care: The DOL's Investment Advice Rule (PTE 2020-02)
  - ❖ Summary of Requirements for Investment Advice Fiduciaries Who Advise ERISA Plans or Individual IRAs to Meet the Exemption
  - ❖ Compliance Dates: Impartial Conduct: 1/31/2022; Documentation and Disclosure: 6/30/2022
  - ❖ Three Areas to Establish:
    - Develop adequate policies and procedures for ERISA accounts and recommendations to remove assets from employer sponsored plans and establish IRA R/Os
      - Adhere to impartial conduct standards
      - Document how recommendations to R/O assets are in the client's best interest
      - Provide disclosures to clients
      - Perform annual reviews and obtain written certification from senior management

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## SEC Hot Topics

- Standards of Care: The DOL's Investment Advice Rule (PTE 2020-02)
  - ❖ Three Areas to Establish (con't):
    - Establish a method of how to assess each R/O recommendation; consider costs, fees, investment choices and benefits
    - Document your evaluation and recommendation
  - ❖ Risk Management Tip: PTE 2020-02 must be considered for your Compliance Program and client disclosure documents, including:
    - Policies and Procedures
    - Advisory Contracts
    - Forms ADV
    - Advisor Training





## SEC Hot Topics

- Standards of Care: The SEC’s New Marketing Rule (Rule 206(4)-1)
  - ❖ New Definition of Advertisement Has Two Prongs
    - First Prong of the Definition: “Any direct or indirect communication an investment adviser makes to more than one person, or to one or more persons if the communication includes hypothetical performance, that: (i) offers the investment adviser’s investment advisory services with regard to securities to prospective clients or private fund investors, or (ii) offers new investment advisory services with regard to securities to current clients or private fund investors. Excluded from this definition are:
      - Extemporaneous, live, oral communications (even if broadcasted);
      - Information in a statutory or regulatory notice or filing;
      - Communications that include hypothetical performance that is provided in response to an unsolicited investor request or to a private fund investor in 1:1 communications



## SEC Hot Topics

- Standards of Care: The SEC's New Marketing Rule (Rule 206(4)-1)
  - ❖ New Definition of Advertisement – Evergreen in Approach
    - Second Prong of the Definition: “Any endorsement or testimonial for which an adviser provides cash and non-cash compensation directly or indirectly (including directed brokerage, awards or other prizes, and reduced advisory fees)”
  - ❖ Amended Rule 206(4)-1 replaces the current advertising and cash solicitation rules; will require new policies and procedures and “Solicitor” Agreements (to become “Endorsement Agreements” in most cases)
  - ❖ Amendments also are made to the Form ADV and books and records rule
    - Form ADV Part 1a, Item 5.L asks if you use performance ads, testimonials or endorsements, third party ratings, etc.
    - Rule 204-2 requires maintenance of ads, testimonials, third party ratings and record of the “intended audience”

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## The SEC's New Marketing Rule

- Use of Testimonials for the First Time – and With Any Media (includes Reviews and Referrals)
  - ❖ Will allow consumers to know how an adviser fares compared to competitors
  - ❖ New Definition: Any statement by a current client or private fund investor about their experience with the investment adviser or its supervised persons
- Rules for Using Testimonials – Disclosures Must Include:
  - ❖ If the testimonial was made by an advisory client or private fund investor
  - ❖ Whether the person providing it was or is being compensated
  - ❖ If the person was compensated, the forms of compensation received
    - Includes fees based on a % of AUM, flat fees, retainers, hourly fees, reduced advisory fees, fee waivers as well as cash and non-cash rewards (including referral fees, prizes and gifts and entertainment)
    - Any material terms related to the compensation and any conflicts

*Advisers are forbidden from compensating any person for a testimonial if he/she is an "ineligible person" subject to a disqualifying Commission action or event*



## SEC Hot Topics: The New Marketing Rule

### What Doesn't Change – the Anti-Fraud Standards

- Cannot make an untrue statement or omission of a material fact
- Must have a “reasonable basis” for making a material statement of fact that the adviser can substantiate upon demand by the SEC
- Must be fair and balanced (potential benefits vs. associated risks)

### Where Should You Be?





## SEC Hot Topics: The New Marketing Rule

- Third Party Ratings (i.e., ratings provided in the ordinary course of business) remain subject to general prohibitions and disclosures
  - ❖ Must have a reasonable basis to believe that any questionnaire or survey used in preparation of the third-party rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses, and is not designed or prepared to produce any predetermined result; and
  - ❖ Clearly and prominently discloses (or believes the third-party rating clearly and prominently discloses):
    - The date on which the rating was given and the period of time upon which the rating was based
    - The identity of the third-party that created and tabulated the rating; and
    - If applicable, that compensation has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating



## SEC Hot Topics: The New Marketing Rule

- ❑ **Portability of performance** allowed if accounts managed at the predecessor adviser are sufficiently similar to the advertising adviser
- ❑ For performance advertising, must show **both gross and net** performance and present results for 1-, 5-, and 10-year periods (or since inception, as applicable), each presented with equal prominence and as of the most recent calendar year-end
- ❑ For **extracted performance** (carveouts from 1 portfolio) must provide or offer to provide promptly the performance of the total portfolio
- ❑ Reference to **specific investment advice** (e.g., a past or a current recommendation) is now expressly permitted; must *be fair and balanced*
  - ❖ Many No-Action Letters are withdrawn, such as Franklin and TCW

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## SEC Hot Topics: The New Marketing Rule

### Performance Advertising

- ❑ **Must consider use of composites**; exception exists if performance is not materially different and exclusion of a portfolio does not alter presentation of the 1-, 5- and 10-year periods
- ❑ **Hypothetical Performance (including model, back tested, and target/projected performance)** may be presented only if the adviser:
  - ❖ Must have policies and procedures for showing performance relevant to the likely **financial situation and investment objectives** of the intended audience
  - ❖ Intended audience must “understand the criteria” and “risks and limitations”
  - ❖ Not considered an ad if the investor “affirmatively seeks hypothetical data”



## Compliance Program Tips and Operational Considerations



- Guidance for Policy and Procedure Development
- Reviewing Client Disclosure Documents
- Using Technology to Stay Ahead
  - ❖ We are in a virtual world – have you developed new protocols for:
    - Conducting branch office exams, supervisory and annual reviews remotely
    - Supervising evolving sales practices and activities
    - Implementing and using compliance technologies to survey activities
    - Forensically test social media posts/websites
    - Preparing for virtual regulatory exams

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## Supplemental Materials

Articles

- Securities and Exchange Commission: 2022 Examination Priorities Report*
- NSCP Currents: Your Road Map to Leveraging 2021's SEC Risk Alerts to Prepare for 2022*
- Practical Compliance & Risk Management for the Securities Industry: How Risk Alerts Can Help You Prepare for Your Next Examination*
- IAA Newsletter: Social Media in 2021 – Are Advisers Subject to the Old Rules or New Rules? And What Then?*
- Core Compliance: Investment Adviser Year-End Compliance Checklist*
- Jacko Law Group, PC: Summary of PTE 2020-02 Requirements*

Risk Alerts

- The Division of Examinations' Review of ESG Investing (Apr. 9, 2021)*
- Observations from Examinations of Investment Advisers Managing Client Accounts that Participate in Wrap Fee Programs (Jul. 21, 2021)*
- EXAMS Observations: Investment Advisers' Fee Calculations (Nov. 10, 2021)*
- Examinations of Private Fund Advisers (Jan. 27, 2022)*

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## Questions? Let us know how we can help!



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## Presentation Link:

<https://www.jackolg.com/schwab-advisor-solutions-session-sec-hot-topics-and-compliance-expectations-for-2022-03-31-2022/>

# Thanks For Attending!

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