

# Compliance Hot Topics and Essentials for Preparing for Year-End

Presenter:

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# Agenda

- Recent Regulatory Developments
  - ❖ Cybersecurity and Private Fund Advisers; Documentation of RIA Compliance Reviews Final Rule
  - ❖ Recent Enforcement Cases
- The Top *Risk Alerts* of 2023
  - ❖ Observations of Newly Registered Investment Advisers
  - ❖ Safeguarding of Customer Records and Information
  - ❖ Examinations Focused on Additional Areas of the Adviser Marketing Rule
  - ❖ Investment Advisers: Assessing Risks, Scoping Examinations and Requesting Documents
- SEC Examination Hot Topics
  - ❖ Conflicts of Interest and Outsourcing by Advisers
  - ❖ Tips for a Successful Exam
- End of the Year Best Practices

## Recent Regulatory Developments

### Cybersecurity Final Rule

- ❑ SEC Adopts New Cyber Rule Requiring Public Companies to Disclose Hacking Incidents (Jul. 26, 2023)
  - ❖ Requires companies to disclose a cyber breach within 4 days after determining if it is material to investors
    - Reporting can be delayed if the DOJ deems it necessary to protect national security or police investigations
  - ❖ Companies must periodically describe their efforts to identify and manage cyber threats
  - ❖ The requirement for companies to disclose board members' expertise in cybersecurity was removed from the Final Rule

## Recent Regulatory Developments

### Private Fund Advisers Final Rule (Aug. 23, 2023) – **Highlights Include:**

- ❑ Advisers to Provide Quarterly Statements to Investors Regarding Fees, Expenses, Fund Performance and Adviser Compensation
- ❑ Funds to Undergo an Annual Audit in Accordance with the Custody Rule
- ❑ Certain Activities of Advisers to Private Funds are Now Restricted
  - ❖ Cannot charge the fund fees related to regulatory, exam or compliance fees unless disclosed within 45 days after end of fiscal quarter
  - ❖ Cannot have claw back to the fund based on certain taxes, borrow from the fund or charge expenses for portfolio investment absent disclosures
  - ❖ Must provide advance disclosure of material economic terms and preferential treatment granted to other investors (e.g., for redemptions)

## Recent Regulatory Developments

### Documentation of RIA Compliance Reviews Final Rule (Aug. 23, 2023)

- All Advisers (Including Private Fund Advisers) Must Document in Writing the Required Annual Review of Their Compliance Policies and Procedures
  - ❖ Codifies the SEC's expectation
    - Already requested during SEC examinations

*Risk Management Tip:* How robust is your Annual Review Report? It should meaningfully specify what tests were performed and the results that led to your conclusions

## Recent Regulatory Developments

### Electronic Communication Recordkeeping Failures (Aug. 8, 2023)

- ❑ 11 Firms Charged for Failure to Maintain and Preserve Electronic Communications
  - ❖ Employees were found to have used various platforms on personal devices to conduct business communications
    - This included WhatsApp, iMessage and Signal
  - ❖ Other concerns involved failure to supervise violations
  - ❖ **Findings:** C&D, Retention of an Independent Consultant to review compliance P&Ps relating to electronic communication retention on personal devices, and combined penalties of \$289 million

*Risk Management Tip:* Consider lessons learned from the JP Morgan 2021 case

## Recent Regulatory Developments

### The Marketing Rule's First Enforcement Cases

- *In the Matter of Titan Global Capital Management USA LLC (Aug. 21, 2023)*
  - ❖ Advertised sky-high performance for its Titan Crypto strategy using hypothetical performance using a mobile trading app
    - Advertised returns as high as 2,700% without appropriate disclosures
  - ❖ Also used hedge clauses in advisory contracts, made conflicting disclosures about how it custodied crypto assets, failed to adopt policies and procedures concerning personal trading in crypto assets
  - ❖ **Findings:** C&D, \$192,454 in disgorgement, \$850,000 civil penalty

## Recent Regulatory Developments

### The Marketing Rule Sees First Enforcement Cases

#### ☐ Nine Investment Advisers Charged with Marketing Rule Violations (Sep. 11, 2023)

- ❖ All advertised hypothetical performance on their websites without having policies and procedures in place as required by the Marketing Rule
  - Hypothetical ads must be relevant to the likely financial situation and investment objectives of the intended audience
  - Two of the advisers failed to maintain required copies of their ads
- ❖ **Findings:** C&D, undertaking to no advertise hypothetical performance without having requisite P&Ps and civil penalties ranging \$50,000 to \$175,000



## The Top Risk Alerts of 2023

### Observations of Newly Registered Investment Advisers

- Purpose of the Exam is to Allow SEC Staff to:
  - ❖ Provide advisers with information about the SEC's exam program
  - ❖ Perform a preliminary risk assessment
  - ❖ Facilitate discussions about the adviser's operations and risks
  - ❖ Promote Compliance
- Document Production Will Typically Involve:
  - ❖ General information about the adviser's business and ops
  - ❖ Data regarding advisory client accounts and marketing efforts
  - ❖ Information about the compliance program and internal controls

# The Top Risk Alerts of 2023

## Observations of Newly Registered Investment Advisers

- Common Deficiencies Cited in Exams Include:
  - ❖ Inadequate controls around portfolio management and fee billing
  - ❖ Omitted procedures to enforce policies (e.g., not testing best ex)
  - ❖ Personnel not aware of the policies or procedures
  - ❖ Compliance manuals not customized to the business
  - ❖ Disclosures contained omissions or inaccuracies
    - E.g. Fees and compensation, disciplinary information, conflicts of interest and website and social media account disclosures

## The Top Risk Alerts of 2023

### Safeguarding Customer Records and Information at Branch Offices

- ❑ Regulation S-P Requires P&Ps that Address Administrative, Technical and Physical Safeguards for Protecting Customer Records
- ❑ Common Issues at Branches Include:
  - ❖ Failure to perform due diligence on vendors
  - ❖ Security measures are weak due to lack of guidance from the home office
    - Misconfigured security settings on systems and apps results
    - Email services missed technical requirements or had weak configurations
  - ❖ Weak cyber controls
    - Lacked P&Ps for password complexity, MFA requirements for remote access, controls to address patch management and vulnerability testing

## The Top Risk Alerts of 2023

### Exams Focused on Additional Areas of the Adviser Marketing Rule

- ❑ Current Exams are Focused on Policies and Procedures, Substantiation Requirement, Performance Advertising and Books and Records
- ❑ Other Areas of Review Include:
  - ❖ Compliance with “fair and balance” requirements and general prohibitions (cannot be fraudulent and misleading)
  - ❖ Testimonials
    - Are disclosures provided and written contracts entered into?
  - ❖ Third-party ratings
    - Does the third-party rating meet certain conditions?
  - ❖ Form ADV and accuracy of completion

## The Top Risk Alerts of 2023

### IAs: Assessing Risks, Scoping Exams and Requesting Documents

□ In Addition to the Areas Covered in New IA exams, the SEC Will Look At Certain Core Areas, Including:

- ❖ Custody
- ❖ Safeguarding of Client Assets
- ❖ Valuation
- ❖ Portfolio Management
- ❖ Fees and Expenses
- ❖ Brokerage and Best Execution

## The Top Risk Alerts of 2023

### IAs: Assessing Risks, Scoping Exams and Requesting Documents

- ❑ The Staff Also Tests the Effectiveness of the Compliance P&Ps for Managing Risks and Conflicts of Interest

*Risk Management Tip:* Do you have an inventory of compliance risks and conflicts that form the basis of your P&Ps?

*Risk Management Tip:* Have you provided training to your employees this year regarding changes to your compliance program, including new P&P updates and documented their attendance?

# SEC Examination Hot Topics

## Outsourcing by Investment Advisers

- ❑ Newer Area of Focus
- ❑ Exam Questions Include Providing:
  - ❖ The name of the service provider
  - ❖ Description of the service provider's affiliation
  - ❖ Description of services provided, including whether they impact marketing and advertising practices
  - ❖ Information on whether the adviser or affiliates have an economic interest in the service provider
    - Now requesting a list of outside legal counsel and external compliance consultants retained and description of services provided

## SEC Examination Hot Topics

### Conflicts of Interest

- Conflicts are Present in Every Business – How You Address Them is Key
- Has the Adviser Focused on Identifying and Addressing Conflicts By:
  - ❖ Providing clients with full and fair disclosure, allowing for informed consent?
  - ❖ Adopted an effective compliance program to mitigate or eliminate conflicts?

*Risk Management Tip:* Have you adopted a formal P&P of the processes your firm goes through to evaluate how the conflict can be mitigated?



## Tips for a Successful Exam

- ❑ Carefully Review Each Document Request *Prior* to Production
- ❑ Request Appears Outside the Scope of The Exam? Question the Relevance
- ❑ READ the Disclosure Documents the SEC Provides at the Inception of the Exam to Understand Their Lawful Reach
- ❑ For Production of Sensitive Information, Determine:
  - ❖ What is privileged
  - ❖ Whether to have documents bates stamped
  - ❖ Encrypt the document production (E.g., Use SEC's Kiteworks Portal)

# Tips for a Successful Exam

## □ Interview Tips

- ❖ Listen to the question and only respond to the question being asked
- ❖ Do not feel compelled to fill a moment of silence
- ❖ Do not volunteer any information unnecessarily
- ❖ If the employee does not understand the question being asked, do not hesitate to let the examiner know
- ❖ If a question is too broad, ask for the examiner to clarify its scope
- ❖ Prepare your team by hosting Mock Interviews
- ❖ Use Outside Counsel, as necessary, to provide guidance on how to address sensitive areas

# End of the Year Best Practices

## Step 1: Prepare

### Know What is Going on in the Industry

- Review SEC *Risk Alerts* and Notable Enforcement Cases
- Be aware of where regulators are focusing their efforts

### Know Your Business

- Assess current business operations and plans for 2024
- Assess conflicts related to your business and map to disclosures and policies and procedures
- Ensure compliance risks have been identified and addressed

## End of the Year Best Practices

### Step 2: Focus on Addressing High-Risk Areas First

#### PTE 2020-02, Cybersecurity and Privacy Reviews

- PTE 2020-02 requires firms to perform an annual review and certification; has this been completed?
- Perform testing of privacy safeguarding protocols particularly around identity theft
  - ❖ Consider recent *Risk Alert* and SEC guidance
- Ensure you have strong Cybersecurity controls that are reviewed frequently

## End of the Year Best Practices

### Fee Calculations, Custody, CE and Marketing Reviews

- Make sure your fee calculation and billing process is being performed in accordance with client agreements and disclosures
- Ensure any required annual financial and/or custody audits get performed and appropriate filings and/or deliveries are completed
- Determine if IAR continuing education is required
- Ensure that the firm is complying with the Investment Adviser Marketing Rule requirements

## End of the Year Best Practices

### Analyze Record Retention

- ❑ Ensure that “off channel” business communications are being captured
  - ❖ Consider whether common apps such as WhatsApp are being used for international calls and messaging
  - ❖ If text messages are allowed for business communications, be sure they are captured and preserved
- ❑ Review policies and procedures to see if electronic communication internal controls address material risks noted by the SEC

# End of the Year Best Practices

## Step 3: Note Year-End Regulatory Filings

- Pull IARD Preliminary Statement on November 6, 2023, and pay fee on or before December 11, 2023
- Make any necessary updates to Form U-4s and ensure that IARs are registered in all required states
  - ❖ Consider Promoters as well; subject to “bad actor” restrictions
- Confirm all required regulatory filings have been made (e.g., Section 13 filings)

# End of the Year Best Practices

## Step 4: Prepare for 2024

- Perform a conflict inventory
- Identify your biggest risks and consider mitigation steps
- Begin preparing for annual Form ADV amendments (establish process for gathering data and updating information)
- Review and update your Compliance Calendar to address newly identified conflicts and risks
  - ❖ Be sure to test newer procedures to see if they are working
- Consider Year-End Training, particularly on the Marketing Rule



## Questions Received from Attendees

### HOT TOPICS

- Do you have any advice for RIAs that charge a flat fee vs. AUM fee?
- Are IT penetration test mandatory for RIAs or is this something the SEC is considering?
- How quickly do Risk Alerts by the SEC need to be reviewed, addressed and result in updates by RIA firm compliance departments?
- If we do not hear back from the SEC for a year after they complete their exam, is it over?
- What type of security measures will be implemented next year?
- What should we consider as we bring on new advisors from a regulatory standpoint?

# Supplemental Materials

## Articles

- JLG Legal Risk Management Tip: What We Learned from the SEC's Recent Risk Alert on Investment Adviser Examinations (Sep. 2023)

## SEC Enforcement Cases

- In the Matter of JP Morgan Securities LLC*
- In the Matter of Titan Global Capital*
- SEC Press Release: SEC Sweep into Marketing Rule Violations Results in Charges Against Nine Investment Advisers (Sep. 11, 2023)
- SEC Press Release: SEC Charges 11 Wall Street Firms with Widespread Recordkeeping Failures (Aug. 8, 2023)

## Risk Alerts

- Investment Advisers: Assessing Risks, Scoping Examinations, and Requesting Documents (Sep. 6, 2023)
- Examinations Focused on Additional Areas of the Adviser Marketing Rule (Jun. 8, 2023)
- Safeguarding Customer Records and Information at Branch Offices (Apr. 26, 2023)
- Observations from Examinations of Newly-Registered Advisers (Mar. 27, 2023)

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



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## Presentation Link:

<https://www.jackolg.com/2023-schwab-advisor-solutions-session-sec-examination-hot-topics-and-compliance-expectations-for-2023/>

# Thanks For attending!

# Disclosure

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