

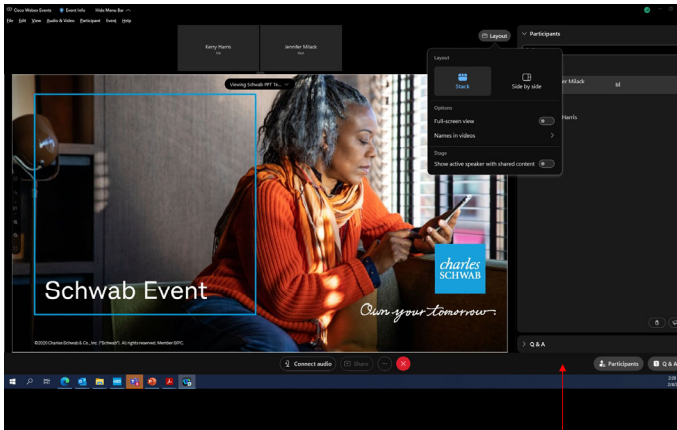
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1

1



2024 Compliance Update

Presenter:

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CEO, Core Compliance & Legal Services, Inc.

2

1

Agenda

- ☐ SEC Examination Priorities in 2024
 - ❖ Examinations of Investment Advisers
 - ❖ Examinations of Investment Advisers to Private Funds
 - ❖ Information Security and Operational Resiliency
 - ❖ Exam Hot Topics: Cybersecurity and AI, Protection of Senior Investors and the Importance of Succession Planning
- ☐ The Latest SEC Rule Proposals and Impact on RIAs
 - ❖ Anti-Money Laundering, Use of Technology, Regulation S-P and Outsourcing to Certain Vendors
- ☐ Case Study: Electronic Communications
- ☐ Tips for Reviewing Your Compliance Program
- ☐ Q&A

SEC Exam Priorities in 2024

Examinations of Investment Advisers

- ☐ Continued Exam Focus on Duty of Loyalty, Duty of Care, and Best Interest
 - ❖ Investment advice on complex products (derivatives), high cost and illiquid products (variable annuities), and unconventional strategies (e.g., to address rising interest rates)
 - Will examine sales to seniors and retirees
 - ❖ Processes for determining advice is in a client's best interest
 - Suitability
 - Best execution
 - Disclosures on costs, risks and conflicts (such as economic incentives)
 - ❖ Compliance Program policies and procedures and annual reviews



SEC Exam Priorities in 2024

Examinations of Investment Advisers

☐ Focus Area #1: Marketing Practices

❖ Have you:

- Adopted and implemented policies and procedures to prevent violations of the Marketing Rule (and the Advisers Act)?
- Appropriately disclosed marketing information in Form ADV?
- Maintained substantiation of books and records and related processes involving implementation of policies and procedures?
- Complied with Marketing Rule's requirements for performance, third-party ratings, testimonials and endorsements?

Tip: The SEC is looking at disclosures and asking for records to substantiate numbers and statements; are you ready?

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5

5



SEC Exam Priorities in 2024

Examinations of Investment Advisers

☐ Focus Area #2: Compensation Arrangements

- ❖ Fee breakpoint calculation processes

☐ Focus Area #3: Valuation Assessments

- ❖ Process for determining illiquid or difficult to value assets (e.g., commercial real estate or private placements)

☐ Focus Area #4: Safeguarding Assessments

- ❖ How MNPI is protected when multiple advisers share office location or have significant turnover of IARs

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6

6



SEC Exam Priorities in 2024

Examinations of Investment Advisers

- ☐ Focus Area #5: Disclosure Assessments
 - ❖ Review of regulatory filings and registration eligibility
- ☐ Focus Area #6: Policies and Procedures on:
 - ❖ Selecting and using third-party and affiliated service providers
 - ❖ Overseeing branch offices
 - ❖ Obtaining informed consent when there are material changes to advisory agreements

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7

7



SEC Exam Priorities in 2024

Examinations of Investment Advisers to Private Funds

- ☐ Priority on Portfolio Management Risk
 - ❖ Exposure to market volatility and high interest rates
 - ❖ Adherence to contractual requirements (e.g., having an advisory board)
 - ❖ Accurate calculation and allocation of private fund fees and expenses
 - ❖ Due diligence assessments of prospective portfolio companies
 - ❖ Controls and disclosures related to side-by-side management with a RIC
 - ❖ Use of affiliated service providers
 - ❖ Adherence to custody requirements (e.g., Form ADV reporting and distribution of audited financial statements)
 - ❖ Policies and procedures for reporting certain events on Form PF

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8

8



SEC Exam Priorities in 2024

In the SPOTLIGHT: Information Security and Operational Resiliency

- ☐ Preventing Interruptions to Mission Critical Services
- ☐ Protecting Client Information, Records and Assets
 - ❖ Safeguarding policies and procedures and oversight of third-party vendors
 - ❖ Response to cyber incidents (e.g., ransomware attacks)
 - ❖ Training of staff on identity theft prevention
 - ❖ Policies and procedures for protecting customer records
 - ❖ Cybersecurity issues associated with third-party vendors

TIP: Do you know how a critical vendor will communicate with you during a cyber event? Is it documented?

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9

9



SEC Exam Priorities in 2024

Other SEC Exam Hot Topics

- ☐ Cybersecurity and AI
 - ❖ Common Schemes
 - Bad actors are using AI and the hype around it to lure investors
 - False claims are made about products and services; “ramp and dump” schemes
 - Social media is being leveraged; voice is replicated to call the individual’s parents or grandparents (senior scam)
 - ❖ SEC Investor Alert – AI and Investment Fraud (Jan. 25, 2024)
 - Describes steps investors can take to protect themselves

TIP: Consider providing SEC Investor Alerts to Senior and Vulnerable Investors

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10

10



SEC Exam Priorities in 2024

Other SEC Exam Hot Topics

☐ How the SEC is Examining AI

- ❖ Exam focus is on how AI is being used (e.g., algorithmic trading signals or tracking of consumer behaviors and their needs)
- ❖ SEC is concerned about how firms are protecting sensitive data
 - Understand the data you are collecting
 - Identify if it contains personally identifiable information
 - Map to what controls are in place
- ❖ Common exam requests include:
 - Provide P&Ps concerning supervision of AI systems
 - Provide documents outlining contingency plans in the case of an AI failure
 - List all compliance training specific to AI

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11

11



SEC Exam Priorities in 2024

Other SEC Exam Hot Topics

☐ Protection of Senior Investors

- ❖ Broker-dealers are subject to *FINRA Rule 2165, Financial Exploitation of Specified Adults and Rule 4512, Customer Account Information*
- ❖ Investment advisers are fiduciaries and must protect seniors
- ❖ Summary Updates to Rule 2165 (effective Mar. 17, 2022):
 - Added safe harbor to put a hold on *securities transactions* (in addition to the already permitted hold on disbursement of funds or securities) if reasonable belief of financial exploitation
 - Extends temporary hold on a securities transaction or disbursement for an *additional 30 days* (total of 55 business days) if the member reports the matter to a state regulatory or agency

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12

12



SEC Exam Priorities in 2024

Other SEC Exam Hot Topics

- ☐ Seniors and Vulnerable Investors
 - ❖ SEC is asking for policies related to completion of *Trusted Contact Forms*
 - ❖ SEC is examining what disclosures and guidance is provided to clients on:
 - What the trusted contact can and can't do
 - When the trusted contact will be contacted (e.g., in the case of financial exploitation)
 - The trusted contact's limited role (e.g., can't transact on the account and will not be told of the holdings in the account)

TIP: Provide a script for your financial professionals regarding the benefits of having a trusted contact; consider providing the SEC's Investor Bulletin: Please Consider Adding a Trusted Contact to Your Account

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13

13



SEC Exam Priorities in 2024

Other SEC Exam Hot Topics

- ☐ Succession Planning
 - ❖ The SEC is asking to see the Firm's Succession Plan during examinations
 - ❖ Do succession planning early, not when you suspect diminished capacity or an unexpected life event
 - ❖ Prepare an action plan with clear step-by-step instructions for the successor
 - Consider short and long terms of absence and "what if" scenarios
 - It is better to have a plan and not need it than to need it and not have a plan

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14

14

The Latest SEC Rule Proposals and Impact on RIAs

Anti-Money Laundering Proposal

- ❑ Would Require Certain IAs to Apply AML/CFT Requirements Per the BSA
 - ❖ IAs covered by the proposed rule include:
 - IAs registered with the SEC
 - IAs that report to the SEC as an ERA
 - ❖ IAs would need to:
 - Implement an AML/CFT program
 - File Suspicious Activity Reports (SARs) with FinCEN
 - Fulfill recordkeeping requirements relating to transmittal of funds
 - NOTE: No CIP requirements are yet proposed
 - ❖ FinCEN to delegate its examination authority to the SEC

The Latest SEC Rule Proposals and Impact on RIAs

Proposal on Advisers' Use of Technology

- ❑ SEC is concerned about conflicts of interest associated with the use of predictive data analytics, AI and other “covered technologies” used by advisers in investor interactions
- ❑ Proposal would require firms to:
 - ❖ Identify and eliminate or neutralize the effect of conflicts of interest
 - ❖ Have written policies and procedures reasonably designed to prevent violations of the proposed rules, including a written annual review
 - Must include the process for evaluation of a covered technology and how the conflicts of interest (if any) are eliminated or neutralized
 - Concern over broad scope of “covered technologies” and application

The Latest SEC Rule Proposals and Impact on RIAs

Proposed Amendments to Regulation S-P

- ☐ Rule is Designed to Provide a Framework to Address Safeguarding
 - ❖ Would require “Covered Institutions” to implement a written incident response program to detect, respond to and recover from unauthorized access to or use of customer information
 - Would require notification to affected individuals
 - ❖ Would require adoption of policies and procedures by all “Covered Institutions” to properly dispose of customer information
 - ❖ Would expand the categories of customer information to be safeguarded and require safeguarding information received from other financial institutions
 - ❖ Would impose new recordkeeping obligations and allow certain “Covered Institutions” to forego delivery of an annual privacy notice

The Latest SEC Rule Proposals and Impact on RIAs

Outsourcing of Certain Vendors

- ☐ The Five Minimum Requirements for Outsourcing “Covered Functions”
 - ❖ Due diligence, monitoring, books and records, third-party recordkeeping and Form ADV reporting
- ☐ “Covered Functions” Are Necessary Functions for the RIA
 - ❖ Such functions, if not performed or performed negatively, would impact the adviser’s ability to provide investment advisory services
 - Adviser, sub-adviser, portfolio management, investment guidelines
 - Client servicing
 - Cybersecurity
 - Portfolio accounting, pricing, reconciliation, trading, allocation, valuation
 - Regulatory compliance

The Latest SEC Rule Proposals and Impact on RIAs

Outsourcing of Certain Vendors – Operational Considerations

- ☐ New Form ADV Disclosures
 - ❖ To disclose which services are outsourced and provide:
 - Service provider's name and address
 - Whether the service provider is a related person
 - Date first engaged
- ☐ Ongoing monitoring to apply to existing arrangements on the compliance date
- ☐ Policies and procedures will need to be adopted to address how the RIA is conducting due diligence of new service providers, monitoring existing relationships and adhering to books and records requirements

Case Study: Electronic Communications

SEC Fines 16 Firms for Off-Channel Communications (Feb. 9, 2024)

- ☐ Settlements involved 5 BDs, 7 dual registrants, and 4 affiliated IAs involving failure to maintain and preserve certain electronic communications conducted through personal messaging platforms
 - ❖ Combined civil penalties of \$81 Mil; requirements to implement enhanced policies and procedures and engage an independent consultant
- ☐ Takeaways
 - ❖ SEC continues to be concerned about off-channel communications and recordkeeping requirements
 - SEC noted that self-reporting results in a significantly lower penalty
 - ❖ Modern business communications must be considered and retained



Case Study: Electronic Communications

Kate Sacker, CCO, works at Rhoades Capital Management (RCM). During an Annual Review, Kate decides to interview certain senior management team members to ensure that RCM supervisors are complying with the adviser's off-channel communication policy, particularly since use of personal devices was permitted. RCM's policy states:

“Use of unapproved electronic business communication methods, such as text, “chats” or instant messaging is not permitted on personal devices. Furthermore, use of personal email, chats or text messaging application for business purposes is not permitted, nor is the forwarding of work-related communications to personal devices.”

Kate interviews three people and asks each if they are using text messaging to communicate with internal employees, or applications, such as WhatsApp to communicate when they are on international travels. Here are their responses:

February 27, 2024

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21

21



Case Study: Electronic Communications

Chuck Rhoades, CEO – “Kate, when our largest client texts and asks me to buy APPL, I must acknowledge that request. When I travel, it is a lot easier for me to use WhatsApp, but those communications are to my assistant instructing him what to do so that shouldn't be a problem.”

Mike Wagner, SVP – “Kate, I only have exchanged messages with an RCM colleague related to a client's request to do a wire transfer. Of course, from time to time I will also need to text staff related to RCM business.”

Wendy Rhoades, CIO – “Kate, I am very careful. I do receive and reply to communications from RCM personal and external contacts in the securities industry; it would be rude not to. But I try not to do this frequently.”

Q: Were these compliance infractions?

Q: If yes, what actions should Kate take?

Q: If yes, should Kate self-report to the SEC?

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22

22



Tips for Evolving Your Compliance Program

Step 1: Review the SEC's 2024 Exam Priorities List

- ☐ Consider Which Priorities Impact Your Business
- ☐ Once Identified, Outline What Steps You Must Take
 - ❖ Are disclosures to investors adequate?
 - ❖ Should policies and procedures be reviewed and updated / expanded upon?
 - ❖ Do personnel require additional or new training?
 - ❖ Are new supervisory controls needed to survey activities and monitor risks?

February 27, 2024

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23

23



Tips for Evolving Your Compliance Program

Step 2: Review Your Use of AI

- ☐ Inventory How and Where AI is used
 - ❖ Identify conflicts
 - ❖ Address supervision and controls in your policies and procedures
- ☐ Consider If Clients Should Receive the SEC's Investor Alerts
 - ❖ *AI and Investment Fraud Alert* (Jan. 25, 2024) identifies how bad actors are using AI to lure victims into scams
 - ❖ *Spotting and Reporting Investment Scams Targeting Older Investors* (Feb. 5, 2024) helps investors to know how to verify they are speaking to an investment professional

February 27, 2024

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24

24



Tips for Evolving Your Compliance Program

Step 3: Further Protect Senior Clients

- Incorporate the Gathering of Trusted Contact Information at client onboarding and during annual client meetings
 - ❖ Take time to explain to clients the importance of gathering this information for unexpected life events
 - ❖ Incorporate enhanced steps into the adviser's policies and procedures manual
- Consider If Clients Should Receive the SEC's Investor Bulletin
 - ❖ *Please Consider Adding a Trusted Contact to Your Account* (Mar. 4, 2020) explains the reasons why to give the name of someone you trust

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25

25



Tips for Evolving Your Compliance Program

Step 4: Consider The Latest SEC Proposed Rules

- Consider Guidance Provided by the SEC Proposed Rules on Anti-Money Laundering, Use of Technology, Regulation S-P and Outsourcing to Certain Vendors
 - ❖ Consider fiduciary duties owed to clients
 - Regardless if the proposal goes into effect, should you consider some of the internal controls discussed for your own compliance program?
 - Have you spoken to senior management about the impact that the proposed rule could have on the organization and your clients?

Tip: Plan ahead! Consider what training, resources, and budget are needed

February 27, 2024

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26

26



Tips for Evolving Your Compliance Program

Step 5: Test the Effectiveness of Your Firm's Off-Channel Communication Surveillance and Recordkeeping

- Interview Personnel and Learn What Off-Channel Communications are Being Used; Conduct Forensic Testing
- Implement Risk Mitigation Solutions
 - ❖ Consider electronic communication retention providers that capture off-channel communications
 - ❖ Provide comprehensive training to all personnel
- Consider if Policies and Procedures Need to be Amended

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27

27



Tips for Evolving Your Compliance Program

Compliance Questions Asked Pre-Conference

- Are there sources to discuss what an SEC exam entails?
- Can you share any specific details for a first time SEC audit?
- What is the SEC looking for in exams for compliance with the IA Marketing Rule?
- What do you suggest to do to address off-channel communications when Compliance is aware that text message communications are being used, but are not currently captured?

February 27, 2024

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28

28

Supplemental Materials

- SEC 2024 Examination Priorities Report
- JLG Best Practices to Use During an SEC Examination
- FinCEN AML Proposed Rule Fact Sheet (Feb. 13, 2024)
- SEC Proposed Rule - Outsourcing by Investment Advisers (Oct. 26, 2022)
- Investor Alert: Artificial Intelligence and Investment Fraud (Jan. 25, 2024)
- Investor Alert: Spotting and Reporting Investment Scams Targeting Older Investors (Feb. 5, 2024)
- Investor Bulletin: Please Consider Adding a Trusted Contact to Your Account (Mar. 4, 2020)
- JLG Risk Management Tip: How to Effectively Manage Your Cybersecurity Program (Nov. 2023)

Questions? Let us know how we can help!



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Presentation Link:

[Schwab Advisor Solutions Session – SEC Hot Topics and Compliance Expectations for 2024 \(jackolg.com\)](https://jackolg.com)

Thanks For attending!

February 27, 2024

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31

31

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32

32