

RIA RISKS AND COMPLIANCE: SEC EXAM PREPARATION

MAY 1, 2023

FIRMA CONFERENCE

SAN ANTONIO, TEXAS

SECURITIES AND EXCHANGE COMMISSION JURISDICTION

Investment advisers with over \$100 million in Assets Under Management (AUM) are required to register with the Securities and Exchange Commission (“SEC”).

Advisers who have at least \$150 or more in private fund assets (e.g., hedge funds, private equity, venture capital and venture debt) are required to register with SEC.

As such, part of the SEC’s oversight involves periodic examinations of registered investment advisers.

PURPOSE OF AN SEC EXAMINATION- WHO WILL THEY EXAMINE?

- New Registrant Exam: ensuring that newly registered advisers are starting off on the right foot and have a strong culture of compliance
- Never Before Examined Advisers: ensuring that those who have been in business for awhile have a strong compliance program
- Advisers with high-risk profiles or those with several deficiencies during past exams
- Private Fund Advisers: continued focus on advisers managing private funds
- Sweep exams: targeted exam of several advisers

2023 SEC EXAMINATION PRIORITIES

- Compliance with recently adopted rules
 - Marketing Rule
 - Derivatives Rule (Mutual fund and ETFs)
 - Fair Valuation Rule (Mutual fund and ETFs)
- Private Funds
 - Conflicts of interest
 - Calculation and allocation of fees and expenses
 - Compliance with the Marketing Rule
 - Policies and procedures concerning use of alternative data
 - Compliance with Custody Rule, including timely delivery of audited financials and selection of permissible auditors

2023 SEC EXAMINATION PRIORITIES

- Standards of Conduct

- Investment advice and recommendations
- Disclosures, particularly any omission of material facts about conflicts of interest
- Process for best interest evaluations
- Factors considered based on an investor's investment profile
- If disclosures enabled clients to provide informed consent to the conflict.

- Environmental, Social and Governance (ESG) Investing

- Whether funds' operations are consistent with their disclosures
- Whether ESG products are properly labeled
- Whether recommendations of ESG products for retail investors are made in their best interest

2023 SEC EXAMINATION PRIORITIES

- Information Security and Operational Resiliency
 - SEC will focus on reviewing firms' practices to prevent service interruptions, and to protect investor information and assets. In particular, the SEC will focus on:
 - ❖ Firms' policies and procedures, including whether they are reasonably designed to protect customer records and information (whether stored internally or with a third party) and whether the records' location has been properly disclosed to the SEC
 - ❖ Firms' practices to protect customer information, particularly that are stored with third-party vendors (security of third-party products, unauthorized use of third parties, etc.)
 - ❖ Firm's operational resiliency planning, e.g., addressing climate-related risks

2023 SEC EXAMINATION PRIORITIES

- Crypto Assets and Emerging Financial Technology
 - Focus area includes “crypto assets or their associated products or services” as well as emerging financial technology such as automated investment advice and mobile apps
 - The SEC will focus on:
 - Firms offering new products, services or practices, such as on-line solutions
 - Registrants that might have been impacted by recent issues in the crypto assets market, especially firms in this space that are new and/or have never been examined before
 - ❖ Specifically, the SEC will investigate whether these firms:
 - Met and followed standards of care when providing investment advice
 - Maintained operations and controls consistent with disclosures
 - Made advice in the investor’s best interest
 - Considered risks of such practices, particularly investor-specific risks (e.g., senior investors)

2023 SEC EXAMINATION PRIORITIES

DON'T MISS: The SEC noted that in addition to core focus areas such as custody, valuation, fees and expenses and portfolio management, 2023 exams of RIAs will also focus on:

- “RIA policies and procedures for retaining and monitoring electronic communications and selecting and using third-party service providers.”
- Additionally, Exams will focus on “fiduciary obligations of RIAs to registered investment companies (i.e., mutual funds), particularly with respect to their receipt of compensation for services.”

EXAMINATION PROCESS

STEP 1: ANNOUNCEMENT CALL

- Most routine SEC examinations are conducted by the SEC regional office that oversees the area in which the adviser is located.
- The SEC examiner will call the Chief Compliance Officer of the firm to announce that they have started an examination of the adviser and will send the request list in the next day or so.

EXAMINATION PROCESS

STEP 2: REQUEST LIST

After the announcement call, the SEC will send its Request List.

The Request List is a list of documentation the SEC expects firms to produce usually within two weeks of the date of the request. In recent exams, the SEC has only given firms one week to produce the materials.

Typical items requested include, but are not limited to: organizational chart, current and former employee list, client information, compliance policies, annual review report, compliance training, complaints, trade blotter, best execution materials, trade errors, soft dollars, mutual fund share class reviews, advisory agreements, securities holdings, financials, marketing materials, valuation, custodian information, private fund information, if applicable and ADV Part 2B.

EXAMINATION PROCESS

STEP 3: Introductory Meeting

Once the items on the request list have been received, the SEC will schedule a time for an introductory meeting. Pre-pandemic, this was done on-site, as was the entire exam; however, most exams have been, and are continuing to be, conducted remotely.

This meeting is a chance for the firm to provide an overview to the SEC. Oftentimes, an overview presentation created by the firm is requested by the SEC.

This is a great opportunity for firms to set the tone of the exam and show they are willing to cooperate with the SEC and ensure a smooth examination.

EXAMINATION PROCESS

Step 4: Interviews

One of the most important components of the examination is the interviewing of firm personnel.

The SEC will want to speak with people in the firm who are familiar with compliance and operations.

Chief Compliance Officer, investment professionals, traders.

It's important that people are prepped on the types of questions the SEC will ask.

Answers should be consistent with what has been provided in response to the request list.

DON'T MISS: INTERVIEW PREP IS KEY!

EXAMINATION PROCESS

Step 5: Exit Interview

After the interviews conclude, the SEC will likely have more follow-up requests.

Depending on the nature of the requests, they may schedule additional meetings to obtain more clarity on the documentation provided by the firm.

Once the SEC has received and reviewed the information it has requested and decides they do not need anything further, they will schedule an exit interview.

At the exit interview, the SEC will go over its findings with the firm.

EXAMINATION PROCESS

Step 6: Deficiency Letter

After the exit interview, the SEC will issue its “Deficiency Letter.”

The Deficiency Letter outlines the violations the SEC found during its examination.

The violations in the letter should not be a surprise, as the SEC has already told the firm during the exit interview what to expect in the letter.

The firm will have 30 days to respond to the SEC’s Deficiency Letter.

HOW TO PREPARE FOR AN EXAM

Overview Presentation

During the initial meeting with the SEC, it is often requested, but also very helpful, to create a firm overview presentation of the firm.

This overview will likely answer a few initial questions the SEC has and give them a better understanding of how the firm operates.

Topics may include:

- History of the firm
- Organization Chart
- Ownership
- Investment Process
- Fees and Expenses
- Compliance Program

HOW TO PREPARE FOR AN EXAM

Polices and Procedures:

- Make sure your polices and procedures are up to date and include policies and procedures pertaining to any recent SEC rules and regulations.
- Are you doing what you say you are doing?
- Have you been testing your polices and procedures and preparing a written annual review report?

DON'T MISS: Compliance manual, Code of Ethics and Annual Review Reports are **ALWAYS** requested by the SEC in the initial request list.

HOW TO PREPARE FOR AN EXAM

Interview Preparation

The SEC will likely want to speak with people in the firm responsible for:

- New Account Opening Process
- Billing
- Trading
- Investment Process
- Compliance

DON'T MISS: The Chief Compliance Officer should sit in on all the interviews

The goal is to make sure your people can articulate what they do and that they follow what is stated in the firm's policies and procedures.

ENFORCEMENT

What if the firm's response to the items cited in the deficiency letter is not enough?

Typically – once you respond to the SEC's deficiency letter, the exam is finished, and you will not hear back from the SEC regarding this SEC. No news is good news!

If the examiners feel that the firm's actions have harmed investors or involve egregious or extensive misconduct, they will refer the matter to the SEC's Enforcement Division.

WHAT IS ENFORCEMENT?

The SEC's enforcement staff conducts investigations into possible violations of the federal securities laws and prosecutes the SEC's civil suits in the federal courts as well as its administrative proceedings.

The mission of the Enforcement Division is “to protect investors and the markets by investigating potential violations of the federal securities laws and litigating the SEC's enforcement actions.”

In civil suits, the SEC seeks:

- Injunctions (orders prohibiting future violations).
- Civil monetary penalties
- Disgorgement of illegal profits

REGULATORY FOCUS

- **Observations (2021-22)**

- Fee documentation and oversight
 - Confirm methodology, review break points
- Mutual fund share class selection
 - Is client paying the lowest possible expense ratio?
- Required Disclosures
 - Disciplinary History, ADV Part 2A and Form CRS
 - Disclosing fees, payments to affiliates and/or receipts from affiliates
- MNPI especially as it relates to alternative data, value-add investors and expert networks
- Testing ESG policies and procedures
- Electronic Communications
- Electronic Signature documentation and verification

REGULATORY FOCUS

- **New Marketing Rule**

DON'T MISS: Important to set a solid foundation here now- we anticipate high regulatory focus in 2023

- Areas that will likely see most scrutiny (if applicable):
 - Cash solicitation, as it gets folded into new rule
 - Testimonials and endorsements
 - Performance, with emphasis on:
 - Gross vs. Net comparisons
 - Prescribed performance time periods
 - Extracted, hypothetical and back tested performance
 - Firms that refrains from these areas will not face the same regulatory pressure

Compliance Resources

- Firm Compliance Documents
 - Code of Ethics / Compliance Manual
- SEC Division of Examinations (<https://www.sec.gov/exams>)
 - Priorities Memos
 - Risk Alerts
 - Staff Letters
 - Studies & Reports
 - Speeches
- Industry Groups
 - Investment Adviser Association (IAA) (<https://www.investmentadviser.org/home>)
 - National Society of Compliance Professionals (NSCP) (<https://nscp.org/>)

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