charles SCHWAB

Compliance Review

Ongoing compliance updates for independent advisors

July 2015

IN THIS ISSUE

SEC exams: Preparing your firm in 2015

Alyssa Briggs, ACA Compliance Group

I. Introduction

When Securities and Exchange Commission ("SEC") examiners call to announce an examination, there is often a looming sense of anxiety, mostly associated with the fear of the unknown. The best way to mitigate this fear is by constantly reassessing your firm's compliance and, at a minimum, conducting a rigorous annual review.[1] But context is critical: Navigating a successful SEC examination also depends on understanding how the ever-evolving process works and staying up to date on the SEC's key areas of focus.

Just as your business evolves, so too does the SEC's exam process. Over the last few years there have been notable changes. For example, examiners today primarily conduct exams focused on each firm's individual key risk areas rather than full-scope exams. Examiners are also using advanced technology, not only to determine which firms to examine but also to conduct the exams themselves.

The first section of this article discusses how exams have changed in the last few years. We then review the requirements of the Compliance Rule as a basis for exam preparedness and a lead-in to the SEC's 2015 exam priorities and practical preparedness considerations.

II. The evolution of the exam process

The National Exam Program ("NEP") is the group that administers exams conducted by the SEC's Office of Compliance Inspections and Examinations ("OCIE"). OCIE is split into various divisions, each responsible for oversight of a specific type of regulated entity. Among other things, OCIE is responsible for overseeing approximately 11,000 Registered Investment Advisors ("advisors" or "firms").[2]

To help meet these objectives, OCIE's advisor examination process has changed in a number of ways.

Shorter, targeted exams

While the SEC has historically conducted "cycle" examinations, based on the amount of time since a firm's last examination, the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") expanded the SEC's examination authority to include additional types of advisors. In response, the NEP developed new methods of conducting exams.

[1] For a broader summary of policies and procedures to assess, see the June 2012 Schwab Compliance Review, *A Primer on Preparing for Your SEC Exam*.

[2] See http://www.sec.gov/news/speech/2014--spch05062014ab.html.

In 2012, OCIE began a series of limited-scope exam initiatives, in which it highlighted key risk areas to review and allowed examiners to select from two to three key risks for each examination.[3] The limited scope of the exam reduces the amount of time examiners need to spend on-site compared with historical exams.

Notably, it appears that OCIE has adopted this approach more broadly and abandoned full-scope exams in favor of a more efficient approach that targets the issues of greatest risk at each firm. Examiners collaborate beforehand to determine a firm's perceived areas of risk, limiting the exam's scope accordingly.

Enhanced technology and data analytics

In recent years the SEC has devoted increased resources to technology in order to complete exams thoroughly and expediently.

Risk selection and scoping

The SEC uses a sophisticated process to choose the firms it examines each fiscal year. OCIE's Risk Assessment and Surveillance Group ("RAS") is responsible for aggregating and analyzing data from SEC filings (regarding both advisors and key individuals) to identify activities or practices that may warrant additional attention through examination. RAS also reviews other internal and external data, including filings from other regulators, legal and background checks, and disciplinary and work history. Examples of items that may increase an advisor's chance of becoming an exam candidate include rapid growth, changes to the business, changes in custody of client assets, changes in the types of assets managed, the amount of time since the last exam, CCO changes, and risk ranking as determined from a prior exam.

Before the start of the SEC's fiscal year (October 1–September 31), RAS provides a proposed list of examination candidates to OCIE's 11 regional offices and its home office in Washington, D.C.[4] Each regional office makes the final determination of firms to examine.

Analyzing transactional data

Before OCIE devoted increased technological resources to the NEP, examiners identified suspicious trade activity by manually testing various trade blotters and other trading output. In 2013, OCIE created the Quantitative Analytics Unit, a team of specialists within the NEP who evaluate risks in the algorithms, models, and software used by advisors. This team developed the National Exam Analytics Tool ("NEAT").

Capabilities of the SEC's new trade analysis tool

NEAT allows examiners to systematically analyze large quantities of trade information from advisors in a short period of time. This analysis helps examiners to identify suspicious activity, outlier trades, and questionable trends. For example, NEAT can search for evidence of problematic trading by comparing the trade blotter with the dates of public filings and other company events (e.g., mergers and earnings reports). The tool can assess best execution by examining the patterns of broker use, commissions charged, and cross trades, and can assist in the detection of potential front running, window dressing, improper allocations, and other types of misconduct.[5]

Leveraging the experience of quantitative analysts

Should examiners require even more sophisticated investigative techniques, they can reach out to the SEC's Division of Economic and Risk Analysis ("DERA"). DERA exists to support the examination and enforcement programs. It is a division of economists and quantitative analysts, mostly PhDs, with the expertise and tools to analyze massive amounts of data with even more specificity than NEAT. DERA often assists with high-frequency trading reviews and suspected money laundering.

Increased interdivisional collaboration

OCIE is the "eyes and ears" of the SEC. Because of their time in the field, examiners are better able to identify new and emerging risks, and can therefore share trends, findings, and industry observations with other offices in order to identify mutual areas of interest and concern.

In particular, OCIE works closely with the Division of Enforcement's Asset Management Unit ("AMU") and the Division of Investment Management ("IM"). Also, typically for training purposes, staff from these divisions may accompany an exam team. It would be incorrect, however, to make the assumption that their presence in itself is cause for concern.

[3] Presence Exam areas of review were marketing, portfolio management, conflicts of interest, safety of client assets, and valuation. See https://www.sec.gov/about/offices/ocie/letter-presence-exams.pdf. Areas of review for the Never-Before Examined ("NBE") advisor initiative were compliance program, filings/disclosures, marketing, portfolio management, and safety of client assets. See http://www.sec.gov/about/offices/ocie/nbe-final-letter-022014.pdf. Areas of review for the NBE Investment Company initiative include compliance program, annual contract review, advertising and distribution of fund shares, valuation of portfolio assets and NAV calculation, and leverage and use of derivatives. See http://www.sec.gov/about/offices/ocie/ocie-never-before-examined-registered-investment-company-initiative.pdf.

[4] For a map of the SEC's regional office locations and the state coverage for each office, see page 9 of the Fiscal Year 2014 SEC Annual Report available at http://www.sec.gov/about/secpar/secafr2014.pdf.

[5] See Chair Mary Jo White's speech "The SEC in 2014" at the 41st Annual Securities Regulation Institute, http://www.sec.gov/News/Speech/Detail/Speech/1370540677500.

OCIE often provides IM with practical considerations when IM contemplates rulemaking changes. For example, if IM is considering implementing a rule, they will often ask OCIE to conduct reviews of various firms through a risk-targeted sweep or other thematic review to assess the costs and operational implications of the proposed rule (for example, OCIE assisted with Dodd-Frank rulemaking such as the crowdfunding JOBS Act, money market reform rules, and municipal advisor rules). IM now also has its own examination group—the Risk and Examinations Office—which conducts its own enterprise-level exams.

OCIE also coordinates with the Financial Industry Regulatory Authority (FINRA), the Department of Justice, the Department of Labor, banking regulators, state regulators, and foreign regulators as needed.

Use of experts

In the last several years, OCIE has hired experts ("senior specialized examiners" or "SSEs") with industry-honed experience in the following areas: hedge funds, private equity, investment companies, funds of hedge funds, valuation, real estate, quantitative analytics, municipal securities, oil and gas, options, derivatives, technology, sales practices, net capital, and risk management.

SSEs are not assigned to work only with a specific OCIE office. Instead, an SSE's role is to assist the entire exam program where needed. These experts often accompany exam teams for all or a portion of their on-site visits.

OCIE has also created units to centralize specialized intelligence. These include the Quantitative Analytics Unit, formed to examine quant advisors, and the Private Fund Unit, formed to examine private fund advisors.

Verifications from third parties

The SEC has always had the authority to reach out to third parties, but examiners seem to have taken advantage of this authority more regularly in the last few years. In particular, the SEC takes advisors' obligations to protect client assets very seriously, and examiners continue to closely examine advisors for compliance with the "custody rule."[6] Examiners now frequently conduct reviews to verify the existence of assets by requesting verification from third parties, such as custodians, administrators, and auditors. The level of verification depends on the level of risk as determined by the examiners. Examiners may also, on occasion, reach out to investors to verify that their statements reflect actual account balances and to verify that investors do not have any concerns related to the advisor.

Follow-up exams

Historically, if a firm was examined, it would mostly likely be several years until the firm's next exam. In the last few years, however, OCIE has begun conducting Corrective Action Reviews ("CARs") to determine whether firms have taken corrective action to address deficiencies noted during the course of an examination.

Even with the move toward more focused, limited-scope reviews, examiners typically have the ability to widen the scope of an exam or go back on-site for a deeper dive. While examiners may plan to review only a few risk areas at a particular firm, in the process of doing so they may determine that other areas of the firm warrant additional scrutiny.

Faster turnaround

As required under Dodd-Frank, OCIE must now complete all exams 180 days after the last day of the on-site portion or the date all requested records were received, whichever is later. Firms should ask for a status update if the duration of the examination appears to exceed this period of time.

Increased transparency

OCIE's primary responsibility is to conduct examinations and identify deficiencies, not to provide advice or dictate best practices. It seems, however, that OCIE now recognizes that advisors appreciate guidance and communication, with the understanding, of course, that the more firms understand about what they *should* be doing to comply with SEC laws and regulations, the more they will be prepared to comply. The same goes for lessons learned—the more OCIE shares about what not to do, the more advisors can assess their own practices and procedures to ensure that their compliance programs are in line with regulatory expectations.

In the last few years, OCIE began publishing examination priorities for each fiscal year. The SEC publishes the priorities on a slightly delayed basis: It publicly announces its exam priorities in January of each year, when it has already been conducting exams under its new priorities for three months. The priorities, however, provide advisors with a "window" onto the focus areas for the coming year.

Additionally, OCIE has regularly published Risk Alerts setting forth findings and observations from examinations, common areas of noncompliance, and informal guidance on how to comply.

[6] Rule 206(4)-2 under the Investment Advisors Act of 1940 is commonly known as the "custody rule." See the final rule release available at https://www.sec.gov/rules/final/2009/ia-2968.pdf. Schwab's July 2014 Compliance Review covers the subject of custody.

III. Logistics

Exam announcement

If your firm is selected for an exam, an examiner will call the regulatory contact listed on the Form ADV Part 1 to announce the exam.[7] Examiners do not typically disclose the type of exam they are conducting. The examiner may ask a number of preliminary questions about your firm to get a better understanding of your business and to confirm certain facts on your Form ADV. The examiner will describe the exam process and disclose the dates they plan to be on-site. If you have a major conflict (for example, a board meeting or travel plans that can't be changed), it is acceptable to request a reschedule date. After the call, the examiner will send an initial document request list.

Document production

Making a good first impression starts with the quality of your document production. You are generally given 1–2 weeks to produce documents, but examiners expect you to be able to produce certain documents within 24 hours. For this reason, it is important to review an updated SEC document request list to ensure that you will be able to produce requested records within this time frame. OCIE provides on its website a list of the core information initially requested by examiners.[8]

Discuss any Freedom of Information Act protection requests, Bates stamping, and attorney-client privilege questions with your legal counsel.

Do not delay in producing documents. Upload documents to the SEC secured portal as soon as possible. While examiners may expect a quick and complete production of documents, examiners generally appreciate any communication about delays in production and will accept a rolling production until all documents have been provided.

Make sure you fully respond to every request item according to the numerical requests made. If an item requested is not applicable to your firm, do not simply ignore the request; be sure to respond in writing that it is not applicable. An organized production helps both you and examiners for the rest of the exam.

Voluntary document production

Examiners may request a number of items that are not books and records explicitly required to be maintained under Rule 204-2, such as committee meeting minutes, trading exception reports, and all email communications.[9] Assuming these documents are available, it is best to produce them without contention. But if you must create a document, you should speak with examiners before allocating time to such a task.

When the examiners arrive[10]

Reserve a conference room (or other similar space to the extent that your firm can accommodate) that provides for a comfortable work environment. Examiners generally appreciate being in a conference room with enough space to set up laptop computers and review documents. Most staff would prefer to work in the same conference room where the interviews will be held so they do not need to transport their belongings for each interview. Place the examiners in a clean room devoid of firm or client documents and with easy access to the restroom.

First day. Day 1 is an opportunity to present your story. Consider creating a presentation that provides an introduction and overview of your firm. Remember that examiners visit a wide variety of firms, and your business is unique. To the extent possible, senior executives should be available on Day 1 to set the tone at the top and emphasize the firm's dedication to compliance.

On-site exam duration. The number of days examiners remain on-site depends on multiple factors, including the scope of the exam, the complexity of the firm, and whether the examiners will need to travel to visit your firm (travel is always a budgetary concern at the SEC). For most exams, the on-site portion lasts from two to five days.

Last day. Examiners may conduct a preliminary exit interview, but no findings are formalized until a deficiency letter is issued. It is important to be proactive. If issues are identified on-site, do not wait for a formal deficiency letter; work to remedy them as soon as possible.

[7] If the examination is for cause (the result of a tip, complaint, referral, etc.), you may not receive a call announcing the exam. However, even in the case of for-cause exams, it is rare for examiners to show up unannounced.

[8] See http://www.sec.gov/info/cco/requestlistcore1108.htm.

[9] See Rule 204-2 under the Investment Advisors Act of 1940, available at https://www.law.cornell.edu/cfr/text/17/275.204-2.

[10] OCIE also conducts correspondence exams. In such cases, the exam will be conducted via document production and telephone interviews in lieu of an on-site review.

Preparing for interviews

Examiners will come ready to ask questions. At a minimum, examiners will have reviewed your Form ADV, both Parts 1 and 2A, your website, and many of the documents you provided in advance. They will also likely have conducted research on publicly available information, as well as information about any applicable legal or disciplinary information naming the firm or its key executives and control persons. They will have reviewed prior exam reports and response letters. Examiners are there to exercise professional skepticism, so avoid being overly defensive.

Everyone on your employee list is fair game for interviews. Depending on the scope, examiners often ask to speak with representatives in various key operational areas of the business: portfolio management, trading, accounting, operations, compliance, risk management, and marketing/investor relations.

The power of visuals

Consider offering visual demonstrations to examiners as often as possible. It is generally more effective to show examiners how a process works than to describe the process to them. Examples of this approach include:

- Detailed and color-coordinated organization charts of the advisor and any affiliated entities
- A demonstration of the firm's order management, portfolio management, compliance, risk management, and CRM systems
- A flow chart of the trade execution and settlement process

Prepare all interviewees. Questions should be answered as briefly and directly as possible. If you don't know the answer, it is best to say so and to come back later with more detail. Momentary periods of silence are OK. Be prepared to have the same question asked multiple times. Review your compliance manual—in addition to questions specific to an interviewee's role, examiners often ask general questions related to gifts and entertainment, personal trading restrictions, and outside business activities that all employees should be able to answer.

After the on-site review

Exams typically continue off-site with additional document requests and potentially additional interviews by phone. During this time, examiners often consult with supervisors and other SEC offices (e.g., IM).

Examiners will schedule a formal exit interview over the phone. At this point, examiners have drafted the deficiency letter. This is your opportunity to clarify any misunderstanding or to correct any perceived inaccuracies before the letter is finalized. Be polite when doing so.

Responding to a deficiency letter

Most exams result in a deficiency letter outlining violations of laws and/or regulations or control weaknesses. Significant issues may be referred to the Division of Enforcement or to another regulator.

Be sure to address all findings and provide corresponding documentation of any changes made within 30 days. Decide which deficiencies to accept and which to contest. The 30-day deadline is to some extent arbitrary. If it is clear that you will need more time to respond sufficiently, request an extension as soon as possible—but there is no guarantee that an extension will be granted.

IV. Compliance rule core requirements

Rule 206(4)-7, the "compliance rule," under the Investment Advisors Act of 1940 ("Advisors Act") requires only three things, and yet many firms fail to get these right. Getting them right is critical to your preparation for an exam, and the SEC is generally unsympathetic to deficiencies in these areas.

Compliance manual

Regardless of the type of exam, examiners will review your compliance manual and use it as a road map for your business. Pore through your compliance manual to ensure that it is:

- **Customized.** Examiners are not fond of "off the shelf" manuals not tailored to an advisor's business.
- **Comprehensive.** It should address key functions of your business so as to "reasonably" prevent violations from occurring and detect and promptly correct any violations that have occurred.[11]
- **Current.** The compliance manual is a living document. If your procedures change, your policy must be amended, and vice versa. Examiners look closely at the current practices of the firm and compare them with the firm's written policies. Future policy plans do not belong in the manual. In addition, ensure that your manual reflects any recent regulatory developments or rulemaking.

[11] The compliance rule release provides a list of the policies and procedures advisors should have, at a minimum. See https://www.sec.gov/rules/final/ia-2204.htm.

Also remember that examiners can request documentation of any testing in your manual. Walk through your compliance manual. Does it say you will test certain things? When examiners ask for evidence of such testing, will you be able to provide it? Remember, when it comes to SEC examinations, a lack of documentation translates to "did not happen."

Annual review

Be sure you have documentation to show that your annual review assessed whether all the policies and procedures of your firm meet the criteria above. Ensure that you have documentation of testing and that you have noted any compliance failures or breaches identified during the prior year. Examiners accept identified weaknesses. By identifying areas of concern and rectifying problems, you demonstrate the rigor with which your firm conducted its annual review.

Chief compliance officer

The following two points outlined in the SEC's compliance rule release are critical to note for an effective chief compliance officer: CCOs must be "empowered with full responsibility and authority to develop and enforce appropriate policies and procedures" and in a "position of sufficient seniority and authority within the organization to compel others to adhere to compliance policies and procedures."[12] More simply stated, the CCO must be free enough to devote sufficient time and focus to this role. He or she must not have so many responsibilities that compliance is neglected or given insufficient attention.

Additionally, a firm's compliance budget should be adequate to ensure that a qualified CCO is assigned to the role and that he or she is able to stay current on regulatory changes, developments, and best practices. This also means that CCOs need to be aware of continuing education opportunities: the SEC's compliance outreach conferences, industry conferences, networking opportunities with other CCOs, etc.

CCOs are expected to detect and rectify compliance issues in a timely manner. At times, however, disagreements arise between CCOs and senior executives regarding the appropriate methods or solutions to address issues. Firms should ensure that there is a designated reporting chain for CCOs and open lines of communication in both directions to help avoid this turn of events. CCOs also are advised to maintain thorough documentation of any issues and their resolution.

V. 2015 SEC high-priority areas

The following issues have been highlighted recently by OCIE and the Division of Enforcement's Asset Management Unit (AMU).[13] Where applicable, review the compliance program of the firm to ensure that these issues are adequately addressed.

A. Focus on retail investors

OCIE is interested in protecting retail investors and, particularly, investors who are saving for retirement. In June 2015, OCIE issued a Risk Alert announcing its launch of a multiyear Retirement-Targeted Industry Reviews and Examinations (ReTIRE) initiative.[14]

Account type selection

Examiners will assess whether there is a reasonable basis for the account type recommended at the inception of an advisory relationship. It would not be appropriate, for example, to transition an elderly client with a few legacy equity holdings in a brokerage account to a fee-based account with no intent to trade in the portfolio. It would also not be appropriate to recommend an IRA rollover to a higher fee-paying account unless the additional fees can truly be justified.

Make sure account-opening disclosures are clear and that all necessary information is obtained from clients. Examiners will review these documents to ensure that what is stated is what is occurring. Examiners will focus closely on whether the services provided and expenses charged are consistent with the advisor's fiduciary duty and whether all conflicts and practices have been disclosed.

Fees

It is quite common for examiners to select accounts and test the accuracy of the fees charged. Some fee tests might include:

- **Fee discounts.** If the firm offers breakpoint discounts, where greater assets in certain investment programs allow for reduced fees, confirming that account assets are aggregated/linked (if applicable) and that the discounts are calculated correctly.
- **New clients.** If the firm charges quarterly fees, verifying that accounts that commenced their advisory relationship during a quarter paid fees based only on the number of days of advisement.

[12] See https://www.sec.gov/rules/final/ia-2204.htm.

[13] See OCIE Examination Priorities for 2015, available at http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf, and AMU's 2015 priorities as addressed in a speech from co-chief Julie Riewe, available at http://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html.

[14] See https://www.sec.gov/about/offices/ocie/retirement-targeted-industry-reviews-and-examinations-initiative.pdf.

- **Terminated clients.** If the firm charges fees in advance, verifying that terminated clients were reimbursed their pro rata portion of prepaid fees for the remaining days for which they did not receive advisory services.

Marketing and sales practices

Examiners are looking for misleading or insufficient disclosures, as well as questionable activity in obtaining new clients—for example, seminars targeted toward seniors, free lunches, or a lack of full disclosure of purpose in advertisements. Expect examiners to closely review your marketing materials, which include pitch books, pamphlets, brochures, and any other promotional materials, as well as advertisements, websites, blogs, speaking engagements, TV/radio presence, and use of social media. Examiners may seek verification that any credentials or other endorsements used in marketing materials or disclosures are current and valid. Firms must avoid using superlatives that cannot be supported, testimonials, and any misleading statements. Firms should be careful when using past specific recommendations. Any advertised performance is subject to a number of other requirements.[15]

Reverse churning

In the last several years, investment advisors have increasingly recommended wrap accounts for clients who previously held brokerage accounts. Because brokers are generally compensated through commissions, they may have an incentive to encourage active trading. Conversely, advisors are generally paid an asset-based fee and do not have the same incentive to trade. Examiners will likely select certain groups of accounts at a higher risk of abuse and test the level of trading and fees paid to determine whether accounts are overpaying fees for the amount of trading in the client's portfolio. Firms that manage wrap accounts that pay an asset-based fee should monitor levels of trading to ensure that they remain appropriate and to avoid reverse churning.

Suitability

Examiners want to see that investment recommendations are made in the best interest of clients. Expect examiners to review investment policy statements alongside trading and portfolio holdings to ensure that portfolios are managed in accordance with client mandates, restrictions, and goals and objectives.

As firms seek higher returns for their investors, many now recommend investments typically associated with higher fees and greater risks, such as private equity and structured products. Examiners will review products offered to retail investors that are typically or were historically offered only to sophisticated investors. Examiners will review these recommendations to ascertain the level of due diligence conducted, disclosures made, and the suitability of the investment for the particular client.

Branch offices

Examiners will focus on supervision of branch-office employees and operations by the firm. Examiners may use data analytics and document requests to identify branches that may be straying from the firm's main office.

'Alternative' investment companies

Examiners will be reviewing the extent to which advisors are recommending alternative registered investment companies ("alt RICs"). Alt RICs are mutual funds registered under the Investment Company Act of 1940 ("IC Act") that provide retail investors with exposure to alternative investment strategies such as long-short equity, currency, global macro, private equity, real estate, and commodities. Historically, access to these investment strategies was restricted to accredited or qualified investors in private funds. Unlike private funds, however, alt RICs are registered mutual funds, and therefore feature daily pricing and liquidity, transparency, and low investment minimums. Alt RICs have grown in popularity due to their high risk-adjusted returns and portfolio diversification benefits. Expect examiners to question whether alt RICs held in retail portfolios are appropriate and that full disclosures have been made regarding the investments' increased risks.

OCIE is also concerned with the direct management of alt RICs. Due to the nature of the investments, alt RICs face greater challenges in complying with the IC Act. The SEC has stated that examiners will review the way in which managers of alt RICs are ensuring compliance in five substantive areas: liquidity, leverage, investor allocations, governance, and sub-advisor oversight. If your firm manages an alternative investment company, make certain it has strong procedures in these areas and complies with all the requirements under the IC Act.

Fixed income investment companies

The SEC is aware that interest rates will not always be near zero. When rates do rise, the prices of bonds will fall. Examiners are reviewing fixed income mutual funds to ensure that trading controls are sufficient and the funds' marketing materials and disclosures are not misleading.[16]

[15] See Rule 206(4)1, available at https://www.law.cornell.edu/cfr/text/17/275.206(4)-1. For a summary of SEC marketing and advertising considerations, see the March 2012 Schwab Compliance Alert titled "Investment Advisor Advertising" by Michael S. Caccese and Douglas Y. Charton of K & L Gates, LLP.

[16] See the SEC's January 2014 IM Guidance Update for additional background and a list of actionable risk management and disclosure suggestions for fixed income fund advisors, available at http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf.

B. Conflicts of interest

Conflicts of interest are an ongoing theme with the SEC and, in recent years, have become a priority of both OCIE and the AMU. Conflicts of interest are considered material facts that firms should either work to eliminate entirely or mitigate and disclose. Below are five ways firms should tackle conflicts of interest on an ongoing basis. For more information, refer to the supplement "Conflicts of interest: Questions to ask yourself."

1. **Assess.** Closely examine your business model, compensation, relationships, employees, fee structures, affiliates, and investment allocations. In general, look for any situation where the advisor or an employee could benefit at the expense of a client or any situation where the advisor is conflicted in the treatment of its clients. To objectively evaluate areas of conflict, attempt to step outside your firm and assess these areas with a critical eye. Require that employees fill out an annual conflicts questionnaire to assess each employee's conflicts. You may consider creating a conflicts committee or engaging a consultant to help assess your firm's conflicts—the more reviewers, the better!
2. **Document.** Your annual review is a good opportunity to reassess your firm's conflicts. It is a good idea to document your review by creating a conflicts log or matrix describing each conflict, how the firm is addressing the conflict (elimination, mitigation, disclosure), the potential impact, and whether the firm deems the conflict material.
3. **Disclose.** Remember that conflicts are not in and of themselves violations. Disclosure is the key. Examiners will review your disclosures carefully to determine whether the firm has disclosed all material facts regarding conflicts or potential conflicts of interest. Examiners will be looking to see not only that you disclosed conflicts but also that the disclosure is as full and clear as possible, providing enough specificity to elicit consent from your clients.
4. **Create or update policies and procedures.** An advisor's compliance manual should contain policies and procedures describing the advisor's steps to monitor and continually re-evaluate ongoing conflicts. The policy should identify the party responsible for evaluating and deciding how to address conflicts.
5. **Train.** Conduct training annually or as needed to address conflicts within the firm and employees' conflicts of interest. Awareness is the first step toward mitigation.

C. Cybersecurity

The SEC has put the onus on advisors to show examiners how they are responding to potential cyber-threats. In February 2015, OCIE published a Risk Alert summarizing observations from its cybersecurity sweep the prior year,[17] and in April 2015 IM issued a Guidance Update on measures firms "may wish to consider."[18] OCIE continues to review cybersecurity compliance and controls of investment advisors. Examiners expect firms to have considered all material aspects of their ever-changing business, including changes to the technological environment and the potential for cyberattacks that threaten a firm's core business and client information.

Risk assessment

Firms should take a risk-based approach to cybersecurity, similar to the management of the firm's other risks. First determine which cybersecurity threats are likely to affect your firm by conducting a risk assessment. This is the most challenging part of the process, and it may be helpful to engage a cybersecurity vendor to help. In the assessment, consider prioritizing risks as high, medium, or low. The SEC suggests that risk assessments address:

- The nature, sensitivity, and location of information that the firm collects, processes, and/or stores, and the technology systems it uses
- Internal and external cybersecurity threats to and vulnerabilities of the firm's information and technology systems
- Security controls and processes currently in place
- The impact should the information or technology systems become compromised
- The effectiveness of the governance structure for the management of cybersecurity risk

Policies and procedures

Develop policies and procedures that show the firm's cybersecurity controls, the designated staff responsible for ensuring compliance with such controls, a detailed incident response plan, and precisely which records will be kept. Policies should include protection of client and investor information, processes for reviewing vendors, internal checks on systems to safeguard client and investor information, and precautionary policies relating to suspicious email or wire requests.

[17] https://www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf.

[18] http://www.sec.gov/investment/im-guidance-2015-02.pdf.

Vendor due diligence

Firms often rely on vendors to assist with firm operations. When engaging and maintaining service providers, firms have an obligation to assess the providers' cybersecurity preparedness. If the vendor's cybersecurity safeguards are weak, the advisor's systems and client information may be easily compromised and open to unauthorized access. Understand what each vendor's level of information access is. Consider including clear terms of security expectations in the vendor contracts and signed confidentiality agreements. If you renew a vendor's contract, inquiries regarding security should be repeated.

Training

Consider including cybersecurity policy highlights when training employees. Warn employees about the ways in which information may be compromised or shared inadvertently (e.g., provide examples of suspicious emails employees should not open). Alert employees to be wary of requests for client passwords, not to open suspicious documents, to use discretion in phone conversations, and to always verify that a call is from an account holder before disclosing confidential account information.

Testing and insurance

Consider penetration testing (hiring a third party to try to hack your system) and phishing tests (spam emails that appear to be from a familiar contact).

Depending on the size and budget of your firm, it may behoove you to consider cybersecurity insurance to cover losses from liability (lawsuits from customers for the breach), breach response costs (to notify customers of the breach), and government fines and penalties.

VI. Conclusion

Understanding how the National Exam Program operates in 2015 and what it is focusing on is critical to being prepared when you are examined. The best way to ensure preparedness for an SEC examination is to never stop reassessing your firm's compliance, including how you are responding to constantly changing regulatory developments. A prepared firm is one that has instituted a strong, risk-based compliance program and coupled it with customized, detailed policies and procedures, and clear and accurate disclosures.

That way, when you are faced with the "unknown," you can be confident that you know reasonably well how the process works and can prepare your firm for the SEC's current review areas.

About the author

Alyssa Briggs, ACA Compliance Group

Alyssa Briggs is a principal consultant with ACA Compliance Group, where she provides ongoing compliance consulting services to investment advisors and private fund managers. The majority of her work consists of conducting mock examinations and annual reviews of these entities. Before joining ACA, Briggs spent six years as an investment advisor examiner with the SEC. While employed at the SEC, she participated in and led numerous examinations of investment advisors, investment companies, and private funds. Several of these exams were referred to the Division of Enforcement for further investigation. Before joining the SEC, Briggs worked for GMAC Residential Capital and received an MBA degree from the University of Dallas. She can be contacted at abriggs@acacompliancegroup.com.

Online compliance resources

Visit schwabadvisorcenter.com > News & Resources > Compliance for compliance and regulatory information.

Schwab works with third-party firms to provide select resources that help keep you informed of certain regulatory and compliance developments. Access *Compliance Hot Topics*, templates and guideline documents, archived issues of *Compliance Review*, third-party resources, and discounts. These resources are complimentary and exclusive to advisors who work with Schwab Advisor Services.

HNW (0715-4163) EML15120AUG15-00 (07/15)

charles SCHWAB

Own your tomorrow™

charles SCHWAB

Advisor Services

Supplement to

SEC exams: Preparing your firm in 2015

Conflicts of interest: Questions to ask yourself

As you conduct your assessment, closely consider whether you have full disclosures and policies to mitigate the following:

Side-by-side trading

1. Does the firm manage clients with different fee structures (e.g., a hedge fund with a performance fee and separate accounts with fixed fees) that trade in similar securities? How does the firm ensure that one client is not offered favorable treatment at the expense of another?
2. Does the firm employ a methodology to equitably allocate hard-to-obtain or limited-quantity securities, such as initial public offerings and secondary offerings?

Client referrals

3. Does the firm pay a broker-dealer or custodian for client referrals without disclosing that its objectivity in utilizing that broker-dealer is conflicted?

Questionable revenue or expenses

4. Does the firm receive any undisclosed compensation?
5. Does the firm charge any undisclosed fees or expenses?

Personal trading

6. Does the firm have controls and procedures in place to detect front running (based on the advisor's securities recommendations and client transactions)?
7. Does the firm maintain a restricted list of securities and companies in which it believes it may possess material, nonpublic information? Does the firm monitor trading against the restricted list for potential insider trading?
8. Is someone other than the chief compliance officer reviewing the CCO's personal trading?

Separate arrangements/preferential treatment

9. If the firm provides financial planning or other planning services (for example, estate planning, tax planning, education funding, charitable gifting planning), does the firm monitor to ensure that these clients are not favored over investment management clients who do not make use of these additional services?
10. If the firm manages private funds, are there any side letter arrangements with certain investors, including preferential terms such as reduced fees and redemption rights?

Employee compensation

11. Are employees compensated for the sale of proprietary or affiliated products?
12. Are employees compensated based on the performance of accounts?

Political and charitable contributions

13. Does the firm review employee political contributions to ensure that it is not receiving business from government entities that were influenced by such contributions?[1]
14. Does the firm create unfair biases by making charitable contributions or sponsoring charity events with a client, vendor, consultant, or service provider?

[1] Rule 206(4)-5 under the Advisors Act (the "pay-to-play rule") prohibits advisors from receiving compensation for advisory services from a government entity for two years following any contribution made to an official of the government entity by the advisor or any of its covered associates.

Investment recommendations/best execution

15. If the firm recommends mutual fund investments, does the firm ensure that clients are recommended the best share class (for example, ensuring that the firm does not cause clients to purchase shares of mutual funds where lower cost institutional share classes exist)?
16. Does the firm receive payments for recommending certain investments? For example, is the firm compensated by a broker-dealer for investing client assets in certain no-transaction-fee mutual funds?
17. Does the firm have an undisclosed bias toward proprietary or affiliated products and investments? Does the firm disclose any additional fees on the management of its proprietary or affiliated mutual funds or private funds?
18. Does the firm receive payments or credits for order flow? If so, does the firm prioritize trading venues based on these payments or credits?
19. If the firm effects cross trades between clients, how does the firm ensure that one client is not favored over the other?

Affiliated broker-dealer

20. Does the firm execute principal transactions through an affiliated broker-dealer without the required written disclosure or consent?

Soft dollars

21. Does the firm receive research or brokerage services paid for by client commissions? If so, how does it monitor the brokers paid with soft dollars to ensure that their services are in the best interest of clients?[2]

Outside employment, directorships, and other business activities

22. Do employees serve as directors, trustees, or officers of outside organizations, including public or private corporations, partnerships, charitable foundations, and other not-for-profit institutions that may affect their decision making? Do employees receive compensation for such activities?

Proxy voting

23. Does the firm use any vendors or have any clients that are affiliated with a publicly traded company in which other clients invest?
24. Does the firm have a client who is an officer, director, or senior executive of an issuer of securities held in client portfolios that may influence the firm to vote proxies with management?
25. Do any employees have personal or business relationships with issuers or individuals who serve as officers or directors of issuers?
26. Do any employees personally own a significant number of an issuer's securities that may influence the direction in which proxies are voted on behalf of clients?
27. Does the firm or an affiliate have a financial interest in the outcome of a vote (for example, if the vote relates to an increase in Rule 12b-1 fees and the firm receives a portion of the fees)?

Gifts and entertainment[3]

28. Is the firm maintaining a log of gifts and entertainment to ensure that no employees are receiving or providing excessive gifts or other gratuities to or from individuals or entities seeking to do business with the firm?
29. Does the firm reach out to brokers annually to request a list of the gifts and entertainment provided to employees and traders?
30. Do any employees attend or participate in conferences or workshops sponsored by an entity or individual that has a business relationship with the firm or its clients?

Valuation[4]

31. If the firm holds any nonmarketable securities, is there a process to price securities? Has the firm established a valuation committee?
32. Does the firm employ an independent third party to provide price estimates? Does the firm ever override these recommendations?
33. If the firm manages an alternative investment company, how does it address the challenges of valuing illiquid instruments on a daily basis?

Service providers

34. Are any service providers also clients of the firm?
35. Are any service providers engaged as a result of a personal relationship?
36. Does the firm benefit in any way from services paid for by the client (research services, discounts, etc.)?
37. Does the firm receive compensation from any third parties for using certain service providers?

[2] The safe harbor under Section 28e of the Securities Exchange Act allows advisors to receive research and brokerage services paid for by client commissions. An advisor may therefore have incentive to route trade orders through brokers for which it receives soft dollar services. This may cause an account to pay a broker a higher commission than another broker might charge.

[3] If the firm manages a registered investment company, it is a good idea to review the recent IM Guidance Update on gifts and entertainment: http://www.sec.gov/investment/im-guidance-2015-01.pdf.

[4] Valuation poses an inherent conflict. When firms charge clients asset- and performance-based fees, there is an incentive to value client securities as highly as possible since the fees an advisor receives are based on the value of the assets under management.

HNW (0715-4163) EML15120AUG15-00 (07/15)

charles SCHWAB

Own your tomorrow™