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REGULATORY NEWS & COMPLIANCE BEST PRACTICES

Common deficiencies cited in SEC exams of IAs revealed

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What **SEC** examiners focus on can shift like the sands, depending on what's hot and the type of firm being queried. We've come up with a list of common deficiencies cited by peers and observers who have been through multiple exams.

Some topics are easy to identify. Problems with custody, even years after Madoff, will attract special attention. Code of ethics lapses, poorly maintained records supporting performance advertising and miscalculated fees will surely draw a demerit.

"I'm not even sure there is a common deficiency," says an exam veteran and CCO at a Pennsylvania firm. "I haven't had the same deficiency twice." The CCO adds that SEC citations could depend on the tastes of the regional office, too. Still, we pieced together this list, along with compliance best practices:

- ✓ **Personal trading**. "It's a very easy deficiency for them to put in the letter" because the rules are so clear, says **Christopher Lewis**, GC/director of **Alaric Compliance** in New York. "The SEC gets very, very granular when it comes to personal trading," responds a New York CCO who survived a recent SEC exam. Your records should be pristine. If not, don't be surprised if examiners start poking around outside the dates of their stated exam period, warns the CCO.

Missing brokerage statements or pre-clearance forms can leave an examiner scratching his head. "Make sure that everything is in order," says the CCO. **TIP**: Assign someone the task to periodically go through personal trading documentation to check if anything's missing. If it is, correct the problem ASAP.

- ✓ **Advertising & marketing**. As mentioned, if you lack documents to support past performance, look out. Avoid flowery language, such as "the best," "best of class," "world class," "superb" and "rare." Is your strategy really "rare," asks **Bart McDonald**, executive VP of **Renaissance Regulatory Services** in Boca Raton, Fla. "Anything like that is going to get scrutinized and you're going to have to be able to back it up."

Don't forget your website. These are public after all and examiners will review them before they step through your door, says **Colleen Montemarano**, senior consultant with **NorthPoint Compliance** in Red Bank, N.J., and a former SEC examiner.

- ✓ **Best execution**. Be careful that the data you use to support your best execution efforts fits your firm. For instance, if you rely heavily on soft dollars but select comparative data that doesn't account for soft dollar benefits, can you make a fair comparison, asks the New York CCO. Note your Form ADV disclosures around this as well. If your brochure describes your execution expenses as low or "within industry norms," be sure your data confirm this contention.

The SEC wants to see that you have a process, says Alaric's Lewis. He suggests firms create a best ex committee that meets quarterly and keeps minutes. McDonald recommends you at least annually compare some brokerage costs. For example, if your firm uses **Fidelity**, pull down quarterly execution reports and compare the expenses with, say, **Schwab**'s or **TD Ameritrade**'s. You also could do this quarterly. Some examiners request that you insert in your procedures that you annually compare different custodians expenses, says McDonald.

- ✓ **Portfolio management**. Examples of scenarios sure to draw a deficiency include giving preferential treatment to certain investors, either in funds or separately managed accounts, an SEC official tells **IA Watch**. The special treatment also shouldn't extend to withdrawals or allocations (e.g., permitting some customers to redeem when gates shut out others).
- ✓ **Failure to adapt your compliance manual to your firm**. "A lot of times an SEC examiner can spot it right away. There's a very good chance that they've already seen [the same manual] at another firm," says Montemarano.
- ✓ **Neglecting to respond promptly and completely to an SEC document request list**. "This is not the way to begin the examination," stresses **Michelle Kennedy**, president of **Compass Compliance Services** in Greenville, S.C. Make your response complete and organized, and be sure to know what you're sharing before you hit "send."
- ✓ **Failing to follow established procedures**. For example, your P&Ps state that all marketing materials must be approved by the CCO via an approval form. But then examiners find that you've never bothered to use the form, says **Karen Huey** of **Professional Compliance Assistance** in Woodstock, Ga.
- ✓ **Inaccurate billing**. This topic's always red hot. You should be testing your fee calculations and, of course, promptly refund any money due to a client, says Huey. Don't allow the same person to do the billing and the testing, she recommends. Are the assets even managed to provoke a fee, asks a second New York CCO. This came up on a recent exam, especially for illiquid assets and loaded variable annuities. While it's not against the rules to charge fees for such assets, the SEC will want to see that someone at the firm is monitoring these circumstances.
- ✓ **Discrepancies across disclosures**. This likely won't be a major deficiency, says McDonald. For instance, perhaps you changed custodians but didn't revise your Form ADV brochure. Or maybe you began accepting soft dollars but the brochure continues to state that you don't. Or what you state in Form ADV, Part 1 doesn't jibe exactly with your disclosure in the Part 2 brochure. So-called "copy cat" brochures are eliciting the red pencil treatment from examiners, cites Huey. These brochures come from firms that have lifted whole sections from another firm's brochures and pasted the text into their own.

Other areas to be aware of include not keeping up-to-date documentation on client needs, goals, objectives and risk tolerances, says Huey. It's a smart idea to maintain investment policy statements on clients. This would also assist in your business continuity planning, she adds.

Valuation mishaps and negligent due diligence of sub-advisers also commonly prompt deficiencies.

A Connecticut CCO at a dually-registered firm warns that SEC examiners will look at compliance with **FINRA**'s net capital rule and the efficacy of the firm's net capital calculations, especially if the firm isn't taking appropriate haircuts and maintaining proper books and records.

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