

# SEC key topics—and how to prepare for an examination

Michelle Jacko, a leading expert on corporate and compliance risk management for advisors, outlines five key topics that her team continuously sees during routine exams, sweep exams, and formal regulatory investigations. To help firms prioritize and develop regulatory processes, she answers frequently asked questions and gives invaluable tips for delivering commonly requested documentation.

## Examiner focus areas

1. Services to retirement accounts >
2. Issues related to aging clients >
3. Cybersecurity >
4. Performance advertising >
5. Disclosure of conflicts of interest >



## 1. Services to retirement accounts

Examiners review how firms communicate with clients about retirement, as well as how they evaluate what's in each client's best interest and whether all options are made available. It's not only important to comply but also critical to clearly document practices, as deficiencies often arise when advisors fail to document their actions.

### Common examiner questions

- What policies and procedures has your investment advisory firm developed for servicing retirement accounts?
- Is training provided to financial advisors for servicing retirement accounts?
- What written disclosures and information is provided to clients, relating to:
  - Available options (e.g. accounts, investments, and associated fees and distribution options, such as maintaining assets in a former employer's plan, IRA rollover, or lump sum distribution)
  - Tax implications of available retirement options
  - Communications related to retirement options
  - Retirement analysis/plans
  - Education on retirement accounts

### How to prepare

- Develop a standard document outlining retirement planning options, and give this to clients at the onset of retirement planning discussions.
- At a firm level, provide training to all advisors working with retirees, and create templates that can be used to clearly and consistently document client discussions.
- Review Form ADV and disclosures related to retirement planning services, along with policy and procedure manuals, to ensure clarity and accuracy.

### Examiner focus areas

1. [Services to retirement accounts >](#)
2. [Issues related to aging clients >](#)
3. [Cybersecurity >](#)
4. [Performance advertising >](#)
5. [Disclosure of conflicts of interest >](#)



## 2. Issues related to aging clients

As more people are living longer, advisors need to manage the associated responsibilities of serving aging clients. This includes diminished capacity (e.g., from the onset of dementia) and the potential for financial exploitation. To help protect vulnerable investors, examiners review a firm's ability to identify financial exploitation as well as its supervisory internal controls. Two FINRA rules announced in February 2018 are designed with the aging population in mind:

- **Rule 4512: Customer Account Information.** Requires firms to make a reasonable effort to obtain name and contact information of a client's trusted contact whenever an account is updated or as part of the 36-month confirmation.
- **Rule 2165: Financial Exploitation of Specified Adults.** Allows firms to hold disbursements up to 15 days and report to a state regulatory agency if the firm believes a client over age 65 or under 18 has a mental or physical impairment that prevents them from protecting their own interests.

In May 2018, the Senior Safe Act (SSA) went into effect. The SSA is intended to help protect senior citizens from financial exploitation by promising immunity to "covered financial institutions" (CFIs) and individuals associated with a CFI who disclose suspected financial exploitation to a "covered agency," such as the SEC, FINRA, or law enforcement. Exploitation in this instance means fraudulently using the resources of a senior citizen for personal benefit or unlawfully depriving a senior citizen of rightful access to or use of benefits, resources, or assets. In addition to the noted FINRA rules, many states now have laws that create new obligations for investment advisors, investment advisor representatives, and broker-dealers.

The SSA doesn't mandate CFIs to make disclosures, but it strongly encourages them to learn how to identify warning signs and common scams that could affect senior citizens.

### Common examiner questions

- What percentage of your firm's clients are over age 62? (Note: SEC, FINRA, states, and Schwab use different ages to define a senior citizen.)
- What percentage of regulatory assets under management is from those clients?
- Describe your policies and procedures related to the following topics:
  - Establishing a trusted contact
  - Steps taken with client accounts upon death
  - Handling client requests for changing beneficiaries
  - Powers of attorney
  - Trustees
  - Frequency of communication with clients

### Examiner focus areas

1. Services to retirement accounts >
2. Issues related to aging clients >
3. Cybersecurity >
4. Performance advertising >
5. Disclosure of conflicts of interest >

## 2. Issues related to aging clients (continued)

### How to prepare

Along with required employee training, firms should develop an escalation system for reporting diminished financial capacity and potential financial exploitation and designate one person to assess the concern. This includes:

- Identifying a client's power of attorney or a trusted contact (if there is one)
- Determining whether a hold should be placed on an account
- Determining whether a matter needs to be reported to Adult Protective Services, a regulator, or law enforcement

Additionally, it's recommended that advisory contracts describe what to do in the event of a death, incapacity, or financial exploitation. That way, if there's an issue settling a client's estate, such as a dispute among family members, the advisor has a document that states the terms and conditions that honor the end-client's wishes and expectations and helps protect the advisor going forward.

### Examiner focus areas

1. Services to retirement accounts >
2. Issues related to aging clients >
3. Cybersecurity >
4. Performance advertising >
5. Disclosure of conflicts of interest >



### How Schwab can help

In support of its advisors and their clients, Schwab assembled a Senior & Vulnerable Investors Investigations team, which assists with vulnerable adults, elder financial exploitation, and diminished capacity. This team serves as a partner between Schwab service professionals and advisors in sensitive client situations, helping to resolve issues that require in-depth research and case management.

In addition, this team can help identify situations where restrictions, monitoring, or a hold should be placed on an account.

Learn about Schwab's Senior & Vulnerable Investors Investigations team, how to identify warning signs, and more [here](#). If you suspect exploitation, elder abuse, or diminished capacity, reach out to your Schwab service team.



## 3. Cybersecurity

As technology becomes more advanced and accessible, protecting clients against cybersecurity threats has become increasingly important and complex. In response, the SEC increasingly asks advisors if they have established policies and procedures to respond to a cyberattack.

In fact, the SEC released a National Exam Program (NEP) Risk Alert in 2017 with observations from examinations of 75 advisory firms. One key finding: The majority of cybersecurity policies and procedures were not reasonably tailored. While policies and procedures might indicate advisors are doing cybersecurity training, up to 25% of employees have not received it. This is a common deficiency.

The 2018 SEC Exam Priority Letter specified that examinations would continue to focus on cybersecurity with specific emphasis on:

- Governance and risk assessment
- Access rights and controls
- Data loss prevention
- Vendor management
- Training
- Incident response

The last three items in that list—vendor management, training, and incident response—are areas where the SEC sees weakness and, therefore, where it continues to focus its examinations. Previous sweep exams focused on:

**Cyber 1 sweep exam:** How firms identify risks related to cybersecurity, governance practices (e.g., policies, procedures, and oversight), network and information protection, vendor management, and detecting unauthorized activities

**Cyber 2 sweep exam:** Validating and testing procedures and controls surrounding cybersecurity preparedness (e.g., access rights and incident response)

In March 2018, Peter Driscoll, director of the SEC’s Office of Compliance Inspections and Examinations, announced a third cybersecurity sweep exam with a focus on three areas:

- Advisors who maintain remote offices
- Advisors who have merged firms
- The use of personal email and other “unregulated forms” of communications used when leading up to and following a merger

### Examiner focus areas

1. Services to retirement accounts >
2. Issues related to aging clients >
- 3. Cybersecurity >**
4. Performance advertising >
5. Disclosure of conflicts of interest >

### 3. Cybersecurity (continued)

#### Common examiner questions

- Does the advisor conduct periodic risk assessments to identify cybersecurity threats, vulnerabilities, and potential business consequences? If so:
  - Identify who conducts them, the month and year completed, and any findings that were deemed to be a moderate or high risk
  - For any findings, describe whether risk areas have been fully or partially remediated and the status
  - Provide evidence of how the firm conducted vendor due diligence on cyber controls
- If the advisor provides clients with online account access, provide the following information:
  - Name of third party that manages the service, functionality for clients on the platform, how clients are authenticated for online access, and security measures used to protect client PINs stored on the site
- Has malware been detected on one or more of the advisor's devices? If so, describe the actions taken.
- Has a critical network resource been impaired by a software or malware function? If so, describe actions taken.
- Has the advisor detected an unauthorized breach of its network? If so, describe actions taken.

#### How to prepare

- Review your firm's incident response plan to ensure that escalation procedures, remediation efforts, and communication plans are thorough and well documented.
- Assess management controls and add cybersecurity risk provisions and develop policies, procedures, and training materials for any vendors or business partners with access to the firm's network.

#### Examiner focus areas

1. Services to retirement accounts >
2. Issues related to aging clients >
- 3. Cybersecurity >**
4. Performance advertising >
5. Disclosure of conflicts of interest >



#### How Schwab can help

Schwab maintains an online Cybersecurity Resource Center to equip its advisors with the information and resources needed to organize, develop, strengthen, and maintain their firms' cybersecurity. Visit the [Cybersecurity Resource Center](#) to browse a library of action-oriented resources, articles, and support links.



## 4. Performance advertising

Performance advertising has featured in every SEC examination and continues to be a leading deficiency for advisors. A 2017 NEP Risk Alert identified the following areas where the most frequent advertising and marketing deficiencies showed up in SEC exams:

- Misleading performance results
- Misleading 1:1 presentations
- Misleading claims of compliance with Global Investment Performance Standards
- Misleading selection of recommendations
- Inadequate compliance policies and procedures
- Misleading use of third-party rankings or awards
- Misleading use of professional designation
- Use of testimonials

### Common examiner questions

- What policies do you have in place for the use of client testimonials in marketing purposes?

When it comes to using testimonials, every client's experience with an advisor is personal and unique. This is well-illustrated by two recent enforcement cases:

- Creative Planning, Inc. and Peter Mallouk—an administrative proceeding against an investment advisor for violation of the testimonial rule in radio advertisements (IA Rel. No. 5035, September 18, 2018)
- Leonard S. Schwartz—an administrative proceeding against two investment advisors, two representatives, and a marketing consultant for violating the testimonial rule using social media and the Internet (IA Rel. No. 4964; July 10, 2018)

### How to prepare

- Pay attention to the use of testimonials and rankings in promoting your firm.
- Monitor social media activity, as SEC examiners review Facebook, LinkedIn, and other social networks before their arrival on-site.
- Examinations generally focus on advertising efforts. This commonly means looking into things like how many accounts are chosen to be in a composite, the selection criteria for those accounts, how strategies are marketed, and whether a solicitor is used.

Develop a checklist for reviewing your own advertising materials, that includes:

- Who is receiving the material?
- How will it be used and what is the intent?
- If intended for a 1:1 presentation, is it labeled as such?
- Are there adequate and appropriate disclosures on risks, indexes, performance numbers and periods, etc.?
- Are appropriate time periods included?
- Have sources been cited?
- Are performance periods consistent?
- Does the material appear genuine or unbiased?

### Examiner focus areas

1. Services to retirement accounts >
2. Issues related to aging clients >
3. Cybersecurity >
- 4. Performance advertising >**
5. Disclosure of conflicts of interest >



## 5. Disclosure of conflicts of interests

In April 2018, the SEC announced an NEP Risk Alert on Advisory Fees, revealing deficiencies observed in these areas:

- Fee billing on incorrect account valuations
- Billing fees in advance or with improper frequency
- Applying incorrect fee rates
- Omitting rebates and applying discounts incorrectly
- Disclosure issues involving advisory fees
- Misallocations of advisor expenses

### Common examiner questions

Examiners are keenly interested in how advisors are calculating their advisory fees, particularly whether advisors are disclosing revenue share and solicitor arrangements.

### How to prepare

- Evaluate advisor fee calculations, and determine whether disclosures are accurate and meaningful. Pay particular attention to how advisors are providing “breakpoints” to clients for additional assets under management.
- Review financials to identify fee-splitting and revenue-sharing arrangements, including incentive and bonus programs and payments to solicitors—all of which should be disclosed in Forms ADV.
- Review disclosures for accuracy in the description of compensation received by and paid to advisors and their personnel.
- Disclose outside business activities as appropriate in Form ADV and other client-facing documents.
- Use a conflict inventory checklist to help identify and proactively develop policies and procedures covering how to detect, mitigate, or eliminate conflicts.

### Examiner focus areas

1. Services to retirement accounts >
2. Issues related to aging clients >
3. Cybersecurity >
4. Performance advertising >
5. Disclosure of conflicts of interest >



## Ensuring compliance

Are you seeing any gaps in your compliance program? Don't wait for an upcoming SEC examination: Circulate this resource at the office. Take action to protect your firm—and your clients.

The services and/or opinions of the authors listed in this publication are not and should not be construed as a recommendation, endorsement, or sponsorship by Charles Schwab & Co., Inc. or any of its officers, directors, or employees. The authors and firms are independent and not affiliated with or employees of Schwab. You must decide the appropriateness of the content for you or your firm. Schwab does not supervise these authors and/or firms and takes no responsibility to monitor the advice or consultation they provide to you.

Schwab does not provide investment planning, legal, regulatory, tax, or compliance advice. Consult professionals in these fields to address your specific circumstances.

For informational purposes only. Third-party trademarks are the property of their respective owners and used with permission. Third-party firms and their employees are not affiliated with or an employee of Schwab.

Information included in this document is intended to be an overview and is subject to change.

©2019 Charles Schwab & Co., Inc. ("Schwab"). All rights reserved. Member SIPC. Schwab Advisor Services™ serves independent investment advisors and includes the custody, trading, and support services of Schwab. Independent investment advisors are not owned by, affiliated with, or supervised by Schwab.

AHA (0319-9S8S) MKT106593-00 (04/19)

The logo for Charles Schwab, featuring the word "charles" in a lowercase, italicized serif font above the word "SCHWAB" in a bold, uppercase sans-serif font, all contained within a blue square.

*Own your tomorrow.*