

## SEC Compliance Outreach Program – San Francisco Regional Office

### Overview

On November 6<sup>th</sup> the SEC conducted a panel on advisory compliance, valuation, and examinations. We provided a summary of the discussion below.

- **Panel 1:** “Examination Process: Best Practices for Handling SEC Exams.”
- **Panel 2:** “Valuation issues impacting Private and Registered Fund Advisers.”
- **Panel 3:** “Examination and Asset Management Unit Priorities (enforcement).”

### Panel 1: Examination Process: Best Practices for Handling SEC Exams

The SEC highlighted its risk-based process for identifying advisors for examinations. The panel discussed using its newly-formed analysis/surveillance unit to identify high risks and individuals most pertinent to a firm’s business exposure. Alongside its quantitative analytics group, the commission uses this information to publish reports on risk trends & patterns. This information may be used to determine the type or frequency of examinations.

#### Risk-Based Overview

##### What are the initial sources of information used to determine risk?

- (1) SEC filings (e.g. ADV, Edgar, 13F, 13G, etc.).
- (2) Outside sources (e.g. referrals, tips) on a firm’s practices.

##### How is a risk assessment conducted?

The agency performs a top-down/bottom up approach to identify firms/ individuals with high-risk characteristics.

##### What are some examples of risk?

- Financial stress.
- Changes in a firm’s lines (credit, transactions, etc.).
- Use of high-risk derivatives (MBS, CDS, swaps, etc.).
- Advisors w/ multiple branches.
- Performance inconsistencies.
- Repeat issues in same area.
- Disciplinary disclosures.
- Multiple conflicts of interest.
- Prior exam results.

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## Panel 1: Examination process continued

- Client complaints (tips, referrals).
- Market events/trends.
- Negative press.
- FINRA and/or State regulators.

### Does the agency have a pre-determined exam cycle?

- No defined exam cycles.
- Agency has staffing issues (about 450 examiners for over 11,000 SEC-registered firms).
- Risk-based algorithms are used to determine exam frequency.

### Exams Overview

- The commission may include staff from: (1) other divisions and (2) other regulators (e.g. State, FINRA).
- They won't tell you the type of exam they are conducting.

### What are the common types of exams? There are approximately six that include:

1. Cause exams – based on tips
2. Risk priority – based on firm's present risk
3. Risk assessment – to determine firm's that have:  
(1) Never been examined or (2) Haven't been examined in a long time.
4. Presence exams – firm's required to register with the commission.
5. Randomly-selected exams
6. Risk-targeted exams
7. Branch exams (Hybrid broker-dealer/RIA firms) – broker dealers with an RIA line of business

All exams can be conducted in person or through correspondence.

### What to expect?

- Examiner will call the firm to set a date for visit.
- They will ask for certain documents (document request letter).
- Majority of the time will be spent through interviews.
- Walk-throughs with the examiner are very helpful.
- Expect for exams to go from 1-day to 1-week (depending on firm).
- Surprise exams are not done often.

### What will examiners look for?

- Identifying risks to the firm's clients?
- Addressing risk with firm/steps to mitigate risk
- Test for problems
- Identify what they find
- Do policies/procedures exist for the firm?

### During the panel, what policies were specifically mentioned in the exam process?

- Custody – some firms may not realize that they have custody of client assets
- Portfolio management
- Advertising/performance
- Trade Blotter/Holdings List

## Panel 1: Examination process continued

- Affiliated Brokerage
- Best Execution

### How does the SEC handle ERISA requirements?

- SEC doesn't review other agencies requirements, but may refer any issues to other agencies (e.g. Dept. of Labor).

### What about exam process for Broker-Dealers w/ RIA operations (hybrid firms)?

- The commission will expect the firm to comply with the investment advisors act (1940 act).
- Firms will be expected to have a separate policies and procedures for the IA side.
- Expect for Questions to be asked about the firm's principal transactions, affiliated brokerage, and code of ethics policies.

### Describe the Exam close-out process?

- An examiner will provide comments for the exam
- Each firm with either receives a: (1) no action letter – no further action needed or a (2) examination summary letter (items to fix).

### Examination statistics:

- 75-80% examination summary (items to fix)
- 20-25% - no further action
- 10% - referral to enforcement

### Common deficiencies:

- Books/records
- Inadequate policies and procedures
- Failure to file
- Annual reviews/Risk assessments
- Personal trading/enforcement
- Best execution/commission
- Custody\*
- Advertisements
- Business Continuity
- New products/services/advertisements – consider risks

### Identifying Custody: Areas to consider:

- Employees or Related Persons – who serve as trustees or granted power of attorneys for client accounts.
- Bill Paying Services
- Online Access to Client Account
- Adviser Acts as a General Partner
- Physical Possession of Assets
- Check-writing authority
- Receipt of Checks Made to Clients

Contact me if you'd like to discuss polices/procedures that are relevant to your practice: [Cory@robersonconsults.com](mailto:Cory@robersonconsults.com)

## Panel 2: Valuation issues Private & Registered Fund

**The commission seeks to evaluate common industry practices concerning the following:**

1. Harder to value assets (e.g. Illiquid securities)
2. Liquidity issues
3. Pricing issues
4. Role of Fund board (40' Act Registered Funds) - reference Morgan Keegan & Company fund deficiencies.
5. Private funds/accounting/auditing
6. Conflict of interest – determining if advisors inflate assets to charge more fees.

**What are some common fund issues/concerns?**

**Registered Companies/40 Act Funds:**

- Are there a market quotes available?
- Role of fund board – are they made aware of fund/market conditions.
- Fair Value – is there a reasonable basis for valuation.

**Private equity/hedge funds:**

- Fair value – what prices received if assets are sold.
- Distressed sales – is this excluded from valuation.
- Valuation based on current market conditions
- ASC 820 – data subject to the most scrutiny

**Valuation Techniques:**

1. Provide ratios/multiples based on comparable securities (market approach).
2. Using averages – averages of comparable securities may not be accurate or too small of a sample to gauge valuation in entire market.
3. Convert cash flow (income approach) – is this approach consistent with company structured products (uniform valuation techniques).
4. Changing market conditions – determining fair value involved determining what people would pay for a certain security in light of reasonable factors.

**Methods for testing valuation:**

- Pricing services - how do they handle price discrepancies/price challenges?
- Market-based – testing to determine any bids for assets.

**Liquidity:**

Is the firm following the diversification rule (1940 Act Funds)

- 85% in liquid securities
  - 15% in other securities (e.g. illiquid securities)
1. How are you checking this rule?
  2. How do you determine which securities are liquid/illiquid?
  3. Can you sell the security within 7 business days?
  4. Do you understand how pricing is done?

## Panel 2: Valuation issues continued

### Do you have adequate documentation on pricing/procedures?

- Who is involved in the process?
- Potential conflicts (portfolio managers) making valuation issues.
- Fund Board (1940 act funds)
- Is the fund board overseeing the evaluation process?

### Tips for Valuation:

- Create a valuation range rather than one estimate.
- How to convert to one-point estimates.
- Further analysis may be needed for wide-range estimates.
- Conservative valuations may not benefit the clients and they could make wrong asset allocation decisions.
- Who are the sources?
- Methodology/who does it?
- How is board informed/what reports are generated?
- What checks do you have for stale prices?
- Overrides – What situations are appropriate?
- Illiquid securities
- Plan B – What happens when no quote or something does/doesn't happen?

## Panel 3: Examination and Asset Management Unit Priorities (OCIE overview)

### Risk Analytic Initiatives:

- Determining difficulties in the industry.

### Focus Exam priorities:

- Firms that have never been examined (approximately 40% of firms haven't been examined).
- Present exam initiative (approximately 15-25% of new registrants).
- Firms who weren't registered (state to SEC firms, private fund registrants).
- Advising firms to conduct an annual review.
- Conducting exams with a shorter duration.
- Conflicts of interests
- Valuation
- Undisclosed compensation
- Expenses
- Cherry Picking

### Advisors should (at a minimum):

- Sample request list
- Do an annual review

### Added risks:

- Private Placements (Reg. D - General solicitations to the public)
- Verifying accredited investors.
- Does safe harbor apply or not?
- Watch out for fraud.
- Section 206(4)-1: Advertisements are still under.
- **Regulation S-ID** (effective 11/20): Anti-identify theft “red flag” policies – Does this apply to your firm?

## Service Offerings

Tier	Complete Firm Review	Review Compliance Documents	Annual Updates filed
Tier 1-Comprehensive*	✓	✓	✓
Tier 2-On-Going*		✓	✓
Tier 3-Basic			✓

The **RIA –in-View Newsletter** is provided quarterly to all clients of Roberson Consults. The annual newsletter is distributed to prospective and current clients. If you have any questions or would like to see a particular topic featured in this newsletter **please contact [cory@robersonconsults.com](mailto:cory@robersonconsults.com)**.

## Additional Resources/State-Registered Advisors

### Other news resources include:

- National Association of Compliance Professionals - NSCP articles
- IA Watch Newsletters
- SEC No-Action Newsletter/SEC news digest

### State Registered Advisors: Does this discussion apply to my firm?

- As a measure of uniformity, all states adopt legislation that is similar to the SEC Investment Advisor Act (uniform securities act). Ultimately, some of the SEC's rules/policies are also adopted by state legislatures. As a best practice, all firms should adopt policies; conduct testing, and stay abreast of the latest SEC updates.  
**Note:** The SEC still holds jurisdiction in cases of investor complaints, trading/securities filings, and/or fraud.

Contact me if you would like to discuss any state compliance issues(s).

## Web CRD/Preliminary Statements/E-Bill Instructions

- **Preliminary Statements:** are scheduled to be released on the week of November 11<sup>th</sup>. Please refer to the web CRD/IARD system for fees due to your firm.
- **Note:** Fees will automatically be transferred to pay renewal fees if you've have sufficient funds in your web CRD flex-funding account.
- **Reminder:** Access E-Bill User privileges: [firms.finra.org](http://firms.finra.org). Go to user administration, search for name, click Edit account and then go to E-bill section to check of user boxes.

## Contact:



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