



Compliance Expectations for 2021

Schwab Advisor Services
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Today's Agenda

- SEC Exam Priorities for 2021 *(Released March 3, 2021)*
 - ❖ New Priorities
 - ❖ Compliance Program Expectations
 - ❖ Internal Controls to Develop
- Case Study: Compliance Best Practices for Remote Supervision
- The New Marketing Rule: How it May Impact the Way You Do Business
- Q&A



SEC Exam Priorities for 2021

- New Priorities
 - ❖ Environmental, Social and Governance (“ESG”) Investing
 - ❖ Regulation Best Interest and Advisory Recommendations for Account Type and Programs
 - ❖ Form CRS
 - ❖ Digital Assets
 - ❖ LIBOR
- Focus areas continue to be retail investors, including seniors, the military, teachers and those saving for retirement
- Revised emphasis on an adviser’s duty of loyalty and duty of care

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SEC Exam Priorities for 2021

- ❑ Carryover Priorities
 - ❖ Advisory Fees and Expenses
 - ❖ Best Execution
 - ❖ Complex Products
 - ❖ Undisclosed Compensation Arrangements
 - ❖ Information Security
 - ❖ Compliance Programs
 - Appropriateness of account selection
 - Portfolio management practices
 - Custody and safekeeping of client assets
 - Business continuity plans / teleworking procedures

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SEC Exam Priorities for 2021

- ❑ Compliance Program Expectations
 - ❖ Are *policies and procedures* reasonably designed, implemented and maintained?
 - ❖ Does the adviser have sufficient *resources* to perform compliance responsibilities?
 - ❖ What is the strength of the compliance and *supervisory programs* as it relates to oversight of:
 - Complex or riskier products or services?
 - Compensation arrangements and mitigation of conflicts?
 - Disclosures made to customers?
 - Custody?
 - Teleworking controls and safeguarding customer assets and PII?

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SEC Exam Priorities for 2021

- Internal Controls to Develop
 - ❖ Expect each exam in 2021 to focus in part on how the advisory firm responded to COVID-19
 - Remote work
 - Supervision of Personnel (including Multiple Branch Offices)
 - Business Continuity Planning
 - Protection of Sensitive Information
 - ❖ For Regulation BI, consider how the adviser will demonstrate how IARs evaluated costs prior to making a program or account type recommendation
 - ❖ For ESG, must consider the adviser's strategy and:
 - How it is marketed; and
 - Whether the adviser's trading and proxy voting aligns

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Case Study: Compliance Best Practices for Remote Supervision

Case Study

Exposed Asset Management is an investment advisory firm based in Colorado. During COVID-19, Exposed purchased a CA-based advisory practice named R.U.Kidding Financial. Unable to fly into California during COVID, Exposed's CCO struggles with learning R.U.Kidding's protocols and procedures to ultimately unify policies and internal controls with Exposed.

During Fall 2020, the CCO learns that R.U.Kidding had permitted its employees to use personal devices during COVID but failed to train or provide guidance on heightened controls relating to teleworking. When the CCO investigated further, she discovered through email surveillance that as recently as last week, customer records were being emailed to personal email addresses; PII from customers to

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Case Study: Compliance Best Practices for Remote Supervision

Case Study

the firm and vice-versa were not password protected nor encrypted, and in more than one case, disbursement instructions from customers seemed suspect, yet Compliance was never notified to investigate.

Q1: What steps should the CCO take to address these challenges?

Q2: What internal controls should be considered for Remote Supervision going forward?



Risk Management Tips for Remote Supervision

- Assess What Risks Exists as a Result of Employees Working Remotely
- Develop Policies and Procedures to Address:
 - ❖ Privacy safeguards and protections at home
 - ❖ Network/remote access
 - ❖ Firewall security
 - ❖ Printing of documents at home
- Establish Security Measures for Virtual Teleconferences, Books and Record Maintenance and Safeguarding Client and Company Data
- Evaluate How the Business Has Changed During COVID-19 and Communicate to What Supervisory Changes to Expect Going Forward
 - ❖ Example: Virtual annual reviews and branch office exams; reliance on compliance technologies

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Looking Ahead: The SEC's New Marketing Rule

Compliance Timetable – Now Known!

- March 5, 2021 – Published in the Federal Register
 - ❖ Effective Date of the Rule: May 4, 2021
 - ❖ Compliance Date: November 4, 2022
- An adviser may elect to comply sooner than 18-months
- If it does so, the adviser will have to comply with all requirements of the Rule, not just some



The SEC's New Marketing Rule

Quick Recap from Our Last Virtual Event

- The new IA Advertising Rule provides modernization of an antiquated rule that dates back to 1961
 - ❖ It is meant to support the change to a principles-based regulation
 - ❖ It also modifies the definition of “advertisement” to be more evergreen in light of ever-changing electronic media and mobile communications
- Amendments create a single rule and will replace the current advertising and cash solicitation rules
 - ❖ The SEC will withdraw certain no-action letters and other guidance addressing these rules, as they will no longer provide or are incorporated into the final rule (to be available on the SEC website)
- Related amendments are made to Form ADV and the books and records rule
- Anti-fraud provisions remain / new “fair and balance” standard

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The SEC's New Marketing Rule

The "New" Definition of an Advertisement

- ❑ Any direct or indirect communication an investment adviser makes to more than one person, or to one or more persons if the communication includes hypothetical performance, that offers the investment adviser's investment advisory services with regard to securities to prospective clients or investors in a private fund advised by the investment adviser or offers new investment advisory services with regard to securities to current clients or investors in a private fund advised by the investment adviser. Excluded from this definition are:
 - ❖ Extemporaneous, live, oral communications (regardless of whether they are broadcasted);
 - ❖ Information in a statutory or regulatory notice, filing or other required communication;
 - ❖ Communications that include hypothetical performance that is provided in response to an unsolicited investor request or to a private fund investor in a one-on-one communication
- ❑ It also includes any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly

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The SEC's New Marketing Rule

The Rule's Big Wows

- ☐ Use of Testimonials for the First Time – and With Any Media
 - ❖ Includes reviews and referrals within electronic media outlets
 - ❖ Will allow consumers to know how an adviser fares compared to competitors
 - ❖ *New Definition:* Any statement by a current client or private fund investor about their experience with the investment adviser or its supervised persons
- ☐ Rules for Using Testimonials – Disclosures Must Include:
 - ❖ If the testimonial was made by an advisory client or private fund investor
 - ❖ Whether the person providing it was or is being compensated
 - ❖ If the person was compensated, the forms of compensation received
 - Includes fees based on a % of AUM, flat fees, retainers, hourly fees, reduced advisory fees, fee waivers as well as cash and non-cash rewards (including referral fees, prizes and gifts and entertainment)
 - Any material terms related to the compensation and any conflicts

Advisers are forbidden from compensating any person for a testimonial if he/she is an "ineligible person" subject to a disqualifying Commission action or event



The SEC's New Marketing Rule

Third Party Ratings

- A rating or ranking of an investment adviser provided by a person who is not a related person and such person provides such ratings or rankings in the ordinary course of its business
- Third-party ratings are differentiated from testimonials and endorsements by the requirement that a third party provides such ratings in the ordinary course of its business
- Third-party ratings remain subject to the general prohibitions



The SEC's New Marketing Rule

Third Party Ratings

- ❑ An Advertisement May Only Include Third-Party Ratings If the Adviser:
 - ❖ Has a reasonable basis to believe that any questionnaire or survey used in preparation of the third-party rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses, and is not designed or prepared to produce any predetermined result; and
 - ❖ Clearly and prominently discloses (or believes the third-party rating clearly and prominently discloses):
 - The date on which the rating was given and the period of time upon which the rating was based
 - The identity of the third-party that created and tabulated the rating; and
 - If applicable, that compensation has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating



The SEC's New Marketing Rule

Form ADV / Books & Records

- Form ADV Part 1A, Item 5.L Will Ask If You Use Performance Ads, Testimonials/Endorsements, References to Specific Investment Advice and Third-Party Ratings
- Changes to Books & Records Rule 204-2: Must Maintain Ads, Disclosures, Records Tied to Oral Ads/Testimonials, Third-Party Rating Questionnaires, and a Record of an Ad's "Intended Audience"
 - ❖ Could be Electronic: "The final rule does not prescribe or prohibit any particular method of maintaining records"



The SEC's New Marketing Rule

Performance Advertising

- ❑ **Gross Performance.** May be presented only if the advertisement also presents net performance:
 - ❖ With at least equal prominence to the gross performance; and
 - ❖ Calculated over the same time period, and using the same type of return and methodology
- ❑ **1-, 5-, 10-Year Periods.** Must present performance results for 1-, 5-, and 10-year periods (or since inception, as applicable), each presented with equal prominence and as of the most recent calendar year-end
 - ❖ Not applicable to private fund performance
 - ❖ No statement that performance results have been approved or reviewed by the SEC
- ❑ **Extracted Performance (carve-outs from 1 portfolio).** Must provide or offer to provide promptly the performance of the total portfolio from which the performance was extracted



The SEC's New Marketing Rule

Performance Advertising

- ❑ **Related Performance.** Must include all related portfolios (individually or in a composite), except that related portfolios may be excluded if (1) performance results are not materially higher than if all related portfolios had been included; and (2) the exclusion of a portfolio does not alter the presentation of 1-, 5-, and 10- year periods
- ❑ **Hypothetical Performance (including model, back tested, and target/projected performance).** May be presented only if adviser:
 - ❖ Adopts policies and procedures to ensure that the performance is relevant to the likely **financial situation and investment objectives** of the intended audience;
 - ❖ Provides criteria used and assumptions made in calculating the performance; and
 - ❖ Provides sufficient information to enable intended audience to understand risks and limitations of using hypothetical performance to make investment decisions



The SEC's New Marketing Rule

Past Specific Recommendations

- Reference to specific investment advice (e.g., a past or a current recommendation) is now expressly permitted
- Presentation must be **fair and balanced**
 - ❖ Failing to provide sufficient information and context for recipients to evaluate the merits of that advice **would not be fair and balanced**
 - ❖ Current no-action letters on past specific recommendations provide comfort that that a presentation is fair and balanced, but **are not the only way to satisfy the fair and balanced standard**



The SEC's New Marketing Rule

Hypothetical Performance Information

- ❑ Policies and procedures to ensure that performance is “relevant to the likely financial situation and investment objectives”
 - ❖ Manageable for institutional managers and 3(c)(7) funds
 - ❖ Challenging for wealth managers, wrap accounts, 3(c)(1) funds
 - ❖ Less challenging for model providers
- ❑ “Criteria used,” “assumptions made,” and “sufficient information to understand risks and limitations” = time to improve disclosure!
- ❑ **Performance targets are considered Hypothetical Performance Information**
 - ❖ No exclusions from policy and disclosure requirements for sophisticated investors
 - ❖ Managers will need “hypothetical performance” policies even if they do not present model or back tested performance

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The SEC's New Marketing Rule

Changes That Will Impact All Advisers

- You May Need New and Updated Policies and Procedures for:
 - ❖ Marketing review
 - ❖ Promoters
 - ❖ Social media
 - ❖ Recordkeeping
 - ❖ Performance presentation
 - ❖ Net performance calculation
 - ❖ Related performance materiality
 - ❖ Hypothetical performance



Supplemental Materials

Articles and SEC Releases

- IAA Newsletter: Social Media in 2021 – Are Advisers Subject to the Old Rules or New Rules? And What Then?*
- 2021 Examination Priorities* from the SEC's Division of Examinations
- SEC Risk Alert: Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers (Aug. 2020)*
- SEC Risk Alert: The Division of Examinations' Continued Focus on Digital Asset Securities*
- JLG Blog: Your First Meeting on the SEC's New Investment Adviser Marketing Rule Should Address These Topics*

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Questions? Let us know how we can help!



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