



# THE DIRTY DOZEN

12 WAYS TO SURVIVE  
AN SEC EXAMINATION

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**IT** starts with a phone call. An SEC examiner's office telephones your firm to let you know that you will be subjected to a thorough review. About a week later, you get a more formal letter that asks you for documents that may include trading records, compliance manuals, client lists, investment records, employee files, financial reporting, cyber security policies and vendor contracts. Your firm will generally have a week or two to prepare and send these documents, and then the SEC examiner will come to your office. There they will set up shop in an empty conference room and begin their onsite review process that will likely include more document requests and interviews with key staff. At the end of this process you will get a letter outlining areas where compliance policies or procedures need improvement.



The good news is that only about 8% of SEC examinations uncover problems serious enough to be turned over to enforcement. The bad news is that, if handled poorly, these examinations can drag on for weeks or months, taking up time and resources that might otherwise be dedicated to growing your business. However, if you approach the examination process in the right way, it can yield useful insight into how to manage the risks of your business. In this white paper we will take a careful look at how this process works, how often advisors can expect to be examined, what kind of examinations they might be subjected to, and what they can do – and not do – to facilitate the process.

### How often are firms examined?

The SEC oversees some 12,200 advisor firms, 11,000 mutual fund companies and 4,000 broker-dealers, with about 500 new firms registering each year. The SEC has doubled spendings since 2003 to \$315 million in 2016, but still the percentage of firms examined each year has dropped from 18% in 2004 to between 12-13% in 2016.<sup>1</sup>

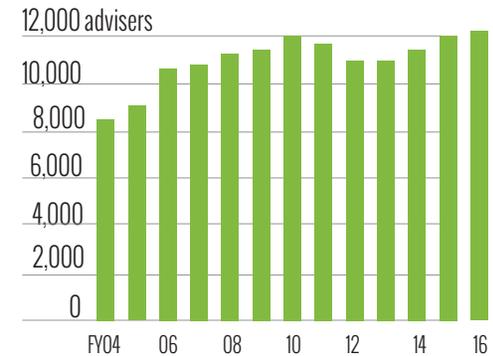
In a speech to the National Society of Compliance Professionals in October 2016, Marc Wyatt, the SEC's Director of the Office of Compliance Inspections and Examinations, explained that

just because the SEC does not show up at your office does not mean they are not watching you. Data analysis is now an important element of the examination process.

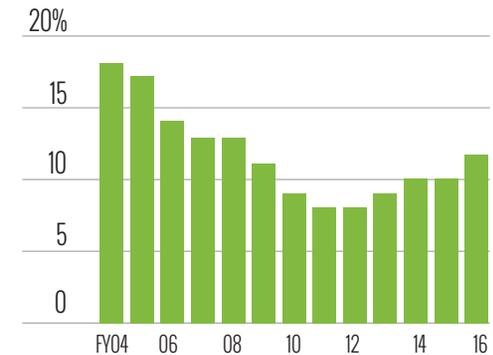
“Although every firm is not examined every year, the total population of registered entities and their activities provide inputs to the development of our risk-based strategy. OCIE’s critics have cited OCIE’s 10% coverage rate in the investment adviser industry and wrongly assume the other 90% of the firms are not reviewed at all — I can assure you that is not the case,” he says. “We analyze data from our entire registrant population, apply various screening methodologies, and arrive at the list of firms we believe expose investors to the most significant risks. It is imperative that the OCIE continually try to improve our ability to identify risks and to incorporate new information and technology into this process, and that we assimilate new insights and learn from the exams we perform.”<sup>2</sup>

“The SEC is working really hard to keep pace with the growth in new firms, but it wasn’t lost on me when they stopped quoting percentages and began quoting volume of examinations,” says Christopher Winn, the founder of AdvisorAssist, a firm that provides compliance services to independent advisor firms. “They’re staying on

### NUMBER OF SEC-REGISTERED INVESTMENT ADVISORS



### SHARE OF ADVISERS EXAMINED BY THE SEC EACH FISCAL YEAR



Note: Fiscal years ends Sept.30; the 2016 ‘examined’ figure is an estimate

Source: Securities and Exchange Commission

<sup>1</sup> “A visit from the SEC? Doesn’t happen for thousands of investment managers,” by Jean Eaglesham, Wall Street Journal, November 1, 2016.

<sup>2</sup> Making the Switch: The Benefits of a Fee-Based Model, CLS Investments, January 2016. <https://www.clsinvest.com/wp-content/uploads/2016/01/Commission-to-Fee-v2.pdf?pdf=CtoFee-PDF>

top of new firms to the extent that they can.” He also says that the agency appears to be focusing on conflicts of interest, so firms with commission-based models are audited more often than fee-based ones.

Winn adds that established firms should expect to be examined roughly every four years, while new ones should anticipate an SEC visit within the first two years they are open. However, as the numbers of firms continue to grow and resources are stretched, the SEC has become more focused on examining newer firms, and ones that are engaging in higher risk conduct. With newer firms, especially, the SEC has begun to employ quicker, less intrusive examination protocols. “In the last couple of years, the SEC has been doing brief, one-hour calls to reach out and let their presence be known for firms that are newer,” Winn notes.

Examinations can also differ in size and scope, in ways that often seem arbitrary. Says, Winn, “I have one firm that is a hybrid with about \$400 or \$500 million, and they received a 13 question document request. I’m working with another firm that has just over \$100 million and they got 30 pages of detail that they want. It will vary greatly by examiner, by region, by whatever the SEC perceives as the risk.”

The good news, though, is that firms have more time to prepare now, since the SEC changed its approach several years ago. “Historically you

would get 72 hours’ notice that they were coming, and you’d have to have everything ready and waiting,” says Winn. “I think they recognized that proved to be extremely inefficient. They show up. Nobody’s ready. Everybody’s running in circles. Clients were coming in. It just made it harder to do their job.” Now, typically the SEC will give firms one or two weeks to produce documentation before they even arrive at the firm.

An SEC examination can be stressful for any advisory firm, since it involves disclosure around sensitive issues and a significant administrative burden around providing necessary documentation. Most experts say that it is important to be as cooperative as possible to minimize the disruption. “It can be very challenging internally some times to get people to cooperate, particularly if you’re working in a smaller firm environment,” says Jack Glasheen, the chief compliance officer at Source Financial, who has spent much of his 30-year career in advisory compliance. “It’s not that people don’t want to cooperate. They just don’t have the time. In order for the audit to go smoothly and have it end painlessly, it’s very advantageous to give them what they are looking for as quickly as possible.”

### DIFFERENT TYPES OF EXAMS

There are several different types of examinations.

▣ **Routine:** This is like a doctor’s check-up. Firms are chosen more or less at random to make sure that all its compliance procedures and policies are up to date.

▣ **Higher risk:** If a firm has had past compliance problems, has hired staff with disciplinary issues, has engaged in risky business practices, or is affiliated with other firms that raise potential conflict of interest issues, it may be selected by the SEC for a higher-risk examination. Firms that have been identified as higher risk are audited more often than average, usually every three years.

▣ **For cause:** Here the SEC has reason to believe a firm has violated securities law, either because of a tip from a customer or other employee, news reports, or the SEC’s own data gathering.

▣ **Sweep:** Sweep exams are really fact-finding missions used to find out how firms are handling an emerging compliance issue. In 2015, for instance, the SEC performed a series of sweep exams focused on cybersecurity in order to develop rules and standards in this area. In 2016, the SEC took a hard look at advisor recommendations of share classes, looking at conflicts of interest when compensation was tied to investment vehicles with substantial loads or distribution fees, including 12b-1 fees.

## **SEVEN WAYS TO PREPARE BEFORE YOU GET THE EXAMINERS CALL**

**T**he better your compliance systems and procedures are before the SEC comes around, the easier it will be to answer their questions and provide the documents they need. Here are some things that any firm can start working on, even before they know they are being examined.

### **1 Start now and make progress**

“We see firms are in a state of inaction because they realize there’s so much to do and they don’t know where and when to start,” says Winn. “The simple answer: the best time to start is today. No matter what you do, no matter how much you can accomplish, just get started. You can keep moving and build momentum.” Your Chief Compliance Officer can help you identify problem areas, whether how you keep records, what you advertise to clients, or how you protect your firm’s data from cyberattack. Even if you cannot tackle all these issues at once, pick one or two and start on them.

### **2 Assess the risks specific to your practice**

Every firm is different, with a different mix of clients, products, services, and strategies. These entail different risks. For instance, one firm whose business is focused on retirement planning might want to take a hard look at how it is providing

rollover advice considering the new DOL regulations. A firm with a heavy trading focus might want to look at transaction costs and execution quality.

Winn recommends developing a brief presentation on your firm in preparation for SEC examinations. “It allows you to tell them, “Look, this is who we are, this is what we do, and this is how we do it.” While creating your presentation you will start to think of things, like, oh yeah, we should really spend a little bit more time looking at this part of the business. It’s useful in framing, positioning, and communicating about your business.”

### **3 Tighten up recordkeeping**

The SEC will likely ask for trading data and year-to-date balance sheet and income statements, preferably delivered electronically. “Many of the firms where I worked were very paper based and the systems were antiquated, so to the degree you can encourage firms to get things off paper and online, it’s very helpful,” says Glasheen.

### **4 Make sure your external footprint matches disclosure**

You can assume that even before the SEC examiners arrive at your office, they will have reviewed your ADV and compared it to your website, your marketing materials, social media



posts, and even the LinkedIn profiles of your key executives. Make sure that the language and content is consistent across all platforms.

**5 Create required documents**

Examiners will want to see documents like compliance manuals, procedures guidelines, and signed codes of ethics. Make sure that your firm has developed these documents and had the appropriate people sign off on them. If you have had them for a while review them carefully to make sure that they are still relevant and up-to-date with your business.

**6 Track and report compliance activities**

One document that is not legally required – but which is extremely useful – is an annual compliance report. “We recommend that advisors, at a minimum, make logs of all core compliance activities,” says Winn. The report does not have to be long or complicated, but it should list core compliance activities for the year, any issues the firm faced and how they were resolved, any testing the firm did on its own activities and/or those of its vendors, and what the results were and goals for the upcoming year. Says Winn, “It’s really just summarizing in a concise manner, what did the CCO do this year, how can we prove it, did he do a good job?”

**7 Find out if vendors are doing their jobs**

The new fiduciary rules make it clear that even if you delegate tasks to outside vendors,

you are still responsible for making sure that these vendors act in your clients’ best interests. It is up to you, for instance, to make sure that your clients’ custodians keep the required records, that your trading partners provide cost-efficient execution, and even that your technology platform adequately protects against cyber threats. You might want to hire a third-party evaluator to check execution quality, or ask your custodian for client records periodically to make sure they are delivering what they promised.

**Reinforce compliance roles and responsibilities with key staff**

At most firms a Chief Compliance Officer (whether in-house or outsourced) oversees most of the compliance functions. Even so, compliance only works if the whole firm is involved. To improve compliance performance make sure that everyone from the C-suite, down to operations, understands what’s expected of them. Christopher Winn says he uses times when everyone is focused on compliance, such as during the annual ADV update process, to review objectives and responsibilities.

“During the first quarter, you’ve got to go through a thorough testing and validating of the accuracy of the ADV,” he says. “It’s a great time to make sure you have the policies around your team, client interface, documentation, and other compliance issues just to make sure you have it all buttoned up.”



## **FIVE WAYS TO SMOOTH OUT THE EXAMINATION PROCESS**

**U**p to now, we have discussed the ways that you can prepare for an examination before it happens, but what about after you receive notice from the SEC? Here are some best practices for getting through an SEC examination quickly, efficiently, and with minimal damage.

### **1 Respond quickly, but not haphazardly**

The examination starts when the SEC sends over a document request, which must be fulfilled within a limited amount of time, usually about a week. The first rule is: do not dawdle.

“Giving them what they need in as usable fashion possible fast seems to go a long way towards making the experience easier,” says Glasheen. “Dragging your feet, not providing the information just doesn’t seem to help you.”

Yet, Winn cautions, “Efficient and quick are not necessarily the same thing. The very first mistake that we see a lot of folks doing is trying to get information over to the SEC as quickly as possible,” he says. It is more important to get the information right – and in the format that the SEC requests.

### **2 Keep an itemized list of all documents you send**

An SEC examination can involve dozens, even hundreds of documents, so it is important to keep track of what you have sent. Winn recommends drafting an itemized list of files with detailed notations about which document request they fill. Then, if an item gets lost or misfiled during the transfer, it is easy to prove that you sent it.

### **3 Give regulators space and privacy – away from daily operations**

Think carefully about where you want regulators to sit in your office. The privacy of a conference room makes it easier for them to conduct interviews – and it keeps them away from your firm’s daily operations. “You want to avoid casual conversations, workflows, and employee interactions being analyzed and interpreted by the regulator,” says Winn. “Let them observe from the documentation, rather than let them watch how you operate your business.”

### **4 Be disciplined about communications with regulators**

Regulators will typically want to speak with multiple people in your organization, and it is important that they all have the same message. Glasheen explains that you want to avoid the kind of “off-the-cuff” remarks that do not specifically address the SEC’s

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questions. If possible, the Chief Compliance Officer should sit in on all meetings and act as a focal point for the entire examination. “Having one person that the entire process should flow through can be very advantageous -- as long as it doesn’t become a bottleneck.”

### **5 Ask for a preliminary exit conversation**

Once the examiners finish their discovery, they will typically have a good idea of what, if any problems, they have uncovered at your firm. Winn recommends that advisors ask for an exit interview before the examiners leave to find out what their recommendations will be. That way, he says, your firm can get to work immediately on any problems, even before any deficiency letter arrives. “If you see things that need to be fixed, don’t wait for the exam letter, fix them,” says Winn. “That way, when the exam letter comes,

you can say, yes, we fully understand and appreciate the issue, and here is what we’ve done to fix it.”

These steps, both before and during the examination, can make the process considerably less painful. Don’t forget, says Glasheen, the examination process can be extremely useful in identifying and fixing problems that may expose your firm to unnecessary risk. “It can be a beneficial experience to have the regulators go through your records and highlight best practices for compliance,” says Glasheen. “It’s not necessarily a game of ‘gotcha’ let’s see what we can find in your records. It’s a way of helping your firm focus on the right way of doing business.”



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