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REGULATORY TIPS

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JUNE 2024 TIPS

Considerations for AI Washing and the Marketing Rule

RIAs are encouraged to pay close attention to the use of AI claims in their Marketing as the SEC will be scrutinizing marketing claims on the firm's use of AI that may be false or misleading, i.e. AI Washing. If you use information regarding the benefits of AI implementation in your marketing, please consider taking the following steps:

- Ensure that all claims made on the use of AI in the business, is supported by disclosures
- If promoting AI-specific tools, include information about the risks associated with it, such as in a firm's use of Predictive Analysis
- Make sure all information on the firm's use of AI in any marketing or on the annual Form ADV is true.

Transitioning to a Non-Broker Protocol Firm

Advisors transitioning from their current employer to a new firm should check to see if the current employer and new firm are both members of Broker Protocol. If they are, the transition should be relatively simple, so long as the transitioning advisor follows the guidelines and only takes certain information (i.e. the client's name, address, phone number, email and account number) and nothing else. If, however, a transitioning advisor is moving from or to a non-Broker Protocol member firm, it is crucial to carefully review your current Employment Contract before making the move. Pay attention to restrictive covenant language relating to non-solicit, confidentiality and trade secret provisions, and discuss with counsel sensitive issues, particularly if contract specifies that payment will be required for departing clients, or an outstanding loan if the transitioning advisor leaves the firm.

Purchase Agreements

One of the most important parts of a business sale is the Asset, Membership or Stock Purchase Agreement. This sales agreement – either for the company or the assets themselves - sets the terms for the transaction and must be approached carefully to avoid potential pitfalls or deal remorse. Here are items to pay close attention to when completing your purchase agreement:

- Description of the Transaction
- Lookback Provisions
- Promissory note
- Guaranty agreement
- Bill of Sale
- Tax Allocation Agreement
- Restricted Covenants
- Representations and Warranties
- Indemnifications
- Closing Conditions

Retaining experienced counsel is highly recommended for complex transactions such as these.

MAY 2024 TIPS

Compliance Training for Managers

Throughout the year, Compliance typically conducts training or sends informational bulletins to firm personnel about new policies, procedures, and regulations that govern the firm's business. But when was the last time that Compliance trained department managers? As personnel get promoted throughout the organization, oftentimes they are put in a supervisory position. The question is: do they know what to do and how to check for compliance infractions or circumventions?

Take time to sit with each manager and explain not only the "red flags" to look for but also how to document findings and reviews (even if there were no findings). In a regulatory exam, you will be asked to produce certain books and records demonstrating your reviews. Are your department managers ready?

Updating Policies and Procedures

Memorial Day is a time when many firms start to think about which policies and procedures require updating based on new regulations, Form ADV disclosure updates, or operational changes in the business. Some suggestions to consider for your 2024 policies and procedure manual updates include:

- IAR's new state requirements for continuing education
- Expanding the firm's expectations for off-channel communication and books and records requirements
- Adding provisions to Form N-PX
- Referencing compliance technologies used to enhance compliance controls
- Referencing new T+1 books and records requirements
- Evaluating current cybersecurity incident response plans and improving on incident report protocols

Once existing internal controls have been evaluated and updated, conduct training with personnel to ensure they understand any new protocols.

CE Requirements for California IARs

California, along with several other states, has become a member of the North American Securities Administrators Association (NASAA). As a result, effective May 1, 2024, investment adviser representatives (“IARs”) in California must now fulfill 12 Continuing Education (CE) units by December 31, 2024, to maintain active status. Failure to do so may result in suspension until the requirement is met.

Additionally, IARs must ensure that six of those units are completed in the Products and Practice category and six in the Ethics and Professional Responsibility category to meet their annual CE requirements. IARs in jurisdictions that have adopted the NASAA IAR CE requirement must satisfy the Products and Practice and Ethics and Professional Responsibility components to meet their CE requirement.

Preparing for the SEC Exam

Organization and preparation are key to a successful SEC exam. To begin, thoroughly review the initial document requests from the SEC staff and be sure that your responsive documents thoroughly address the SEC’s requests. Timely communication is key. Respond to SEC requests promptly and accurately. Next, assign a point of contact person and share this with the SEC. Designate someone to coordinate communication and document requests received from the Staff. Prepare your team for interviews with the examiners. Consider conducting mock interviews so that your team knows what to expect. Be prepared to address any known deficiencies. Be able to discuss corrective actions taken upon identification of any deficiencies. Importantly, stay organized! Maintain a centralized repository of compliance-related documents for easy access. When you engage with examiners, be cooperative and ask questions; if you do not understand a request, follow-up so that you can provide meaningful responses. Be sure to keep records of all communications and interactions with examiners so that you can reference as needed. Finally, remember to stay calm and maintain composure and professionalism throughout the examination process.

Strategies for Effective Business Continuity

For advisory firms, a business continuity plan is essential for preparing for the unexpected. Whether the owner has a short-term absence for an extended vacation or sabbatical, medium-term due to an unforeseen accident or illness, or long-term due to incapacity or even death, a succession plan provides a roadmap for your personnel and clients on what to do in response to the absence. To begin, identify what needs to be performed, such as financial planning and portfolio management. Next, evaluate potential candidates and consider whether they are approved on the same platform as your qualified custodian and have a similar style of management. Next, work with counsel to create the succession plan and consider the roles and responsibilities of the successor, as well as how much you would pay that individual for his/her services. Finally, analyze the plan. Share it with key personnel and evaluate what might have been missed.

APRIL 2024 TIPS

Private Fund Advisers Rule – Quarterly Statements

The SEC has ramped up enforcement actions against those managing crypto or digital currencies with the goal of preventing fraud and price manipulation, and encouraging market transparency, compliance, and disclosure. The agency has expanded the Crypto Assets and Cyber Unit to ensure firms that handle major crypto exchanges that include securities, register with the SEC and follow established regulatory rules.

- If you are unsure if you must register with the SEC, take the Howey Test
- Explore existing rules that may be applied to digital currencies
- Ensure your disclosures are accurate and up-to-date as this is a big focus on enforcement

Succession Planning for Smaller Businesses

It is crucial for smaller businesses to have a solid succession plan in place for unexpected events where a business owner or key member of the team becomes unavailable either temporarily, short-term, or in the case of a permanent absence. Important considerations include:

- Identifying a successor or professionals who can assist with portfolio management
- Identifying those responsible for client servicing
- Agreeing on successor compensation, especially for long-term or permanent absences
- Best approach to client and employee communication on changes to leadership

Identifying and Addressing Risk

For compliance officers, identifying and assessing risks is at the forefront of their minds. But where should one begin? To conduct a risk review, consider taking the following steps:

1. Inventory your compliance obligations under securities laws and pursuant to your disclosures to investors.
2. Identify areas of conflicts of interest. As you approach this, think about what your clients would want to know about and how they could be harmed. Then consider if the conflict can be mitigated or eliminated.
3. Map identified business practices and regulatory risks to your compliance internal controls and look for any gaps; then address them.
4. Assess the effectiveness of existing compliance functions and consider how they can be strengthened.

5. Identify additional compliance procedures that are warranted based on changes to products or services and consider new regulatory guidance and requirements.

Document findings and calendar when processes will be conducted.

MARCH 2024 TIPS

Now that Form ADV is Filed, What Now?

Now that the Form ADV is filed, it is time to reflect on what else might need to occur.

- If disclosures were changed, would advisory contracts require updating and clarification?
- Do policies and procedures need to be developed to address new conflicts of interest in business practices?
- Is it better to send clients the entire Form ADV or just a summary of material changes?

The answer to this depends on the type of updates that occurred. Spend time reviewing how changes to the Form ADV impact the firm and its compliance program. Be sure to maintain copies of the changes that were made and be sure to keep a log of how and who you are sending your amended Form ADV to.

Private Fund Advisers Rule – Quarterly Statements

Last year, regulations for Private Fund Advisers underwent significant changes that will affect both SEC-registered advisers and private fund managers. One of those changes is that advisers must provide quarterly statements to investors on fees, expenses, fund performance and compensation. To remain compliant with this new rule, private fund advisers should:

- Implement a strong protocol that accounts for deadlines, accuracy, and details related to the transparency and impact of fees to the investor's account. It is crucial to establish supervisory controls surrounding this process.
- Maintain awareness of SEC guidance on private fund best practices and regulatory requirements, including disclosures to investors.

Best Practices for Off-Channel Communications

The SEC continues to focus on off-channel communications with emphasis on recordkeeping. Although IAs face many challenges in maintaining records especially for communication via personal devices, it is crucial to implement and adopt company-wide policies and procedures and mandate ongoing employee training. The SEC has assessed steep fines for firms that fail to capture business communications, which most frequently are transmitted via text or applications such as WhatsApp on personal devices. Taking proactive steps to discuss with clients the best method to communicate with the advisor pursuant to your firm's policies will help to avoid regulatory consequences.

Regulatory Compliance for New Hybrid Investment Advisers

Investment Advisers transitioning to their own investment advisory firm must be ready to oversee the adviser's compliance program. Here are a few things to prioritize and consider.

- Timely completion of all annual regulatory filings. To stay on track, develop an annual compliance calendar.
- When you update your Form ADV, be sure to also update your advisory agreement and other disclosure documents as appropriate.
- Remember that you are responsible for your own compliance books and records, regardless of your broker-dealer affiliation. Make sure your compliance program addresses advisory recordkeeping requirements and takes into consideration how you are maintaining and surveying off-channel and electronic communications.
- legal counsel to address questions relating to compliance program challenges you may face.

FEBRUARY 2024 TIPS

Advisory Agreements

Remember that any changes to your client agreements must be reflected in your Form ADV filings and vice versa. Your client agreement reflects your servicing arrangement with a particular client, while the Form ADV brochure showcases your firm's disclosures about your services. With this in mind, take the following steps when reviewing your servicing terms and disclosures:

- Consider changes to your business and its operations which necessitate amendments to existing disclosures
- Assess whether new legal requirements or regulatory guidance impact existing terms and conditions
- Review your fee structure and ensure it lines up with fee disclosures in your advisory contracts and Form ADV
- Always consider your conflicts of interest and provide meaningful disclosures for clients to have informed consent

Conflicts of Interest

Addressing conflicts of interest proactively and transparently is key to client trust. Conflicts of interest are always present and can be addressed with a strong compliance program:

- Start by identifying conflicts. Consider doing a conflict inventory.
- Determine if the conflict can be mitigated or, when possible, eliminated.
- Have processes in place to mitigate or eliminate conflicts of interest.

Supervisory controls, disclosures to clients, strong policies and procedures, and training often help to mitigate conflicts.

It is important to adopt a formal protocol on how your firm identifies, evaluates, and mitigates conflicts of interest. Not only is this a regulatory requirement under Rule 206(4)-7, but it is an important part of your fiduciary duty to clients.

SEC EXAMS and Cybersecurity

Cybersecurity remains one of the hottest SEC examination areas. As a fiduciary, it is critical for advisers to review their cybersecurity framework often to protect investors.

The NIST recommends key steps to take when handling cyber security incidents:

- Prevention: Use strong passwords, multi-factor authentication and encrypted internet connections.
- Detection: Investigate to identify the root cause and document findings.
- Containment and Recovery: Contain the incident and identify vulnerabilities to prevent further attack.
- Post-incident: Complete the incident report, retest systems, and address existing vulnerabilities.
- Cyber training: Mandate employee cyber training to educate end-users on preventing future attacks.

Taking time to train is key. Most often, the end user is the weakest link.

Pre-dispute Arbitration Agreements

When drafting pre-dispute arbitration agreements, it is important to note that FINRA examiners will red-flag agreements containing language that may infringe on your clients' rights to take legal action against the firm. Such language violates Regulatory Notice 21-16 and may alert FINRA to scrutinize your firm's compliance program. This includes language that:

- contains indemnification or hold harmless provisions
- prevents or limits awards by the arbitrator
- limits class-action claims
- sets a self-imposed time limit for customer claims

Work with counsel to ensure that your language aligns with these expectations.

JANUARY 2024 TIPS

Compliance and Artificial Intelligence

Artificial Intelligence (“AI”) is a powerful tool increasingly being used by financial institutions. AI allows software programs and computer systems to perform tasks such as investment decisions, company analysis and even trading, which historically was performed by human beings.

During recent regulatory examinations, the SEC is looking at whether firms have considered how AI is being used within the organization – in marketing and promoting the adviser, with trading and portfolio models, and even with supervision activities. Consequently, it is critically important for you to evaluate your supervisory controls and procedures when using AI.

Consider whether your compliance policies and procedures address the supervision of AI systems used by the firm, including how AI outputs are managed. Assess what data security measures are employed when using AI and what conflicts of interest may exist related to AI outputs.

Evaluate how you are validating processes and algorithms and ensure that adequate resources are used to train personnel on how to manage and supervise AI. In this fast-growing area, consider if an AI Committee should be established to explore these and other AI-related issues to help stay ahead of the curve to address these regulatory and business risks.

Trusted Contact information

As the US population continues to age, so too do we see an increase in senior client issues. Of late, we have seen an increase in the number of unexpected life events with advisory clients – be it dementia, financial exploitation, or death. When the unexpected occurs, advisers are often the only ones that can take steps to help ensure that their client’s finances are taken care of in response to that event. That is why it is so important to gather Trusted Contact information. This allows the advisor to reach out to the client’s trusted family member, friend, or fiduciary to gather important information needed to assist the client in their life situation. When you meet with your clients this year, be sure that their Trusted Contact information is up to date and explain the importance of having this information on file.

The Importance of Succession Planning

VUCA, or Volatility, Uncertainty, Complexity, and Ambiguity is a term known by many successful executives. As a business owner, you must plan for the unexpected. But have you done so in terms of succession planning? Updating your succession plan and creating an exit strategy provides peace of mind to you, family members, company personnel and your clients. Make your succession plan a priority in early 2024 to prepare for the future.

When Was the Last Time Your Advisory Contracts Were Updated?

As you review your advisory client agreements, consider adding provisions for electronic signatures and if desired, have any amendments to contracts be made through negative consent. Be sure that any changes to disclosures in your advisory contract are also made in your Forms ADV.