

THIS MONTH'S RESOURCE: Calculating your Regulatory Assets Under Management Looking Ahead for 2021

CALCULATING YOUR REGULATORY ASSETS UNDER MANAGEMENT

Not correctly calculating regulatory assets under management (AUM) is one of the most common compliance deficiencies. The SEC staff defines AUM for the purposes of Item 5.F on the Form ADV Part 1 as *securities portfolios for which you provide continuous and regular supervisory or management services*. The SEC staff further expands on what constitutes a *securities portfolio* as well as *regular supervisory or management services*.

**State registered Advisors - please note that the states have adopted this definition as well.

The SEC's definition of ***securities portfolios***:

- Cash and cash equivalents are considered securities.
- At least 50% of the account's total value must consist of securities for the account to be considered a securities portfolio.
- Family accounts, accounts for which you receive no compensation, accounts for non-US persons, and all assets within in a private fund, including any uncalled mandatory commitments, must all be counted as securities.

The SEC's definition of ***continuous and regular supervisory or management services***:

- Firm *has discretion over an account*, and your advisory firm provides ongoing supervisory or management services with respect to the account, (or)
- Firm *does not have discretion over an account*, but you have an ongoing duty to select or make recommendations based upon the needs of your client, and if the client accepts your investment recommendation, you are responsible for arranging or effecting the purchase or sale.

Even if the firm does not have discretion of the account and the firm is not directly executing the recommended transactions, the firm may be in a situation in which the client's portfolio should NOT be considered regulatory AUM for the purposes of the Form ADV.

A challenge today is that the offering of comprehensive financial planning services – where advisors provide holistic financial planning advice on *all* of a client's net worth. This does *not* mean the advisor can claim all of those assets as regulatory AUM. In fact, most of the time, the advisor should *not* include outside 401(k) plans and other non-managed assets that were advised upon as part of the financial plan, nor the value of brokerage accounts holding mutual funds and various types of annuities (unless the advisor *truly* provides ongoing management services), nor Third Party Managed accounts or separately managed account assets (unless the advisor retains the *discretionary* right to hire/fire the Third Party Manager and reallocate to another one). In fact, even having discretion over an account doesn't automatically ensure it is counted as regulatory AUM, particularly if it's a passive buy-and-hold account unless the advisor can actually substantiate that monitoring and due diligence is occurring outside of any periodic client review meetings!

For advisors who want to report *some* number representing the total scope of their *advice* – including the amount of assets that don't count as regulatory AUM – it is permissible to report on Assets Under Advisement (AUA) in the advisor's marketing and in Part 2 of Form ADV, as long as the advisor can document and substantiate the calculation process. But the fact that it's permissible to report both AUM and also a (typically large) AUA amount doesn't change the fact that, when reporting regulatory AUM itself, it's crucial to report the right number on the Part 1 filing!

The SEC further provides a few factors to help you evaluate if your firm is providing *continuous and regular supervisory or management services* to an account:

- Does your advisory contact with the client suggest you provide ongoing management services of the account?
- Does your actual management practice also reflect ongoing management services?
- Are you compensated based on the average value of the client's assets you manage?

In other words, even meeting with clients “regularly” on a quarterly basis is not *continuous and regular* asset management; the advisor must also substantiate that due diligence monitoring and other management services are occurring between the quarterly (or less frequent) meetings as well!

The SEC suggests that if you receive compensation like either of the following scenarios, it's likely that your firm **DOES NOT** provide *continuous and regular supervisory or management services to an account*:

- You are compensated based on the time spent with a client (or)
- You are paid a retained based on a percentage of assets covered under a financial plan.

In addition, the SEC indicates when calculating the *value of the portfolio* by providing the following guidance:

- Only include the value of each securities portfolio for which you *provide continuous and regular supervisory or management services*.
- Exclude assets that are *managed by another person or firm*.
- *Real estate or business operations* that you manage on behalf of a client rather than as an investment.
- Do not deduct any outstanding indebtedness, etc. on the securities portfolio.

And lastly, the SEC attempts to outline further a few common scenarios in which an RIA firm would likely NOT be considered to have regulatory assets under management from an RIA compliance standpoint. Those scenarios include:

- Only provide market timing recommendations to a client but do not have any ongoing management responsibilities.
- Only provide market newsletters or commentary.
- Help a client with an initial asset allocation but do not continuously and regulatory monitor the account.
- Only provide advice on a periodic or intermittent basis such as only when a client calls, when there is a market event, or only on a specific date each quarter, etc.

THIRD-PARTY MONEY MANAGEMENT

Regulatory AUM also becomes a tricky topic if you are an investment adviser who utilizes third-party asset or investment managers (e.g. turn-key asset management providers (TAMPs), sub-advisers, etc.). The SEC states that in such *manager of manager* situations, an RIA firm may be able to count such assets as AUM for regulatory purposes if the firm has discretionary authority to hire and fire managers and reallocate assets among them.

ILLIQUID ASSETS

While the SEC does provide substantial latitude to the advisor in determining what is a “reasonable” estimate of value – which is straightforward for market-traded securities, but can be more challenging for infrequently traded or illiquid assets. However, the SEC does expect that the advisor is consistent in using the same values for AUM calculation purposes that are used to report values to clients (e.g., in quarterly or annual portfolio statements) and when calculating the advisor’s own fees. There needs to be documentation and client disclosure for assets that are not valued on a regular basis by the vendor or Custodian. Key Takeaway on Illiquid Asset Reporting - Retain your documentation.....Don’t get caught on an exam without it!

LOOKING AHEAD TO 2021...

We are anxiously awaiting the 2021 SEC priorities. Not a surprise to see a delay in this annual report published by the SEC due to the shift in the presidential administration as well as leadership at the Securities and Exchange Commission. Let us look ahead on what may be anticipated for areas of focus in 2021:

CONTINUED EDUCATION AND GUIDANCE FROM SEC

The SEC issued a record 10 Risk Alerts in 2020 offering firms exam observations or guidance relating to Form CRS, Cybersecurity, Branch offices, supervision. Another year of increased education for firms is expected with areas such as supervision for remote officing, COVID-related disclosures, and cybersecurity.

INCREASE IN EXAMS AND ENFORCEMENT ACTIONS

It was a rather unusual year and who would have thought that the SEC would be out in full force conducting exams more than usual...Virtually! It is anticipated - and especially after 'efficiencies' were developed for conducting exams remotely – an increase for regulatory reach out in 2021. This appears eminent, especially under the Biden Administration. In 2020, the SEC saw an increase in fraudulent schemes targeting everyday investors, as highlighted in SEC Risk Alerts and public comments last year. Enforcement of these schemes will flow into 2021. Finally, during the last four years there was a move away from investigations of larger Wall Street and publicly traded corporations. Under the new Biden Administration, it is anticipated that there will be a shift back to focusing on more investigations and enforcement cases that involve insider trading, larger regulated entities such as broker and asset managers, and increased fines for publicly traded companies.

CONTINUED COVID 19- IMPLICATIONS

According to the 2020 SEC's Annual report published in November 2020, the Division's Office of Market Intelligence obtained approximately 16,000 tips, complaints, and referrals—roughly 71 percent increase over the same time in 2019. Further, the SEC opened more than 150 COVID-related inquiries and investigations and announced several COVID-related fraud enforcement actions. It is anticipated there will be a continued focus on investigating firms promoting fraudulent or misleading claims related to COVID. As published in last year's Risk Alert, the SEC commended on the crackdown of such fraudulent schemes, the accuracy and adequacy of information related to COVID-19 issuers advertised into the marketplace, including claims about potential COVID-19 treatments, the manufacture and sale of personal protection equipment, and disaster-response capabilities. It would only make sense that the SEC will be busy with several enforcement actions relating to COVID-19 in 2021.

IMPLEMENTATION OF REG BI

Last year's Reg BI Rule intended to enhance the quality and transparency of the retail investor relationships with investment adviser and broker dealers. Late in 2020, the SEC did publicly announce there would be a focus on 2021 exams relating to the implementation of Reg BI. Considerations of Reg BI that may be the subject of focus during an examination include: continued evaluation of firm policies and procedures, changed in firm product offerings, including the removal of higher cost products when lower cost products are available (*HINT: Mutual Fund share class!*), evaluation of how firms have considered costs in making a recommendation (*HINT: documenting rationale on Rollovers!*), use of complex products with clients (*HINT: Alternative Asset Due Diligence and Risk Disclosure*).

BITCOIN

For 2021, SEC may be forced to provide some guidance around Bitcoin as popularity is increasing and regulators are forced to address this type of 'investment' with firms. Their response is across the map but it can be anything from a large crackdown with clear restrictions of such investment or the opposite with a move to approve cryptocurrency ETF and mutual funds. Time will tell but it is anticipated there will be buzz in this area.

WHISTEBLOWERS

2020 was a standout year for the SEC's Whistleblower Program. The SEC issued a record \$175 million in awards to 39 individuals, accounting for roughly 37 percent of the total number of awards over the life of the program. The SEC hopes this will incentivize those who have inside information to come forward and make reports to the SEC.

ATTENTION CCO- WHAT ARE YOUR NEW YEAR'S RESOLUTIONS FOR 2021?

Here are some ideas and focus areas to consider:

- Increased IAR Education throughout the year to make compliance more creative and fun
- Enhancing the security for mobile devices or laptops, what happens when these are mis-placed or stolen?
- Creating more detail procedures for Remote officing
- Conducting your onsite Branch office reviews
- Reviewing the Compliance Manual to ensure it accurately reflects firm's policies
- Audit of all Vendor Agreements and conducting the due diligence on these vendors
- Performing a mock exam – Are you ready for the SEC?
- Refreshing the Firm's business continuity plan with lessons learned
- Increasing your knowledge base for Advisers Act or SEC related material with designation, training
- Improving controls for Zoom, use of electronic signatures, electronic storage of documents
- Testing of Policies and procedures and documenting internally

Pick a few goals for 2021 and let us help accomplish them!

CRP is here to assist and enhance your Firm's Compliance Program in 2021 with great resources and tools.