CCO TASK SUPPORT

Please be sure to check your SmartRIA CCO portal to keep up with your monthly Compliance tasks.
Please contact the following for:

- **Task Related Questions:** Nancy Harry: nharry@thecomplianceresource.com
  Stacie Craddock: scraddock@thecomplianceresource.com
  Sara Sparks: ssparks@thecomplianceresource.com

- **Login and Portal Requests:** Sara Sparks: ssparks@thecomplianceresource.com

CCO TOOLS INCLUDED THIS MONTH:

- **Annual IAR Attestation Templates** - Please tailor to your firm and its practice. Ensure all IARs have completed and return. (Gifts, Personal Securities Transactions, Social Media Profiles, Charitable Contributions, Written Supervisory Procedures, Code of Ethics, Outside Business Activities, etc.)

- **ADV Annual Amendment Checklist** - During the month of January, our team will be reaching out to firms to schedule a time to review and update your firm's ADV Part 1A, 2A and Form CRS. ADV Annual Amendments are due March 31st.

- **CCO Checklist** – Complete the attached CCO Checklist for the month of January 2022.

CRP POLICY & MANUAL UPDATES TO FIRMS

CCO ACTION: Update/Add Definition in Compliance Manual – This month's update is found under "Definitions" section of the Firm's Compliance Manual.

CURRENT LANGUAGE IN MANUAL:

HIGH NET WORTH INDIVIDUAL
A natural person with $750,000 in investable assets or $1.5 million in net worth.

NEW LANGUAGE FOR JANUARY 2022:

HIGH NET WORTH INDIVIDUAL (*NOTE: UPDATE DOLLAR AMOUNTS ONLY*)
A natural person with $1,000,000 in investable assets or $2.0 million in net worth.

QUALIFIED CLIENT or QUALIFIED PURCHASER - ***(****ADD UNDER DEFINITIONS****)***
An individual who is a qualified client or who is a "qualified purchaser" as defined in section 2(a)(51)(a) of the investment company act of 1940.

The term qualified client means:

1. A natural person who, or a company that, immediately after entering into the contract has at least $1,000,000 under the management of the investment adviser;
2. A natural person who, or a company that, the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either:
    a. Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $2,000,000. For purposes of calculating a natural person's net worth:
        i. The person's primary residence must not be included as an asset;
        ii. Indebtedness secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time the investment advisory contract is entered into may not be included as a liability (except that if the amount of such indebtedness outstanding at the time of calculation exceeds the amount outstanding 60 days before such time, other than as a result of the acquisition of the primary residence, the amount of such excess must be included as a liability); and
        iii. Indebtedness that is secured by the person's primary residence in excess of the estimated fair market value of the residence must be included as a liability; or
3. Is a qualified purchaser as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(51)(A)) at the time the contract is entered into; or
4. A natural person who immediately prior to entering into the contract is:
    a. An executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or
    b. An employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

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!

SEC FINES $125 MILLION FOR FAILING TO SUPERVISE ITS EMPLOYEES' USE OF WHATSAPP, TEXT MESSAGES AND PERSONAL EMAIL TO CONDUCT FIRM BUSINESS

Last month, the SEC fined JP Morgan Securities, a SEC-registered broker-dealer, $125 million for violating SEC recordkeeping rules and failing to supervise its employees to prevent such violations. The SEC found JPMS employees often communicated about securities business matters on their personal devices, using text messages, WhatsApp, and personal email accounts which were neither supervised by JPMS nor captured in JPMS’ books and records. Firms can be assured additional investigations of a firm’s record preservation practices will occur in 2022.

CCO TIPS

- ☐ **REVIEW and tailor compliance manual on approved devices and means of communications may be used to conduct the firm's securities business.**
- ☐ **TRAIN your IARs regarding your firm's policy**
- ☐ **OBTAIN ATTESTATIONS or certifications from IAR documenting their knowledge of, and compliance with, the Firm's policy**
- ☐ **RECORD personal devices used at the Firm (Use CRP TECHNOLOGY DEVICE INVENTORY & POLICY REVIEW Form)**
- ☐ **SUPERVISE and review for use of non-approved communications media in compliance reviews of communications**