NASAA 2013 Coordinated Investment Adviser Examinations

Investment Adviser Operations Project Group
NASAA Investment Adviser Section
October, 2013
NASAA’s Coordinated Exams Program is a biennial initiative conducted to identify common investment adviser deficiencies.

- The data draws from a sample of state-level investment-adviser examinations, reported by states.

- States report examinations on a voluntary basis.

- The number and types of exams reported by each state varies year-to-year and is at the discretion of each state.

- The goal of NASAA’s Coordinated Exam Initiative is to draw from sample data to identify common regulatory deficiencies and develop best practices to avoid regulatory violations
Increasing Exams – Increasing Deficiencies

- 2011: Exams: 825, Deficiencies: 3543
- 2013: Exams: 1130, Deficiencies: 6482

Legend:
- Blue: Exams
- Red: Deficiencies
2013 Reported Examinations

1,130 advisers between Jan. 1, 2013 and June 30, 2013*

- 183 advisers (16.2%) were affiliated with a BD
- 126 advisers (11.2%) used or acted as solicitors
- 74 advisers (6.5%) managed pooled investments
- 712 advisers (63%) had one IAR only
- 65 advisers (5.8%) had only financial planning clients
- 411 advisers (36.8%) had AUM >$30MM

* In some instances, exams conducted in late Summer and Fall of 2012 were counted if the state had performed the majority of their exams prior to January 1, 2013.
Who Conducted the Exams?

Securities examiners from 44 jurisdictions including Alberta, British Columbia, Ontario and Quebec, Canada

What Was Found?

6,482 deficiencies in 20 categories
The Categories

• Books and Records
• Financials
• Registration
  – ADV, U4, Firm, IARs, ADV Delivery
• Fees
• Contracts
• Advertising
  – Ads, Websites, Business Cards, Seminars,
• Privacy
• Supervisory/Compliance
  – Supervisory Procedures, Compliance Procedures

• Investment Activities
  – Adherence to Investment Policy, Fairness, Conflicts
• Performance Advertising
• Performance Reporting
• Custody
• Acting as Solicitor
• Paying Solicitors
• Pooled Investment Vehicles (Hedge Fund)
• Custodial Arrangements
• Unethical Practices
• Brochure Delivery
• Financial Planning
• IA/BD Crossover
Percentage of Exams With Category Deficiencies

All Advisers with AUM > 0

% of Exams noting at least one deficiency in the category
Deficiencies Comparing AUM

< $30MM vs. > $30MM

% of Exams noting at least one deficiency in the category

- Books & Records
  - <30MM: 70.4%
  - >30MM: 65.3%
- Registration
  - <30MM: 62.8%
  - >30MM: 62.8%
- Contracts
  - <30MM: 53.0%
  - >30MM: 46.0%
- Privacy
  - <30MM: 41.2%
  - >30MM: 41.2%
- Brochure Delivery
  - <30MM: 21.8%
  - >30MM: 22.8%
- Fees
  - <30MM: 19.6%
  - >30MM: 19.6%
- Advertising
  - <30MM: 16.3%
  - >30MM: 16.3%
- Supervision
  - <30MM: 16.4%
  - >30MM: 16.4%
- Custody
  - <30MM: 15.1%
  - >30MM: 15.1%
- Financials
  - <30MM: 15.1%
  - >30MM: 15.1%
- Investment Activities
  - <30MM: 10.6%
  - >30MM: 6.6%
- Unethical Practices
  - <30MM: 7.8%
  - >30MM: 6.6%
Deficiencies of 1st Time Examinees

% of Exams noting at least one deficiency in the category

- Books & Records
- Registration
- Contracts
- Privacy
- Brochure Delivery
- Fees
- Advertising
- Supervision
- Custody
- Financials
- Investment Activities
- Unethical Practices

AUM > 0
<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Suitability Documentation</td>
<td>10.8%</td>
</tr>
<tr>
<td>Missing Client Contracts</td>
<td>8.5%</td>
</tr>
<tr>
<td>Trial Balance/Fin'l Statements</td>
<td>7.1%</td>
</tr>
<tr>
<td>WSP-Business Continuity Plan</td>
<td>4.9%</td>
</tr>
<tr>
<td>Disclosure Brochure</td>
<td>4.6%</td>
</tr>
<tr>
<td>Changes to Disclosure Brochure</td>
<td>3.2%</td>
</tr>
<tr>
<td>General/Aux Ledgers</td>
<td>3.2%</td>
</tr>
<tr>
<td>Order Memorandum</td>
<td>3.1%</td>
</tr>
<tr>
<td>Advertising File</td>
<td>3.0%</td>
</tr>
<tr>
<td>No WSP/Compliance Manual</td>
<td>2.9%</td>
</tr>
</tbody>
</table>

68.2% of all advisers with AUM > 0
Registrations Deficiencies (1,211)

- **Form ADV - Part 1 vs. Part 2**: 13.5%
- **Form ADV - Fee structure**: 9.5%
- **Form ADV - Services provided**: 9.3%
- **Form ADV - Business description**: 7.5%
- **Timely filing of amendments**: 6.9%
- **Form ADV - Conflicts of interest**: 4.8%
- **Form ADV - Personnel**: 4.8%
- **Form ADV - Affiliations**: 4.0%
- **Form ADV - Overstated AUM**: 3.6%
- **Form ADV - Discretion**: 2.9%

58.5% of all advisers with AUM > 0
Contracts Deficiencies (791)

- Not properly executed: 10.9%
- Fee: 10.5%
- Fee formula: 10.4%
- Hedge clauses: 9.0%
- In writing: 6.4%
- 48 hour rescission clause: 5.4%
- Not updated: 5.3%
- Discretionary authority: 5.1%
- Services: 4.6%
- Capital gains compensation: 4.3%
- Refund of pre-paid fees: 4.3%

44.0% of all advisers with AUM > 0
Privacy Policy Deficiencies (181)

- Annual delivery: 48.6%
- Initial delivery: 19.9%
- No privacy policy: 13.8%
- No/Inadequate policy: 10.5%
- Disclosed confidential client information (UBP): 1.7%

19.6% of all advisers with AUM > 0
Brochure Delivery Deficiencies (227)

- Annual offering/delivery: 49.3%
- Update/Material change delivery: 20.7%
- Initial delivery: 13.7%

18.3% of all advisers with AUM > 0
Advertising Deficiencies (266)

- Insufficient website disclaimer: 19.2%
- Misuse of “RIA” or "IAR": 18.4%
- Qualifications, services, or fees (UBP): 13.2%
- Other misleading statements or omissions (UBP): 10.2%
- Misleading use of other professional designation: 6.0%
- Testimonials (UBP): 6.0%
- Exaggerated claims (UBP): 5.6%
- Performance advertising (UBP): 5.3%
- Misleading charts, graphs, formulas or other devices (UBP): 3.8%
- Misleading past profitable recommendations (UBP): 1.9%
- Guarantees of specific results or against loss (UBP): 0.8%
- Misuse of third party reports (UBP): 0.4%

18.1% of all advisers with AUM > 0

Where Found
- Website 27.4%
- Business Cards/Letterhead 12.8%
- Social Media 4.9%
- Flyers/Pamphlets 4.9%
- Newsletters 3.8%
Fees Deficiencies (201)

- Doesn't match contract or ADV: 49.8%
- Miscalculated fees (overcharging): 11.9%
- Unreasonable/Excessive fee (UBP): 8.0%
- Charging undisclosed fees: 3.5%
- Preferential fees: 1.5%

18.1% of all advisers with AUM > 0
Supervision Deficiencies (189)

- Failure to periodically assess and update: 29.6%
- Failure to follow procedures: 29.1%
- No procedures to prevent misuse of material nonpublic information? (UBP): 8.5%
- Failure to avoid or mitigate conflicts of interest: 3.7%

16.7% of all advisers with AUM > 0

Other:
- Personal trading supervision
- Remote location supervision
Custody Deficiencies (210)

- Direct Fee Deduction: Proper client invoice: 33.3%
- Direct Fee Deduction: Dual invoicing client and custodian: 10.5%
- Direct Fee Deduction: Written client authorization: 8.1%
- Other ability to obtain customer funds or securities: 5.7%
- Direct Fee Deduction: Notice to Administrator on ADV: 5.2%
- Trustee: Notice to administrator: 2.4%
- Safekeeping: Notice to administrator on ADV: 2.4%

16.6% of all advisers with AUM > 0
Financials Deficiencies (170)

- Inadequate net worth (for discretion): 15.9%
- Poor financial condition: 11.8%
- Commingling IA records with outside business or personal accounts: 7.6%
- Inadequate net worth (for custody): 7.1%
- Inadequate net worth (normal): 6.5%
- Insufficient bond: 4.7%
- Evidence of borrowing from customers (UBP): 3.5%
- Evidence of income or expenses for investments or offerings not recorded on regular IA books/records: 2.9%
- Evidence of income or expenses for undisclosed outside business activities: 2.4%
- Evidence of lending to customers (UBP): 1.2%
- Evidence of customer funds diversion: 0.6%

13% of all advisers with AUM > 0
Investment Activities Deficiencies (81)

- Disclosure of soft dollars: 19.8%
- Inconsistent activity with client’s investment policy or contract: 18.5%
- Unsuitable recommendations (UBP): 13.6%
- Inconsistent activity with adviser’s stated philosophy or brochure: 9.9%
- Unauthorized discretion (UBP): 6.2%
- Use of soft dollars: 3.7%
- Trading on unauthorized third-party instructions (UBP): 1.2%

7.1% of all advisers with AUM > 0
Comparing Advisers of Non-Pooled Investments to Pooled Investments

% of Exams noting at least one deficiency in the category

AUM > 0

---

<table>
<thead>
<tr>
<th>Category</th>
<th>No PIV</th>
<th>PIV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Books &amp; Records</td>
<td>55.6%</td>
<td>55.6%</td>
</tr>
<tr>
<td>Registration</td>
<td>47.3%</td>
<td>47.3%</td>
</tr>
<tr>
<td>Contracts</td>
<td>23.9%</td>
<td>29.0%</td>
</tr>
<tr>
<td>Privacy</td>
<td>18.3%</td>
<td>19.7%</td>
</tr>
<tr>
<td>Advertising</td>
<td>11.6%</td>
<td>15.5%</td>
</tr>
<tr>
<td>Fees</td>
<td>17.1%</td>
<td>21.2%</td>
</tr>
<tr>
<td>Brochure Delivery</td>
<td>21.2%</td>
<td>29.0%</td>
</tr>
<tr>
<td>Custody</td>
<td>19.7%</td>
<td>13.4%</td>
</tr>
<tr>
<td>Supervision</td>
<td>29.0%</td>
<td>13.4%</td>
</tr>
<tr>
<td>Financials</td>
<td>15.5%</td>
<td>13.4%</td>
</tr>
<tr>
<td>Investment Activities</td>
<td>13.4%</td>
<td>8.2%</td>
</tr>
<tr>
<td>Custody Arrangements</td>
<td>8.2%</td>
<td>8.2%</td>
</tr>
</tbody>
</table>
Pooled Investments Deficiencies

- Custody as general partner of the fund: 20.6%
- Independent CPA performs annual audit (if required): 8.8%
- Violation of offering exemption: 8.8%
- Suitability questionnaires for each investor: 8.8%
- Offering document doesn’t contain adequate advisers disclosure information: 5.9%
- Adviser’s brochure not provided to investors (if required): 5.9%
- Performance fees not consistent with subscription agreement, offering document, and/or ADV: 2.9%
- Performance fees charged to non-qualified investors: 2.9%
- Unrealistic valuation of unpriced securities: 2.9%
- Fund financials inaccurate or misleading: 2.9%
- Sales compensation paid to unlicensed individuals or entities: 2.9%
- Publicly advertised or general solicitations made: 2.9%
- Investor(s) not meeting minimum qualifications in subscription agreement and offering document: 2.9%

26.0% of all PIV advisers with AUM > 0
Solicitor Deficiencies

- Solicitor agreement: No written agreement with third party adviser: 17.9%
- Solicitor agreement: Description of solicitors activities: 14.3%
- Solicitor agreement: Compensation arrangement: 10.7%
- Solicitor not providing the third party adviser’s ADV Part 2/disclosure brochure to prospects: 7.1%
- Solicitor agreement: Provision requiring solicitor to deliver third party adviser’s disclosure brochure: 7.1%
- Solicitor violating any other terms of its agreement with the third party adviser: 3.6%
- Solicitor not providing its solicitor disclosure document to prospects: 3.6%
- Solicitor disclosure document: Solicitor’s relationship to the third party adviser: 3.6%
- Solicitor disclosure document: Name of the third party adviser: 3.6%
- Solicitor disclosure document: No written document: 3.6%

24.1% of all advisers who acted as solicitor
Paying Solicitors Deficiencies

25.0% of all advisers who paid solicitors for referrals

- Solicitor agreement: No written agreement with each solicitor 17.4%
- Solicitor not providing the adviser’s ADV Part 2/disclosure brochure to prospects 8.7%
- Solicitor not providing its solicitor disclosure document to prospects 8.7%
- Solicitor disclosure document: Terms and description of solicitor’s compensation 8.7%
- Solicitor disclosure document: No written document 8.7%
- Adviser adequately supervises its solicitor’s activities 4.3%
- Solicitor disclosure document: Clause for any additional advisory fees charged to compensate the solicitor 4.3%
Performance Advertising Deficiencies

- No disclosure if results reflect reinvestment of dividends or other earnings: 10.9%
- Results compared to dissimilar index without disclosure of material differences: 9.1%
- Actual Portfolios: Misleading results due to inclusion or exclusion of any accounts: 7.3%
- Suggestion of profit not balanced by disclosure of possible loss: 7.3%
- Effects of material market or economic conditions not disclosed: 7.3%
- Backtesting: No or inadequate disclosure of nature and limitations of backtesting: 5.5%
- Model Portfolios: No disclosure that the model differs materially from actual client portfolios: 5.5%
- Model Portfolios: No disclosure if changes to model had material effect on results: 5.5%
- Model Portfolios: No disclosure of limitations of model: 5.5%
- Actual Portfolios: Accounts used are not representative of all clients: 5.5%
- Inadequate backup documentation for calculation: 5.5%

32.7% of all advisers who advertised performance
Financial Planning Deficiencies

- No written planning contract: 28.6%
- Inadequate client contract: 21.4%
- Inadequate disclosure of planning fees: 21.4%
- Unreasonable or excessive fees: 7.1%
- No or inadequate disclosure of conflicts of interest: 3.6%

8.3% of all advisers offering financial planning services.
Suggested Best Practices

- Prepare and maintain all required records, including financial records. Back-up electronic data and protect records. Document checks forwarded.

- Review and revise Form ADV and disclosure brochure annually to reflect current and accurate information.

- Review and update all contracts.

- Prepare and distribute a privacy policy initially and annually.

- Deliver disclosure brochure initially and annually as required.
Suggested Best Practices

- Review all advertisements, including website and performance advertising, for accuracy.

- Calculate and document fees correctly in accordance with contracts and ADV.

- Prepare and maintain written compliance and supervisory procedures relevant to the type of business to include business continuity plan. Assess and update periodically.

- Implement appropriate custody safeguards, as applicable. Pay close attention to direct fee deduction invoices.
Suggested Best Practices

- Keep accurate financials. File timely with the jurisdiction. Maintain surety bond if required.

- Make sure client’s investment policy and suitability information are current.

- Disclose soft dollars or benefits received.

- Prepare and maintain current client profiles.

- Review solicitor agreements, disclosure, and delivery procedures.