



2013 IA Switch Audit Report

A Report Summarizing the Missouri Securities Division's 2013 IA Switch Firm Audit Findings
and Associated Suggested Best Practices

December 2013

Missouri Securities Division

Office of Secretary of State Jason Kander

The IA Switch

In an effort to bolster the regulation of the financial services industry, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) in 2010. The Dodd-Frank Act contained several significant changes to the regulatory framework of the financial services industry. Those changes were intended to aid regulators in their oversight of the industry and to better protect the savings of the nation’s investors.

One of the effects of the Dodd-Frank Act was a historic shift in the regulatory oversight of certain investment advisers. Specifically, investment advisers that managed client assets valued between \$25 million and \$100 million (“mid-sized investment advisers”), were required to transition from registration with the Securities and Exchange Commission to state registration (the “IA Switch”). As a result of that registration transition, mid-sized investment advisers were forced to adapt to a new regulatory regime, including new rules governing their conduct.

To help ease that transition, the Missouri Securities Division (the “Division”) and the Commissioner of Securities (the “Commissioner”) conducted a significant outreach campaign. Under that campaign, the Division and the Commissioner: implemented a pre-registration examination program; conducted “listening sessions” with the investment adviser industry in St. Louis and Kansas City; issued eight advisory releases related to the IA Switch; launched a website focused entirely on information for mid-sized advisers; published a quarterly newsletter providing IA Switch guidance; and issued three no-action determinations to provide relief to investment advisers during the transition. (For more information on the Division’s efforts during the IA Switch and the findings from the pre-registration examinations of mid-sized investment advisers, click [here](#)).

Mid-Sized Investment Adviser Examinations

After completing the pre-registration examinations of the 62 mid-sized investment advisers switching to Missouri registration, the Division set a goal to conduct an on-site field audit of each of the 30 mid-sized investment advisers based in Missouri within a year. However, to achieve that goal, the Division first needed to make a few changes to its audit schedule and practices.

Despite adding 62 firms to its regulatory universe, the Division stood firm in its desire to maintain a 4-year audit cycle¹ for Missouri-based investment advisers. Accordingly, the Audit Unit revised its schedule to allow for ten additional investment adviser audits per year. With that change, the Division ensured it could visit each of the new mid-sized investment advisers by June 28, 2013, while also maintaining a regular audit schedule for those investment advisers registered in Missouri prior to the IA Switch.

In addition to scheduling changes, the Division increased the efficiency of its processes by implementing new technology (notably, electronic examination modules) and focusing its approach on issues or areas of risk identified during the pre-registration examination process.

¹ Auditing each investment adviser once every four years.

For example, during the pre-registration examination process the Division noted that many mid-sized investment advisers employed individuals that were dually registered (as investment adviser representatives and broker-dealer agents). Based on that information, the Division composed a broker-dealer document request list to be sent to the related broker-dealer prior to the investment adviser exam. Among other things, that list requested documents related to the broker-dealer's supervisory policies and procedures. Once those documents were collected, the Division used the gathered information in its audit preparation, highlighting potential areas of focus.

By June 28, 2013, the Audit Unit of the Division met its goal, conducting a field audit of each of the 30 recently transitioned mid-sized investment advisers. After returning from those field audits the Division's auditors worked diligently to examine the information and documents collected and issue deficiency letters outlining their findings. The length of the ensuing process varied depending on the responsiveness of the firms and the number of deficiencies. Investment advisers that responded timely to the deficiency letters, and resolved deficiencies by adopting the best practices suggested by the Audit Unit, had their audits quickly closed. Those investment advisers that took longer to respond to deficiency letters, or that were hesitant to adopt the Audit Unit's suggestions, experienced a more lengthy process. In all, the Audit Unit closed² each of the mid-sized investment adviser audits by October of 2013.

Although the Division altered its approach to more effectively audit those mid-sized investment advisers, the work to fully complete the Dodd-Frank-mandated changes continues. The Audit Unit will continue to hone its approach so it can better protect Missouri's investors while also regulating a larger number of investment advisers. As part of that process, Missouri is joined by other states in examining the findings of its mid-sized investment adviser audits.

National Audit Findings

Similar to Missouri, over the last 16 months many other states focused their investment adviser audits on the recently transitioned mid-sized investment advisers. During that period, the North American Securities Administrators Association ("NASAA") collected data from those states on the most prevalent investment adviser audit deficiencies and issued a report summarizing their findings. According to that report, states volunteered audit information on 1,130 different investment advisers. For the most part, the common deficiencies did not substantially vary based on the amount of assets under management. Essentially, most investment advisers struggled with the same compliance issues. Some common deficiencies included:

- Failure to maintain up-to-date client suitability information;
- Inconsistencies between ADV Part 1 and ADV Part 2;
- Improperly executed client contracts;
- Failure to annually deliver a copy of the firm's privacy policy;
- Failure to annually offer/deliver ADV Part 2;
- Failure to update material changes on ADV Part 1 and ADV Part 2;
- Charging incorrect fees; and

² Excluding two that were referred to the Division's Enforcement Section for formal investigation.

- Failure to disclose that the investment adviser receives soft dollar benefits.

To read NASAA's full report, click [here](#).

Missouri's Audit Findings and Suggested Best Practices

Missouri's audit findings were similar to those in NASAA's IA Sweep 2013 Report. Many of the above-listed deficiencies were noted during the Division's audit of Missouri's mid-sized investment advisers. Specifically, the Division noted the following common deficiencies:

Deficiency	Rule	% of Mid-Sized Advisors Cited
Failure to maintain general/auxiliary ledgers	15 CSR 30-51.140(1)(B)	13.8%
Failure to maintain records or documents necessary to demonstrate the calculation of performance or rate of return	15 CSR 30-51.140(1)(N)	10.3%
Failure to update material information within 30 days	15 CSR 30-51.160(3)(A)	10.3%
Entering into an investment advisory contract without disclosing necessary ³ information in writing	15 CSR 30-51.172(1)(R)	10.3%
Failure to maintain required financial statements	15 CSR 30-51.040(1)	6.9%
Failure to maintain copies of advertisements	15 CSR 30-51.140(1)(K)	6.9%
Making recommendations to a client without reasonable grounds to believe those recommendations are suitable	15 CSR 30-51.172(1)(A)	6.9%
Charging a client unreasonable fees in light of the fees charged by other advisers providing essentially the same services	15 CSR 30-51.172(1)(N)	6.9%

These results indicate that there were few wide-spread issues discovered during the mid-sized adviser audits, which is likely attributable to the fact that all of those advisers underwent a pre-registration examination approximately a year (in some cases less) before their first field audit. However, there was one significant trend that was more prevalent in mid-sized investment

³ Namely: (1) the services to be provided; (2) the term of the contract; (3) the advisory fee or the formula for computing the fee; (4) the amount or the manner of calculation of the amount of the prepaid fee to be returned in the event of contract termination; (5) whether the contract grants discretionary power to the adviser or its representatives; and (6) that no assignment of such contract shall be made by the adviser without the client's consent.

advisers than in other investment advisers. That trend involved the use of client login credentials by mid-sized investment advisers to access client accounts.⁴

The Division found that many mid-sized investment advisers maintained client login information and were accessing brokerage/401K accounts, essentially as the client, to effect transactions. This was concerning for a few reasons. First, if the adviser was using the client's personal login credentials, the adviser likely had unfettered access to the client's account, including the ability to withdraw client funds or securities. If the adviser had that ability, the adviser effectively had custody of the client's funds/securities, and was required to maintain that custody in accordance with Rule 206(4)-2 of the Investment Advisers Act of 1940 (which is incorporated by reference in Missouri's securities regulations at MO 15 CSR 30-51.100).

In addition to reviewing compliance with the requirements of Rule 206(4)-2, for mid-sized investment advisers using client login credentials, the Division also reviewed whether: (1) the adviser had proper authorization (from the client and the account provider) to access client accounts in that manner; (2) the adviser had sufficient supervisory policies and procedures in place to maintain client login information and monitor its use; and (3) the transactions made by the adviser were consistent with the advisory agreement or other authorizations. In many cases, mid-sized investment advisers lacked sufficient controls/oversight to maintain that client login information.

Based on the above and other common deficiencies, the Division suggests the following as best practices for compliance with the Missouri Securities Act of 2003:

- If as part of your advisory business you access client accounts online, request unique login credentials from the account provider that provide limited authorizations (falling short of custody);
- When updating your Form ADV Part 1, ADV Part 2, or client contracts, be sure those changes are reflected in all other documents you provide to regulators (including those filed on IARD) or clients;
- Because websites and social media accounts are considered a form of advertising, investment advisers should maintain copies of current and historical pages of your website/social media account in an advertising file;
- In order to avoid an inadvertent custody situation, advisers that receive checks from customers (which should be immediately forwarded on to a custodian) should maintain a check log or other tracking system reflecting: the date the check is received, the date forwarded, the check date and amount, the client name and account number, the payor, the payee, and the method of delivery (UPS, USPS, etc.); and
- Investment advisers should keep accurate and current suitability information about their clients. It is recommended that investment advisers document any periodic attempts to keep that information updated. Useful suitability information to keep for clients may include: the customer's name, tax identification number, address, telephone number,

⁴ This deficiency was categorized as, "Dishonest or unethical business practices (other)."

date of birth, employment status, annual income, net worth, the customer's investment objectives, risk tolerance, and time horizon.

Future Changes and Areas of Emphasis

Although the Division has now closed all of its initial mid-sized investment adviser audits, the transition of those advisers to state regulation will be an on-going process. In order to continue to foster that transition and to better regulate all investment advisers, the Division has re-tooled its IA Switch webpage (<http://www.sos.mo.gov/securities/iaswitch>) to focus on continuing compliance issues and trends. That page will be periodically updated with frequently asked questions, advisory releases from the Commissioner, links to relevant articles, and other useful compliance information. In addition to the re-tooling of the IA Switch webpage, the Division anticipates a few changes to its examination program.

To make the most efficient use of its time out in the field, in 2014 the Audit Unit will place an increasingly greater emphasis on gathering information on its audit targets before venturing into the field. By collecting more documents beforehand, and using available ADV information to develop a specific focus, the Audit Unit will be able to concentrate their time in the field on examining anticipated areas of concern. This, in turn, will allow the Audit Unit to expand its audit schedule and incorporate mid-sized investment advisers into the 4-year cycle.

Second, because many of Missouri's mid-sized investment advisers employ persons that are dually registered as investment adviser representatives and broker-dealer agents, the Division will likely place an increased emphasis on broker-dealer audits, and broker-dealer supervision of agents that are dually registered as investment adviser representatives. This focus will not only be on policies and procedures, but how well the broker-dealer actually puts those policies and procedures into practice.

Last, in order to better understand emerging issues in broker-dealer compliance, the Division has already begun a series of desk audits examining specific compliance issues. Some Missouri-registered broker-dealers may receive letters requesting information and documents related to specific areas of their operations or compliance programs. Those letters are not related to any open investigation, but rather, are aimed at gathering information on certain compliance issues and trends.

If you have any questions about the Division's examination program or the continuing compliance obligations of Missouri's investment advisers, please visit the Division's new website (www.sos.mo.gov/securities) or the Division's IA Switch website (linked above).