Speech

How We Protect Retail Investors

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I. Disclaimer

Thank you for that very kind introduction and for inviting me to speak today. I am grateful for this opportunity to speak with you today, particularly to this great audience of practitioners. Before I start, let me remind you that the views I express today are my own and do not necessarily reflect the views of the Commission, the Chairman, other Commissioners, or my colleagues on the Commission staff.[1]

II. Introduction

As soon as Chairman Jay Clayton was sworn in, he made clear that one of his top priorities was retail investors. He asked a number of questions all aimed at the principle that the SEC's analysis should start and end with the long-term interests of the Main Street investor. One of those questions was "[a]re investors benefiting from our efforts?"[2]

In OCIE, our efforts are primarily directed at examinations, risk-assessment and industry and investor outreach. Reflecting on Chairman Clayton's question, it is imperative that OCIE continually ask itself how best it can deploy its resources to protect the retail investor through primarily examinations, but also outreach and partnering with compliance officers. For years, OCIE has pushed the pillars of preventing fraud while promoting compliance. To me, these principles go hand in hand with investor protection. In the title of this speech, I refer to how "we" protect retail investors; not as just OCIE, but as a "collective we," including compliance officers, senior management, and OCIE. Today, I would like to highlight several areas where OCIE works to protect investors through examinations as well as partnering with compliance professionals.

III. Examination Priorities Designed to Target Risks to Retail Investors, Including Seniors

OCIE's primary role is conducting examinations, and so the first place it must look to protect retail investors is in how it performs examinations and what risk areas of a firm it focuses on during those examinations. In general, OCIE aims to examine areas of risk that could cause particular harm to retail investors and firms whose characteristics may reflect an increased risk of noncompliance and harm to retail investors.

Each year, OCIE engages in a deliberative process to identify the areas that we believe exhibit the highest risks to investors. The output of this process is a document that OCIE publishes annually setting forth our examination priorities for the upcoming year. OCIE does this for two primary reasons: one, OCIE believes that it should be thoughtful, deliberate, and transparent about how it is spending its time and resources in order to deliver the highest return that it can to taxpayers and the investing public; and two, its hope that regulated entities and their compliance professionals will use this information when looking internally at their own businesses to address high-risk areas to avoid potential compliance weaknesses.

In 2019, our examination priorities include several areas that OCIE believes serve to protect retail investors, particularly seniors and those saving for retirement.[3] There are also core risk areas, such as the safeguarding of assets, that it covers each year in examinations. Today, I'd like to highlight some of OCIE's examination priorities and core risk areas, and discuss how OCIE's focus on these topics helps to accomplish our investor protection goal. The priorities and risk areas that I will discuss are examinations related to: (1) fees, expenses, and related disclosures; (2) the safeguarding of client assets; (3)undisclosed conflicts of interests; (4) firms borrowing from clients; and (5) the protection of seniors. Finally, I will discuss the critical role that compliance programs—and Chief Compliance Officers—play in protecting retail investors.

A. Fees, Expenses, and Related Disclosures

The disclosures that investors receive, especially regarding fees and expenses, are critical to their ability to make informed investment decisions, including about whether to engage or retain a particular investment professional. In the advisory space, where I will focus most of my remarks, the terms of a client's advisory fees and expenses are typically detailed in an advisory agreement and described in an adviser's Form ADV, fee schedules, and other materials provided to the client. A financial professional that fails to adhere to the terms of these agreements and disclosures runs an increased risk of overbilling their clients and potentially violating the federal securities laws, including the antifraud provisions.[4]

To evaluate whether investors are receiving accurate information about fees and expenses, examiners closely review a firm's disclosures and identify whether applicable fees and charges were disclosed and compare those disclosures to how the firm in practice is assessing and collecting fees. Examiners have identified several types of fee and expense discrepancies when conducting these reviews.[5] For example, examiners have observed advisers valuing client assets using a process that differs from that described in the client's advisory agreement. In some instances, advisers used the market value of the assets at the end of the billing cycle versus using the average daily balance of the account over the entire billing cycle. In others, advisers included assets in the fee calculation that the advisory agreement stated would be excluded.

Examiners may also review the adviser's frequency of billing and application of fee rate, rebates, breakpoints and discounts to assess whether the adviser is acting in accordance with the advisory agreement, as well as advisers that have not refunded pre-paid or over-charged fees to former clients. In many instances, when examiners have identified these types of fee and expense issues, the advisers have remediated and made clients whole.

OCIE tracks many of its own key performance indicators, one of which is recoveries that were obtained as a result of findings from an examination. Over the past five years, OCIE has been instrumental in the payment of hundreds of millions in recoveries directly back to investors. This can take many forms, but primarily those mentioned above related to overbilling clients, whether intentional or not. To OCIE, recoveries are a particular area of importance and satisfaction in ensuring that investors are made whole.

B. Safeguarding of Client Assets

Keeping investor assets safe from theft and misuse is key to investor protection and an evergreen area of focus for OCIE. There are several ways OCIE examines firms to see if they are safeguarding client assets. OCIE examines for compliance with the Custody Rule,[6] it examines for misappropriation, and it examines to verify the existence of client assets. I will discuss each of these in turn.

1. Custody of Client Assets

SEC-registered investment advisers who have custody of their clients' funds or securities must safeguard them as required by the Custody Rule. Custody means holding client funds or securities, directly or indirectly, or having the authority to obtain possession of them. One example of where an adviser has authority to obtain possession of funds or securities is an arrangement under which the adviser is authorized or permitted to withdraw client funds or securities, such as bill pay services.

To help protect investor assets from theft or misuse, OCIE examines for compliance with the Custody Rule, which requires advisers with custody of client assets to:

1. Hold its clients' funds and securities at a qualified custodian, typically a broker-dealer or a bank, and in a separate account for each client under that client's name (or in the adviser's name as agent or trustee for the clients);
2. Notify its clients of where their assets are being held by promptly informing a client when an account is opened by the adviser and when any changes are made;
3. Have a reasonable basis, after due inquiry, that the qualified custodian sends account statements to clients at least quarterly; and
4. Undergo an annual surprise examination, or use an approved alternate approach.

Examiners have frequently observed deficiencies with respect to the custody rule, and in 2017, OCIE issued a Risk Alert identifying some of the typical deficiencies that it saw in this area – the most common one being that advisers did not recognize that they had custody of client assets and were subject to the rule.[7] Another common deficiency was that advisers did not undergo surprise examinations by an independent public accountant meeting the requirements of the rule. In fact, that 2017 Risk Alert followed a 2013 Risk Alert focused specifically on compliance with the Custody Rule. The 2013 Risk Alert identified these same issues and others, including that advisers did not hold client assets at a qualified custodian in accordance with the requirements of the Custody Rule.[8]

OCIE considers compliance with the Custody Rule to be one of the primary safeguards against misappropriation or misuse of client assets, so it will continue to focus its attention in this area to help protect investor assets.

2. Misappropriation

OCIE also seeks to protect investors by examining for misappropriation of investor assets. Misappropriation is basically just another word for stealing. Advisers, broker-dealers, and transfer agents, in particular, are responsible for handling and safeguarding investor funds and assets, and many of those firms have vast amounts of assets under their management or flowing through them on a daily basis. Many of these firms also have hundreds or even thousands of representatives located in offices spread around the country. In order to protect client funds and assets, it is imperative that firms have a robust system of internal controls surrounding their representatives' handling of these funds and assets.

The scope of an exam in this risk area may include a review of firms' policies, procedures, and internal controls surrounding their handling or processing of investor funds and assets. Examiners have identified instances of misappropriation, as well as internal control weaknesses that could lead to misappropriation. Examiners swiftly refer these cases to Enforcement so that they may immediately take steps to prevent any further misappropriation and attempt to recover whatever assets have been taken.[9] As you might imagine, identifying and stopping this type of behavior is particularly gratifying to examiners because their efforts to protect investors are evident and impactful.

3. Asset Verification

Another important type of review that examiners may conduct during an examination is asset verification. When examiners conduct asset verification, they are seeking to verify the existence and integrity of client assets managed or held by the SEC-registered entity. Verifying client assets and transactions to a reasonable degree of

certainty helps examination staff evaluate whether observed or reported business activities are legitimate and not part of a fraudulent scheme.

Put another way, verifying client assets and transactions allows examiners to confirm the veracity of the information provided by a firm through verification against independently obtained source data. OCIE does not take what registrants provide at "face value" and exercises professional skepticism – even well-intentioned firms with competent and ethical personnel can make human errors that may not surface until a thorough analysis is performed against a corroborating data set from the custodian(s). Examinations to verify assets may also help to identify issues of overbilling, and inadequate disclosures of conflicts of interest. The greatest fear an investor may have is that their assets are "no longer there." In sum, OCIE's examinations to verify assets help to ensure the necessary safeguarding of investor assets.

C. Disclosure of Conflicts of Interest

Many firms have conflicts of interest that exist as a result of, among other things, their business structure, compensation structure, personnel or relationships, or relationships with affiliates and service providers. Nevertheless, an adviser's fiduciary obligations pursuant to Section 206 of the Advisers Act include an obligation not to subrogate a client's interests to its own. An adviser must deal fairly with clients and prospective clients and, at a minimum, make full disclosure of any material conflict or potential conflict.

Almost all of our examinations review an adviser's disclosures in connection with its operations to evaluate whether the adviser has appropriately identified and disclosed conflicts. OCIE believes that full disclosure of conflicts of interest puts clients in the best position to be able to make judgments for themselves about whether to engage, or continue with, the services of an adviser.

Examiners have observed advisers that failed to disclose various conflicts of interest to their clients. For example, examiners have observed advisers:

1. Recommending certain investments to their clients without disclosing their own interest in the investment. Examples of such interest may include owning a proprietary interest in the investment, serving as a board member of the company that was invested in, or receiving compensation for making the recommendation;
2. Not providing adequate disclosure about how they would allocate investment opportunities among multiple clients with the same or similar investment strategies, or how they would allocate investment opportunities between themselves and their clients; and
3. Recommending their clients use affiliated broker-dealers or other service providers without adequately disclosing the affiliation or the receipt of compensation for making the recommendation.

Another conflict of interest for an adviser exists when the adviser has an incentive to recommend certain share classes over others based on the amount of compensation they will receive when their recommendations are executed. When mutual funds offer investors different types of shares, known as "classes," each share class will have different fees and expenses, and therefore, different performance results. The offering of mutual fund share classes allows investors to be in a fee and expense structure that best fits their investment goals, including the time that they expect to remain invested in the mutual fund.[10]

OCIE has focused on mutual fund share class selection since 2016 as part of its national examination priorities, and the more than 250 examinations conducted in this area serve as a great example of how the examination program helps to protect retail investors.[11]

OCIE's examinations in this risk area frequently identified deficiencies in the areas of best execution, disclosure, and compliance – including deficiencies that were consistent with recent settled actions the Commission has instituted against advisers for failing to disclose conflicts of interest associated with the receipt of 12b-1 fees.[12]

As a result of these examination and Enforcement efforts, many investment advisers that made inappropriate share class recommendations remedied their misconduct by (1) notifying their clients and moving them to a lower-

cost share class, and (2) compensating their clients in the amount they were disadvantaged.[13] OCIE believes that the examination and enforcement activity in this area over the last few years has had a meaningful impact in reducing the likelihood that investors are disadvantaged by inappropriate share class recommendations by investment advisers. However, OCIE does not intend to rest on its laurels in this area and with disclosures of conflicts in general – it is continuing to examine for this issue – and continuing to observe deficiencies. I urge firms and investors to pay close attention to this area so that investors have the benefit of maximizing the amount of money they have at work for them.

D. Firms Borrowing from Clients

One concerning practice I have seen a number of times over my career in OCIE is a firm borrowing or taking a loan from clients. The need for the loan can sound innocent enough. Perhaps it is a new and growing adviser with little capital, a registered representative that recently moved from being an employee representative to an independent representative with more overhead costs, or a bank-affiliated adviser that seeks to cross-sell products to provide "holistic" services.

The practice is fraught with risk to clients. A firm may not appropriately disclose its financial condition, particularly when that condition is poor, the illiquidity of the investment or the financial incentives of the financial professional or their firm. A firm may entice clients with the allure of a "growing business" but not adequately disclose the risks. For example, OCIE has seen several firms targeting seniors who are invested in conservative and safer fixed income securities to lend their assets to a firm without being told the risks of investing in an unsecured note with a financial professional and/or a firm with little capital and a promise of a higher return. Often, little or no disclosures are provided on the illiquidity of the investment, or the financial incentives that advisers, broker-dealers and their representatives may receive to recommend these products to clients and customers. When examiners see these types of arrangements, they will look at whether all material risks, expenses and compensation are adequately disclosed to clients and customers.[14]

E. Focus on Issues Relevant to Seniors

OCIE also remains focused on protecting senior investors through its examinations and investor outreach efforts, particularly as the population of seniors in the United States continues to grow.[15] For example, OCIE recently concluded a review of over 200 investment advisers with a significant senior client base. Among other things, OCIE wanted to gain an understanding of whether advisers with a significant senior client base had policies and procedures that addressed the protection of senior investors. OCIE also focused on whether firms were aware of certain state and federal laws (specific cites to be added) addressing senior financial abuse and exploitation.[16] This effort was designed to raise awareness and assess industry practices in this critical area of investor protection.

OCIE also seeks to raise awareness and help influence behavior in a positive way through outreach events directed at senior investors. Along with our colleagues in the Office of Investor Education and Advocacy, OCIE staff participated in or hosted more than 50 outreach events for seniors over the past two years. These in-person engagements provide valuable touchpoints where SEC staff is able to share information about common investment scams and arm seniors with knowledge to help them avoid becoming victims of financial schemes.

IV. Devoting Adequate Compliance Resources & Empowering the CCO

Lastly, but perhaps most importantly, I'd like to say a few words about the important role that compliance programs and compliance officers play in ensuring that market participants and firms protect investors. Compliance officers are on the front lines of ensuring registrants meet their obligation under applicable securities laws and regulations. It's not an overstatement to say that I view compliance officers and personnel as partners

We cannot underscore enough a firm's continued need to assess whether its compliance program has adequate resources to support its compliance function.[17] For without adequate resources, compliance professionals are like swimmers swimming against the tide constantly working to keep up and not lose ground. We are concerned

when we hear directly from industry participants and read press reports that compliance resources and budgets are being cut or are not keeping up with firms' risk profiles.

On a related point, OCIE and others at the Commission have heard from CCOs of investment advisers that there is a feeling and concern that CCOs bear the ultimate responsibility for the success or failures of any compliance program. These concerns, while understandable, from OCIE's perspective are not warranted. A CCO, while a critical component to the effectiveness of any compliance program, is just that, one component. As the Advisers Act Compliance Rule states, a CCO is responsible for "administering" the compliance policies and procedures that the adviser, not just the CCO, adopts. Consequently, I believe that compliance obligations and opportunities lie with personnel firm-wide, including importantly senior management and ownership, the tone from the top, and the first line or business side of an enterprise. That is not to say that OCIE does not have high, perhaps very high expectations for CCOs. We see on examinations competent CCOs that are not empowered to live up to the role that the Commission described in the adopting release of the compliance rule. An empowered CCO should have full authority to develop and enforce policies and procedures and be of sufficient seniority and authority within the firm to compel others – including others in senior management to follow and enforce those policies and procedures.

OCIE wants to help CCOs perform their challenging jobs because an effective CCO and compliance program is critical to the protection for retail investors. Because OCIE only has the resources to examine a fraction of registered firms each year, it seeks other avenues to inform and empower CCOs. A CCO who wants to improve the firm's compliance culture may have difficulty in getting the attention of firm management absent an examination. An important way OCIE tries to assist is by being as transparent as possible about the deficiencies it commonly sees during examinations so even if OCIE does not visit in a particular year, you are still hearing from us. OCIE risk alerts are a significant tool in this regard.

All of this underscores the importance of culture at any firm, and specifically the importance of a firm's compliance culture.[18] Without a solid compliance culture, supported by a sincere "tone at the top" by senior management a firm stands to lose the hard earned trust of its clients, investors, customers and other key stakeholders. Without that culture, the best compliance policies and procedures ever written would not hold up to the myriad of tests, challenges and issues that today's fast-moving marketplace present.

In sum, OCIE sees the compliance function as equally important to key business lines to the overall success of a firm. Accordingly, OCIE hopes that all of a firm's personnel, not just compliance, be an active and positive partner in the protection of investors. To assist CCOs and frankly to better understand from their perspective what it is that OCIE is doing well and what it could improve on, OCIE is kicking off a pilot initiative to hold regional roundtables in select cities with CCOs. I hope these meetings with CCOs outside of an examination context will foster a healthy dialog with the compliance community as both the "collective we" continue to search for ways to strengthen the role of the CCO, improve the culture of compliance, and deliver on the shared goal of investor protection. .

V. Conclusion

Thank you for having me here today. I would also like to thank my team who helped put this speech together including Matt O'Toole, Chris Mulligan, Mavis Kelly, Kristin Snyder, and Dan Kahl. I wish you all a thoughtful and productive conference.

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[1] The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

[2] SEC Chairman Jay Clayton, "Remarks at the Economic Club of New York" (Jul. 12, 2017), available at https://www.sec.gov/news/speech/remarks-economic-club-new-york; see also "Equity Market Structure 2019: Looking Back & Moving Forward" (Mar. 9, 2019), available at https://www.sec.gov/news/speech/clayton-redfearn-equity-market-structure-2019.

[3] OCIE 2019 Examination Priorities (Dec. 20, 2018), available at https://www.sec.gov/files/OCIE%202019%20Priorities.pdf.

[4] See e.g., In the Matter of Retirement Capital Strategies, Inc., Release No. IA-5065 (Nov. 19, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-5065.pdf.

[5] OCIE Risk Alert, "Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers" (Apr. 12, 2018), available at https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf.

[6] Rule 206(4)-2 under the Investment Advisers Act of 1940 ("Advisers Act").

[7] OCIE Risk Alert, "The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers" (Feb. 7, 2017), available at https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf.

[8] OCIE Risk Alert, "Significant Deficiencies InvolvingCustodyand Safety of Client Assets" (Mar. 4, 2013), available at https://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf.

[9] See, e.g., GW & Wade, LLC, Release No. IA-3706 (Oct. 28, 2013), available at https://www.sec.gov/litigation/admin/2013/ia-3706.pdf.; and Dennis Gibb and Sweetwater Investments, Inc., Release No. IA-5215 (March 29, 2019), available at https://www.sec.gov/litigation/admin/2019/33-10623.pdf.

[10] Investor Bulletin: Mutual Fund Classes (Aug. 4, 2016), available at https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-mutual-fund-classes.

[11] OCIE Risk Alert, "OCIE's 2016 Share Class Initiative" (Jul. 13, 2016), available at https://www.sec.gov/ocie/announcement/ocie-risk-alert-2016-share-class-initiative.pdf.

[12] See SEC Press Release 2019-28, "SEC Share Class Initiative Returning More Than $125 Million to Investors" (Mar. 11, 2019), available at https://www.sec.gov/news/press-release/2019-28.

[13] See id.

[14] See, e.g., AmericaFirst Capital Management, LLC, Release No. IA-10454 (Jan. 23. 2018).

[15] OCIE 2019 Examination Priorities (Dec. 20, 2018), available at https://www.sec.gov/files/OCIE%202019%20Priorities.pdf

[16] See OCIE Report, "Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Serving Senior Investors" (Sept. 22, 2008), available at http://www.sec.gov/spotlight/seniors/seniorspracticesreport092208.pdf; and "Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Serving Senior Investors 2010 Addendum" (Aug. 12, 2010), available at http://www.sec.gov/spotlight/seniors/seniors practicesreport081210.pdf. See also Section 303 ("Senior Safe Act") of the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018, available at https://www.congress.gov/bill/115th-congress/senate-bill/2155/text#toc-id45B692A3CB264F64BDE568E071AA2CFD. Lastly, according to the North American Securities Administrators Association (NASAA), nearly all states have existing state laws that contain mandatory reporting requirements when there is a suspicion of elder abuse, whether physical, mental, or financial. Some of these laws specifically mandate reporting by investment advisers. See, http://serveourseniors.org/wp-content/uploads/2016/09/NASAA-Guide-For-Developing-Practices-and-Procedures-For-Protecting-Senior-Investors-and-Vulnerable-Adults-From-Financial-Exploitation.pdf.

[17] See, e.g., Lori Richards, Open Letter to CEOs of SEC-Registered Firms (Dec. 2, 2008), available at https://www.sec.gov/about/offices/ocie/ceoletter.htm.

[18] See Chairman Jay Clayton, "Observations on Culture at Financial Institutions and the SEC" (June 18, 2018), available at https://www.sec.gov/news/speech/speech-clayton-061818.