



Private Wealth

Test Anxiety

The SEC's proposal to let private firms conduct regulatory exams of registered investment advisers has left the industry divided.

By Bailey McCann

THE SECURITIES AND EXCHANGE COMMISSION is taking a closer look at registered investment advisers. Last year the SEC began considering a proposal from former commissioner Daniel Gallagher to allow third-party firms to provide regulatory examinations of RIAs. Then in January, through the release of its examination priorities for 2016, the SEC signaled that it would be using what resources it had to put the industry under more scrutiny. No matter who's doing the exams, industry observers have concerns about enforcement and the consistency of the process.

"The recent tension we've seen, where OCIE [the SEC's Office of Compliance Inspections and Examinations] is more willing to go to the enforcement division if they find something during the examination process, is a real thing," says Derek Steingarten, a New York-based partner with the investment management practice at law firm K&L Gates. "That said, they've also been much more transparent about going into detail on the examination process. So in some sense parties should be aware of what they need to have in place from a compliance perspective prior to an examination."

The commission has been trying to improve examination of investment advisers since the 2008-'09 financial crisis. By its own admission, it examines about 9 percent of advisers in the industry each year. This means that an RIA can expect to be reviewed once over a ten-year period, but in some cases a review never happens.

Now the SEC, which declined to comment on policy considerations, is looking at letting third-party examiners take over. Later this year it's expected to release a highly anticipated draft proposal for opening up examinations to such providers, and the investment adviser industry has questions.

"The idea of having third-party companies do an exam is a politically elegant solution," says Todd Cipperman, a securities lawyer and founding principal of Wayne, Pennsylvania-based Cipperman Compliance



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Compliance Services

Services, which provides compliance consulting and outsourced chief compliance officer solutions. "By going with a third party, taxpayers aren't on the hook for more funding, and investment advisers would be on the hook for their own examination costs."

Daniel Bernstein, chief compliance attorney at MarketCounsel, an Englewood, New Jersey-based adviser to RIAs, isn't so sure. The timeline before the industry sees a proposal is likely to be extended beyond the end of this year, and the comment period will be rife with tension, Bernstein predicts. "How do you vet the examiners and ensure quality?" he asks. "What will the questions be? This is going to be a long process."

Supporters of the proposal, like Skip Schweiss, TD Ameritrade Institutional's Denver-based managing director of adviser advocacy and industry affairs, say that if the rules keep the examinations narrowly tailored and objective, the SEC could mitigate the risk that the process becomes murky or lacks rigor.

"We think the examinations should focus on clearly objective topics, like asset verification, that are also narrow in scope," Schweiss explains. "I call them smoke detector exams: If I smell smoke while I'm going through the building, then I'm going to call the fire department."

Compliance consultants have suggested that a whistle-blower mechanism could be put in place if an area of material weakness is raised by a third-party examiner and if senior management doesn't fix the issue. But the role that third parties could play in enforcement is unclear. During a financial statement audit, for example, accountants may bring up areas of weakness they find in a statement, or even refuse to sign off on an audit, but that doesn't limit an entity from going out and finding an auditor who will sign.

There's also potential for embedded conflicts of interest if third-party examiners that also happen to be accountants or consultants are allowed to pitch other services. "One of the questions I have about this is how the relationships would be managed," says Mitch Kraskin, founder and CEO of New York-based Compliance Science, which provides compliance technology consulting and solutions.

Despite such uncertainty, third-party examiners will probably become the norm for investment advisers, absent a big cash infusion from the federal government to the SEC. Cipperman expects feedback on the commission's proposal to focus on standards that will make the examination process consistent. "I can tell you empirically that I don't see massive fraud in the RIA community," he says. "I think you have seen some weakness in procedure, and if this process tightens that up, it will ultimately be better for the industry." •