



INCREASED SCRUTINY LEADS TO GREATER FINANCIAL OVERSIGHT AND THE OPPORTUNITY TO STRENGTHEN CLIENT RELATIONSHIPS

HIGHLIGHTS

- A final financial reform bill has not yet passed the House and Senate, but the SEC and FINRA are already tightening regulations for advisors.
- One change is that regulators are responding more readily to tips and complaints, but advisors should be prepared for a complete routine-type audit as well.
- A holistic reporting process, driven by technology, will serve two critical functions in growing your business: help prevent compliance issues and support strong client relationships.

Despite a few setbacks, the momentum for financial transparency has not slowed down. Voices demanding reform are coming from many sources, including many in the financial services industry itself. Americans are speaking up in other ways. Polls and primaries are telling the story that voters are fed up with their current legislators, opening the door for new candidates in the fall elections. The pressure is on.

Bernie Madoff helped set reform in motion, but the press regularly reports new million-dollar scandals; most recently, Kenneth Starr (ironically known as an advisor to the stars) was charged with a \$30 million fraud.¹

The House and Senate have both passed reform bills. Now the two bills are being resolved in a joint committee to form legislation that is acceptable to, and can be passed by, both houses of Congress.²

Regulators are Stepping up the Pressure. As regulators, the SEC and FINRA are in a position to respond to public pressure and opinion without waiting for Congress to act. They are displaying a new sense of urgency by stepping up compliance requirements and audits.

New focus for FINRA

"The financial crisis provided a potent reminder of the need for FINRA and all other regulators, to re-examine how we can more effectively protect investors," said FINRA CEO Rick Ketchum in a May 28 speech at the 2010 annual conference in Baltimore. He stressed that FINRA is moving toward identifying fraud early. "To ensure that serious matters get escalated quickly, FINRA has focused on the speed and efficiency with which we bring

enforcement actions. Quicker action means more investors escape harm. We need to be out of the business of sweeping up bodies, and into the business of getting in there before too many investors are hurt.”

A key strategy is to look closely at what FINRA-regulated firms are reporting about themselves. “Since much of the information used for examination is self-reported, to mitigate the risk that inaccurate information provided by firms may affect the focus of examinations and conceal violations, FINRA is independently verifying information, including custody information with DTCC or other outside custodians. We are also verifying customer account activity and balances directly with customers.”

Ketchum identified internal measures that support fraud identification strategies, and these will be expanded throughout the current year.

- Focus on training fraud protection specialists who identify scams before they occur.
- Taking a closer look at advisory businesses operated within a firm or by an affiliate. If possible conflicts of interest are identified, auditors will want to see “appropriate internal controls and segregation of duties.”
- Examinations will fit the nature of individual broker-dealer firms, rather than follow a cookie-cutter process.

A newly-formed Office of Fraud Detection and Market Intelligence is the central point for fraud issues. The office investigates insider trading, includes the Office of the Whistleblower and manages the first review of filings from firms. Ketchum made it clear that FINRA will follow up on tips on fraud and is looking more closely at “material misstatements in financial reports, unusual money movement, and any apparent red flags involving a firm’s auditor or exceptional off-balance sheet items.”³

SEC takes action

The SEC’s stepped up efforts to prevent fraud largely parallel those at FINRA.

Tips and complaints are also getting more attention. A tip could lead to a surprise examination for an RIA. And if the audit is the result of a problem which has been reported to the SEC, the examiner may be dubious about the firm’s compliance at the outset. With this new audit development, there is more reason than ever to develop a compliance process that means you are always prepared⁴

Recent headlines have focused on surprise audits, but the SEC is continuing with routine exams as well. In a webinar sponsored by InvestmentNews, *What to do When the SEC Examiner Calls*,⁵ several themes emerged.

Top issue: custody arrangements

In a list of “top ten focus areas” for the SEC, Number One is “custody arrangements and safety of assets.” It is likely that examiners will want to see copies of custody agreements and other outside vendors. They will also want to know if the custodian issues reports for the adviser.

Consistency with compliance manual

The SEC sees the compliance manual as a critical central document. Even if advisers are following procedures outlined in their manual, examiners expect them to be familiar with the language in the document. “The key is to read and be familiar with your compliance manual,” an adviser-panelist said.

Accessing data

Once notified, there is not much time for the firm to prepare for an audit. One panelist described a recent SEC audit. He was notified about the upcoming audit on a Friday afternoon; the firm was given about two weeks to provide records which the SEC wanted to see before the on-site part of the audit. Examiners want information such as reports to clients, accounts balances, etc., as well as the firm’s books, before they visit the office.

“The key is to be organized,” the adviser said. “Fortunately our firm has electronic data.”

If you can’t access some requested data, it is recommended that you provide what you have first, then move on to the less accessible information. If you can’t access records for several months, that sets off a warning to examiners.

Both compliance and adviser participants emphasized that you cannot get ready for an exam at the last minute. Technology plays a key role in preparation.

It is important to be organized and have procedures in place where you can get your information easily. Even if you’re a small shop, spend the money on the technology so you can have it relatively available.

It takes 20 years to build a reputation and five minutes to ruin it. Exams are getting tougher. Use any compliance resources you need to stay ahead. Go to management and say there’s a reason why you need [the resources].

A holistic “know your client” approach

A broadly based reporting capability has the potential to incorporate a wider array of client financial information in one place. This might include a savings account or mortgage that you would not previously have included in a report. With the client’s permission, an advisor can look at a much broader financial picture, one that includes accounts that are not in-house.

Serving in a wealth management capacity, make sure that one part of the overall portfolio does not have a negative effect on other components or the client’s overall financial picture. After all, when you visit the doctor, one of the key questions is, “What medications are you taking now?”

To avoid unintended financial side effects, identify and monitor a wide range of financial resources so a proper balance can be maintained. (If a client does not want to provide broader personal financial information, be sure to document that fact.)

As you incorporate a more complete picture of all of your clients’ assets and liabilities, you gain an opportunity to provide more appropriate recommendations.

The more you know and understand about your clients’ full financial spectrum, the better you can offer your advisory capabilities.

Outsourced reporting can leverage your capabilities

Clients are seeking the more comprehensive resources of an advisor with a wealth management practice and regulatory pressure means better record-keeping and reporting. Outside providers have enhanced their technology to meet those needs.

With the near-certainty of more stringent audits, one of the many challenges advisors face is reporting. Your clients expect you to manage their investments and meet their goals, but behind the scenes you are required to provide a performance report every 90 days.

The cost of meeting reporting requirements can be labor intensive, consuming dedicated staff time. Depending on the software and provider, a staff member may be required to download the data.

An outsourced solution may be an effective way to manage these issues. What should you look for in a reporting solution that can meet the twin goals of enhancing client relationships and improving staff productivity?

- expertise in data management
- minimal staff and advisor input so they are free to be productive in other ways
- product agnostic
- yet provide the investment options that fit your strategies

More questions: what is the flexibility of the reporting platform? Can it be customized for the functions of the client, the advisor or others who have a reason to be part of the wealth management process? Looking ahead, will the outsourcing provider offer the flexibility and foresight to grow with you and manage the inevitable changes in regulation that will take place in the future?

Talk to clients: link the fiduciary standard with your wealth management capabilities

When clients sit down to talk with you, what is in the back of their minds? Perhaps they are thinking, “Bernie Madoff sent fake reports to his clients.”

With that kind of cautious thinking, establishing and reinforcing trust is an ongoing part of your relationship. Try something like this:

Mr. and Mrs. Smith, I’m glad you are new clients. I recognize the importance of your \$250,000 that we’re investing, the cornerstone for your retirement planning.

Beyond building that portfolio, your other financial decisions will have a bearing on how comfortable your retirement will be. My clients often call me when they are making decisions in their financial lives. For instance, just yesterday, someone called to talk over whether they should buy a car or lease it.



That kind of conversation helps us make better decisions and will have an influence on how well you meet the objectives that we have been talking about.

The reports you receive from us are generated by an outside provider, so there is a system of checks and balances in place. We have a new service, aggregation, that can incorporate other parts of your financial life into one report. For instance, your mortgage or other outstanding loans can be included in your quarterly report.

Tighter regulation and oversight will continue to add unwelcome complexity to the advisory business. But, as one of thousands of advisors who already takes your fiduciary role seriously,

you have an opportunity to gain client trust and stronger relationships.

Follow the lead of a Texas advisor. Talk to your clients about how you handle fiduciary responsibilities.

For example, to underscore the importance of separate custody, he said. "I'm going to be bringing [the Ken Starr investigation] up. I'm going to tell everyone and anyone I can about it. I always tell my clients very frankly that they should not trust me to have custody of their funds, and *they should not trust anybody who's advising them to have custody of their funds.*"⁶

¹ The Starr treatment: How celeb adviser allegedly got away with it by Hilary Johnson May 28, 2010 at www.investmentnews.com/article/20100528/FREE/100529873.

² Regulatory Wire: Is it game-over for the fiduciary standard this year? by Brian O'Connell, May 21, 2010 at www.riabiz.com/a/1205006.

³ Regulatory Wire: ... FINRA's Ketchum on new fraud focus by Brian O'Connell, May 28, 2010 at www.riabiz.com/a/1353001. (Ketchum's speech is available at www.Finra.org/Newsroom/Speeches/Ketchum/P121537.)

⁴ The SEC's unannounced compliance exams are growing more common. ... How to test your firm's readiness by Les Abromovitz, April 28, 2010 at www.riabiz.com/a/938003.

⁵ *What to do When the SEC Examiner Calls*, Investment Newswebcast, at <http://event.on24.com/eventRegistration/EventLobbyServlet?target=lobby.jsp&eventid=210231&sessionid=1&key=131317D47BB36789AE8CAFA7EB009783&eventuserid=36930872>

⁶ The Starr treatment: How celeb adviser allegedly got away with it by Hilary Johnson, May 28, 2010 at www.investmentnews.com/article/20100528/FREE/100529873.

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Client Services: 888-612-9300 clientservices@envestnet.com

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