



COLORADO

**Department of
Regulatory Agencies**

Division of Securities

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Tung Chan, Securities Commissioner

Colorado Division of Securities 2020 - 2021 Investment Adviser Examination Priorities

The Division staff's 2020 - 2021 examination priorities appear below. While not an exhaustive list of areas to be covered, the priorities reflect a focus by the Division to 1) ensure that firms are adequately prepared for and addressing potential disruptions related to current events like the COVID-19 pandemic and the SolarWinds cyberattack, 2) assist investment advisers, particularly new firms, in establishing and maintaining a compliance program by providing regulatory guidance documents, and 3) continue to address common deficiencies identified on examinations specifically in the areas of advisory fee calculation and disclosure and maintaining required financial statements.

I. COVID-19 Disruptions

In 2020 many of our lives and businesses have faced unimaginable disruptions and challenges related to the COVID-19 pandemic. These challenges have created important regulatory and compliance considerations for State licensed investment adviser firms. Many of these considerations will require firms to implement or update their written procedures to address potential challenges such as health risks, remote work environments, and recent market volatility. Through 2020 and extending into 2021, the Division's examination section has been focused on ensuring that advisers are addressing COVID-19 related challenges in the following areas.

A. Business Continuity and Succession Planning

Rule 51-4.12(IA) requires investment advisers to implement and maintain written procedures relating to business continuity and succession planning. While facing a pandemic, it is important for all firms, particularly solo adviser firms, to assign duties and have a plan "...in the event of the death or unavailability of key personnel." Simply put, if you have health issues or are hospitalized, how will your clients be notified and continue to receive services? Firms' continuity plans must also provide details to minimize disruptions should the office begin to work remotely. Are there any business operations that cannot be performed remotely? How will you access the firm's books and records? Please see the Rule for all requirements and update your procedures regularly.

B. Cybersecurity and Protection of Client Information

Rule 51-4.14(IA) requires investment advisers to establish and maintain written cybersecurity procedures reasonably designed to achieve cybersecurity. Cybersecurity has been a priority of the Division for several years and continues to be an increasing threat to all businesses. Firms should be regularly assessing the risk of cyber threats



including conducting due diligence on any third party vendors that maintain or have access to your data and confidential information.

If the pandemic has led to your employees working remotely and an increase in electronic communications, how does your cybersecurity plan address this work plan? It may be a good time to conduct the required annual assessment to consider the potential risks and vulnerabilities presented from remote work. More employees may be accessing networks and communicating with clients through their private devices; sensitive documents may be printed from remote locations or emailed for remote client meetings; employees may need additional training; and clients may be more likely to give trade instructions through email, which requires identity authentication. Please see the Rule for all requirements and update your procedures regularly. Additionally, the Colorado Division of Securities Cyber Security Checklist can be found at <http://bit.ly/3tvJ7Ao>.

C. Supervision

Rule 51-4.6(IA)(19) requires investment advisers to have written procedures to supervise the activities of all representatives. Single person firms are not exempt from this Rule. These procedures should be tailored to the specific activities and operations of each firm. Has moving to a remote work environment changed your firm's business operations? Supervisors may not have the same level of oversight and interaction with employees which could impact activities from trade oversight, handling of clients' checks that are mailed to the office, or the continued maintenance and updating of firms' books and records. Firms should review and update your procedures to address changes to remote work.

II. New Firm Compliance Reviews

The Division has devoted significant resources to assisting new firms in establishing and maintaining the required books and records from the start of their operations. In addition to conducting a thorough initial licensing application review focused on the major disclosure documents (Form ADV and advisory contract), the Division has begun to examine all firms within 1-2 years of becoming licensed. These "compliance review" examinations use a modified process and efficiencies to complete quicker exams designed to assist firms with their compliance program and identify the most serious deficiencies and compliance issues early on.

The Division is also striving to provide additional resources to our investment adviser licensees and will be releasing additional guidance to licensees in 2021. In 2019, the Division hosted our inaugural Securities Workshop and when it is safe to meet again in person, the Staff looks forward to continuing to offer similar trainings. Whenever you have any questions about your business practices and compliance procedures, we recommend that you give the Division a call.

III. Common Deficiencies Identified on Examinations

One of the great benefits of the Division's examination program is that the staff has an opportunity to meet with over 100 state licensed investment adviser firms every year. Through this process, we have the opportunity to get to know members of the industry, and to review enough compliance programs to recognize common deficiencies. The



following areas have recently been of particular concern, and deficiencies in these areas may significantly prolong the examination process.

A. Advisory Fee Calculation and Invoicing

Division examinations continue to regularly uncover advisers that miscalculate their advisory fees or calculate fees inconsistently with disclosure documents. Please compare your advisory contract, Form ADV Part 2 Item 5, and actual fee billing practices to ensure all are consistent and that the method of calculation is clear.

Rule 51-4.10(IA) requires firms that directly deduct fees from client accounts to provide fee disclosure through an itemized invoice to clients. This requirement also applies to advisers who utilized third party advisers. Itemization includes the amount of assets under management or services the fee is based on, the formula used to calculate the fee, and the time period covered by the fee. As a reminder, a client should be able to look at their invoice, easily understand what they are paying, and be able to re-create the fee charged with the information contained therein.

B. Maintaining Financial Records

Rule 51-4.6(IA)(A)(1) and (6) require investment advisers to maintain a journal of cash receipts and financial statements including all working papers related to the adviser's business. When firms do not keep the required documents, it creates challenges in verifying whether the firms meet the liquid net worth requirements in **Rule 51-4.13(IA)**. This has led to significant prolonged examinations. Firms are strongly recommended to review this Rule and make sure they comply with it. In other cases, firms are commingling their advisory business with other business activities. Firms should be sure to be able to show through journals and financial statements the financials attributed to the advisory business and clearly differentiate it from all other lines of businesses or subsidiary businesses. Failure to differentiate cash flow, revenues, fees, expenses and other line items of the advisory business from other lines of business can significantly prolong the examination process.

Throughout our 2020 and 2021 examinations, we have and expect to continue to allocate extra time and resources to these prioritized items. However, priorities may be adjusted during the year in light of new information learned from examinations, complaints, referrals, industry developments, current events, ongoing risk assessments, and coordination with other regulators.

Note: Statutes and rules governing the Division's examination authority can be located online at <http://bit.ly/3jkmGsY>.

