Official Newsletter of Gordian Compliance Solutions, LLC.

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INVESTMENT ADVISER NEWS UPDATES

FLAWED METRICS UNDERMINE THE SEC'S RECORD NUMBER OF 2015 ENFORCEMENT CASES

The United States Securities and Exchange Commission (SEC) is reporting a record number of enforcement actions for 2015, but there is some cause for concern regarding the agency's perceived success regarding enforcement actions. The SEC claims to have carried out "807 enforcement actions and obtained $4.2 billion in penalties and disgorgements of ill-gotten gains for the year ended Sept. 30."[1] "That's a 7% increase from the previous year's record of 755 actions in fiscal year 2014. Fines and disgorgement increased 1% from $4.16 billion last year."[2]

However, according to media outlets such as Bloomberg and InvestmentNews.com, the SEC "double counts cases and loads up in September to boost fiscal year number.[3]" This raises a concern over the validity of SEC number of enforcement cases. "The [SEC] counts actions against the same people two or three times."[4] "The commission's enforcement action statistics show a 50% increase in the number of enforcement cases the SEC brought in 2014 compared to 2000."[5]

The main reason for such an increase in numbers seems to stem from the SEC's push to secure Congressional funding. Congress is authorized to cut the agency's budget if the goals are not met and SEC is "far from alone among federal agencies in having an incentive to use statistics to burnish its image."[6]

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[1] *SEC Filed Record Number of Enforcement Cases and Highest Fines in 2015*, InvestmentNews.com (October 22, 2015)

[2] *Id.*

[3] *SEC Using 'Flawed Metrics' to Report Enforcement Actions*, InvestmentNews.com (September 25, 2015)

[4] *Id.*

[5] *Id.*

[6] *Id.*

AVOIDING ENFORCEMENT: THE NECESSITY OF A STRONG COMPLIANCE PROGRAM

Rule 206(4)-7 under the Investment Adviser's Act of 1940 requires an annual assessment of a firm's policies and procedures to ensure the compliance program is reasonably designed to assist the firm in avoiding violations of federal and state securities laws. Far too often, however, enforcement actions arise against the firm, or key compliance personnel, due to ineffective assessment of a firm's compliance program.

"The state of the compliance function says a lot about the firm's likelihood of engaging in misconduct and facing sanctions."[1] To evaluate the strength of a firm's compliance program, an investment adviser should look at the following:

- Are compliance personnel included in critical meetings?
- Are their views typically sought and followed?
- Do compliance officers report to the CEO and have significant visibility with the board?
- Is the compliance department viewed as an important partner in the business and not simply as a support function or a cost center?
- Is compliance given the personnel and resources necessary to fully cover the entity's needs?[2]

Compliance failures occur most commonly where the Chief Compliance Officer (CCO) lacks the necessary resources to carry out an investment adviser's compliance program. This was issue at play in *Pekin Singer*—the CCO requested additional resources necessary to implement the firm's under-supported compliance program. The requests were ignored up until the Commission was at the door.[3] While the Securities And Exchange Commission decided not to charge the CCO in *Pekin Singer* as the "CCO's plea for help went unanswered,"[4] the fact remains that not all cases are cut and dry. Firms should be cognizant of the compliance failures that can put the investment adviser and the Chief Compliance Officer (CCO) at risk for an enforcement action.

The SEC represents that it "takes the question of whether to charge a CCO very seriously and carefully."[5] However, CCOs should be mindful of the instances where the SEC has sought enforcement against CCOs for violation of Rule 206(4)-7 in the following categories [6]:

1. **Misconduct unrelated to the compliance function.** This involves a CCO's direct involvement in the misconduct while serving as a CEO or CFO. For example, a CCO serving as a co-portfolio manager that misleads the fund administrator and auditor about asset values would likely invite enforcement.[7]
2. **Obstruction or misleading the Commission staff.** In most cases, this involves the compliance officer altering the documents to deceive the Commission.
3. **CCO has exhibited a failure to carry out his/her responsibilities.**

Since 2003, the SEC has brought more than 8000 enforcement actions, with a total of five "against individuals with CCO-only titles."[8] While the SEC's enforcement activity has been narrow thus far with respect to CCO liability, the fact remains that

the relative strength of a compliance program can be a strong indicator of potential enforcement action. Firms and CCOs alike can alleviate the risk of enforcement action by carefully evaluating the compliance concerns that face their advisory business.

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[1] *2015 National Society of Compliance Professionals, National Conference: Keynotes Address*, National Society of Compliance Professionals, Inc. (November 4, 2015)

[2] *Id.*

[3] *2015 National Society of Compliance Professionals, National Conference: Keynotes Address*, National Society of Compliance Professionals, Inc. (November 4, 2015); see also *In the Matter of Pekin Singer Strauss Asset Management Inc.*, Release No. 4126, United States Securities & Exchange Commission (June 23, 2015)

[4] *2015 National Society of Compliance Professionals, National Conference: Keynotes Address*, National Society of Compliance Professionals, Inc. (November 4, 2015)

[5] *Id.*

[6] *Id.*

[7] *SEC Charges Hedge Fund Advisory Firm With Conducting Fraudulent Fund Valuation Scheme*, Release 2015-134, United States Securities and Exchange Commission (July 1, 2015)

[8] *2015 National Society of Compliance Professionals, National Conference: Keynotes Address*, National Society of Compliance Professionals, Inc. (November 4, 2015)

FIDELITY CHARGED BY MASSACHUSETTS WITH DISHONEST AND UNETHICAL BEHAVIOR

"Fidelity was charged in an administrative complaint with dishonest and unethical behavior by the Commonwealth of Massachusetts for allowing unregistered investment advisers to make trades through the Fidelity broker-dealer platform," resulting in the illegal generation of fees for Fidelity and the unregistered advisors. [1]

"[At] least 13 unregistered Massachusetts investment advisors (IA)" traded through Fidelity's broker-dealer platform.[2] The complaint notes that in one instance, approximately 20 Fidelity customers paid more than $732,000 in advisory fees over a 10-year period to one particular IA using the platform.[3] Massachusetts alleges that Fidelity had knowledge of the unregistered individual "acting as an advisor" and encouraged this activity by providing the individual with free trades and "gifts such as frequent flyer miles and tickets to a professional sporting event."[4] Fidelity's negligence in this situation combined with their full knowledge of the "range of investor protections provisions" demonstrates "a profound failure of their regulatory obligations".[5]

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[1] *Fidelity Charged by Massachusetts with Dishonest and Unethical Behavior*, InvestmentNews.com (October 26, 2015)

[2] *Id.*

[3] *Fidelity 'Ignored' Unregistered Advisors Trading on Its Platform*, ThinkAdvisor.com (October 26, 2015)

[4] *Fidelity Charged By Massachusetts with Dishonest and Unethical Behavior*, InvestmentNews.com (October 26, 2015)

[5] *Id.*

SEC'S PROPOSED RULEMAKING FOR A NEW FIDUCIARY STANDARD EXPECTED IN OCTOBER 2016

2016 appears to be bringing some large changes as to how investment advisers act in their clients' best interests.

After five years of drafting the rule, "The SEC Office of Management and Budget" expects to release "the notice of proposed rulemaking for the Personalized Investment Advices Standard of Conduct" in October 2016.[1] The proposed rule "would require all brokers and advisers to provide financial advice in the best interests of the client."[2]

While the rulemaking proposal suggests that a new fiduciary standard is a top priority, there is a concern that the rule might not come out on time. The SEC declined to comment.[3]

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[1] *SEC's Fiduciary Standard Expected in October 2016*, InvestmentNews.com (November 23, 2015)

[2] *Id.*

[3] *Id.*

FINDING THE RIGHT CCO

On October 14, 2015, SEC Chief of Staff Buddy Donahue spoke at the NRS Annual Conference. His talk shed some light on the evolving role of the CCO position, and what firm's should be looking for in a CCO, chief among them being:

- Must be knowledgeable in the Rules and Regulations that apply to the firm's advisory business, and the requirements of various regulatory regimes in a firm's jurisdiction of operation
- Insight into the firm and its structure
- Clear understanding of how the firm identifies all of the conflicts of interest that might exist.
- Clarity on who the clients are and what products or services are provided
- Deep understanding of compliance and other technology platforms the firm is using
- Detailed knowledge of the policies and procedures of the firm
- Understanding of the various markets in which the firm operates. This may include specific practices of those markets and areas of concern.
- Strong familiarity with the firm's culture, belief that the client always comes first, and the firm will "do the right thing".
- Be able to challenge themselves and others to identify risks and establish open environment where tough questions can be asked.[1]

Investment advisers will succeed based on the efforts of key personnel—CCOs included. Advisers should be mindful of this non-exhaustive list of qualities in evaluating whether to trust a particular employee with administering the firm's compliance program as the CCO.

[1] *The Role of the CCO, Version 3.0*, National Society of Compliance Professionals, Inc. (November 2015)

CYBERSECURITY SAFEGUARDS FOR 2016

Cybersecurity is an important aspect for investment adviser compliance programs. As the holidays are wrapping up, many employees will be out of the office or working remotely—which creates a great opportunity for hackers to obtain private information.

Steps to strengthen your cybersecurity measures can include:

- Appointment of an information security manager to oversee data security and protection of personally identifiable information (the PII)
- Adoption and implementation of a formal written information security policy
- Encryption of any PII stored on its internal network
- Installation of a firewall and logging system to prevent and detect malicious intrusions
- Employment of a cybersecurity firm to provide ongoing reports, penetration testing, and advice on information technology security.[1]

We anticipate that cybersecurity will continue to be a hot-button issue for regulators as it was in 2015. For questions pertaining to the effectiveness of your firm's cybersecurity policy, please contact your Gordian consultant.

[1] *Don't be a Turkey: Recipes for a Successful and Cyberattack-Free Thanksgiving*, National Society of Compliance Professionals, Inc. (November 4, 2015)

SOFT DOLLARS: A PRIMER

Soft dollar use is a contentious issue for regulators given the potential conflicts of interest that arise in their implementation. What follows is a general primer to help understand soft dollar use, the conflicts it can trigger, and practical tips to assist in making the most of your potential soft dollar arrangements.

Definition & Conflict

The SEC defines soft dollar services as "arrangements under which products or services other than execution of securities transactions are obtained by an adviser from or through a broker in exchange for the direction by the adviser of client brokerage transactions to the broker."[1] Often times, the accumulation of soft dollar credits used to cover brokerage products results in advisers paying higher commission rates to brokers.

The higher commission paid for these products or services may influence an investment adviser's choice to execute trades with a particular broker, creating a conflict of interest between the investment adviser and how the adviser seeks best execution for client account transactions. To avoid any potential breach of fiduciary duty, advisers should follow the guidance put forth by the SEC in implementing any soft dollar arrangements.

Section 28(e) and the "Safe Harbor"

Section 28(e) of the Securities and Exchange Act of 1934 provides a "safe harbor" for advisers to implement soft dollar arrangements while maintaining the fiduciary duty to their clients. Advisers considering soft dollar use need to apply the following method of analysis when evaluating potential soft dollar arrangements:

1. Determine if the product or service falls within the criteria of eligible brokerage or research services under Section 28(e);
2. Determine if the products or services received provide appropriate assistance in the performance of an adviser's investment decision making process; AND
3. Make a good-faith determination that the amount of commission paid is reasonable in light of the value of the products and services.[2]

The SEC has provided some guidance to demonstrate when a product or service will fall under the Section 28(e) safe harbor[3]:

- **Brokerage Services**: Products and services that relate to "the execution of the trade from the point at which the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution, through the point at which funds are delivered or credited to the advised account."[4]

- **Research Services**: Products or services that cover "advice," "analyses," or "reports" within the meaning of Section 28(e)(3).[5] Such advice or reports tend to focus on the availability of securities, market/industry/economic factors, and mechanisms of security valuation. Under this methodology, research "related to the market for securities, such as trade analytics (including analytics available through order management systems) and advice on market color and execution strategies, are eligible for the safe harbor."[6] While research is a fairly broad category, the SEC has noted specific items that do not fall into the research category for the purposes of the safe harbor:
  - Physical items, such as computer hardware, which do not reflect the expression of reasoning or knowledge relating to the subject matter identified in the statute.[7]
  - Mass-marketed publications.[8]

Once the adviser has decided that the product or service fits the Section 28(e) safe harbor, they must determine if it provides assistance in the investment making process. Products or services that provide information and data regarding securities, valuation, or economic conditions will likely be eligible under the safe harbor because they provide assistance during the investment process. Products or services that provide no expression of knowledge, or products that maintain physical attributes, will not be eligible for soft dollar use. "Where research products and services have mixed use—i.e. certain of them appropriately assist in the decision making process with respect to clients while others do not—[the

adviser] should make a reasonable allocation of the cost of the product according to its use."[9] In the case of any mixed-used items (e.g. OMS systems, proxy services, etc.) a case-by-case determination must be made by the adviser given their unique functionality and properties. Expenditures on mixed-use items should be carefully documented to ensure that soft dollars are not used on ineligible products and services.

Finally, advisers must make a good-faith determination that the commissions paid to the broker are reasonable in light of the value of the product or services.[10] This obligation is satisfied where the adviser honestly believes that the amount of commissions paid are reasonable in relation to the value of the product or service, either in terms of the particular transaction or in the adviser's overall investment discretion responsibilities.[11] Upholding this good faith standard will depend on the value a particular product or service provides to each adviser's investment strategy.

Compliance Considerations

After determining if a particular soft dollar arrangement falls under the Section 28(e) safe harbor, advisers should be mindful of the additional compliance considerations.

First, appropriate disclosure of an adviser's soft dollar use should be made on the Form ADV Part 1 and 2, as well as in the offering documents for private fund managers. Second, advisers should outline a strong policy within their firm's compliance manual. This soft dollar policy should lay out the adviser's compliance with the Section 28(e) safe harbor, the steps taken to evaluate and revise the firm's yearly budget, and any mechanism used by the firm to monitor its soft dollar use.

Soft dollar arrangements can provide advisers with a great value and access to products and services that can tremendously raise the effectiveness of their advisory services. However, soft dollar use is not without its risks, and requires strong procedures in place to implement effectively. For any questions about soft dollar use, or any risk associated with your firm's policies, please contact your Gordian consultant.

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[1] *Release No. 1469*, United States Securities and Exchange Commission (February 14, 1995)

[2] 15 U.S. Code § 78bb(e); see also *Client Commission (Soft Dollar) Arrangements: The Section 28(e) Safe Harbor*, Proskauer Rose LLP (October 2011)

[3] *Release No. 34-54165*, United States Securities and Exchange Commission (July 24, 2006)

[4] *Id.*

[5] *Release No. 34-2370*, United States Securities and Exchange Commission (April 28, 1986)

[6] *Release No. 34-54165*, United States Securities and Exchange Commission (July 24, 2006)

[7] *Id.*

[8] *Id.*

[9] *Client Commission (Soft Dollar) Arrangements: The Section 28(e) Safe Harbor*, Proskauer Rose LLP (October 2011)

[10] *Id.*

[11] *Id.*

BROKER DEALER UPDATES

FINRA PROPOSES NEW "PAY-TO-PLAY" RULES FOR BROKER-DEALERS

On December 24, 2015, the Financial Regulatory Authority (FINRA) proposed rules that would places restrictions on certain political contributions of FINRA member broker-dealers.

Proposed FINRA Rules 2030 and 4580 "would regulate the activities of member firms that engage in distribution or solicitation activities for compensation with government entities on behalf of investment advisers."[1] The FINRA rules would closely resemble the SEC's own "Pay-To-Play" rules for investment advisers, established back in 2010. De minimis exemptions in the proposed rules would allow brokers contribute up to $350 in an election year and $150 in a non-election to political figures or offices.[2] If a broker chooses to contribute over these caps, they would be unable to solicit or transact business from the receiving government official or entity within a two-year period of the donation.[3]

Comment period for the rule extends 21 days from its publication in the Federal Registrar.

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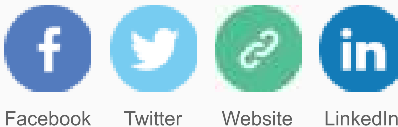
[1] *Notice of Filing of a Proposed Rule Change to Adopt FINRA Rule 2030 and FINRA Rule 4580 to Establish "Pay-To-Play" and Related Rules*, Release No. 34-76767, United States Securities and Exchange Commission (December 24, 2015)

[2] *Id.*

[3] *Id.*



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