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SEC REGULATORY UPDATES

First Half of 2017 to Feature Lean SEC; Mary Jo White Departs

The United States Securities and Exchange Commission (SEC) is one of many federal agencies caught in the middle of President-Elect Donald Trump's incoming sea change.

The SEC's current crop of commissioners indicates that the commission "will probably avoid controversial rulemakings and enforcement cases" for the time being.[1] The Senate adjourned its lame-duck session back in December without confirming two SEC commissioner nominees—Hester Peirce (R) and Lisa Fairfax (D).[2] Additionally, Chairwoman Mary Jo White announced back in November that she would be stepping down from her position, alongside four other SEC division directors.[3] "Chair White, who became the 31st Chair of the SEC in April 2013, will be one of the SEC's longest serving chairs."[4]

Heading into 2017, only Commissioner Michael Piwowar (R) and Commissioner Kara Stein (D) remain, with 3 vacant commissioner positions in total.[5] Registrants can expect scheduled exams to carry on, but large and transformative regulatory rulings look to be few and far between with SEC leadership in flux. At this time, it is unclear what regulatory impact the incoming administration will have on SEC exam priorities and new rule making—even in light of the President-Elect's comments regarding Dodd-Frank and the Department of Labor's proposed Fiduciary Rule.

However, change looks to be on the horizon. Yesterday, President-Elect Trump nominated Jay Clayton for the vacant SEC Chair position.[6] Clayton is a partner at Sullivan & Cromwell "and has represented some of the biggest names on Wall Street, including Goldman Sachs and Barclays, and helped them weather regulatory

scrutiny."[7] Clayton's Wall Street-friendly history marks a sharp divergence from an SEC regime that heighted enforcement efforts under White's direction. His nomination will be interesting to monitor as he moves through the Senate for confirmation.

[1] *SEC to Have Skeleton Crew in First Half of 2017*, Investment News (December 13, 2016)

[2] *Id.*

[3] *Press Release: SEC Chair Mary Jo White Announces Departure Plans*, United States Securities & Exchange Commission (November 14, 2016)

[4] *SEC to Have Skeleton Crew in First Half of 2017*, Investment News (December 13, 2016)

[5] *Id.*

[6] *Trump to tap Wall Street lawyer, Jay Clayton, to head SEC*, The Washington Post (January 4, 2017)

[7] *Id.*

Fourth Quarter Enforcement Actions

Several high-profile enforcement actions made headlines this past quarter:

- **Ernst & Young**: The SEC settled charges against the audit firm for more than $11.8 million, relating "to failed audits of an oil services company that used deceptive income tax accounting to inflate earnings."[1] According to the SEC's order, Ernst & Young "repeatedly failed to detect [Weatherford International's] fraud until it was more than four years ongoing." [2] Specifically, the "audit team was aware of post-closing adjustments that Weatherford was making to significantly lower its year-end provision for income taxes each year, but it relied on Weatherford's unsubstantiated explanations instead of performing the required audit procedures to scrutinize the company's accounting."[3] The Ernst & Young action highlights the importance for registered investment advisers, and compliance professionals, to ensure thorough diligence processes are applied for third-party vendors (on an initial and ongoing basis).

- **Weston Capital Asset Management**: The SEC charged former movie producer David R. Bergstein with defrauding investors through two unregistered hedge funds sponsored by Weston Capital Asset Management. [4] "[T]he SEC alleges that Bergstein misappropriated at least $2.3 million of money that was purportedly meant for investments in medical-billing businesses and helped Weston Capital Asset Management conceal the true nature of the transaction from Weston investors. In a second allegedly fraudulent transaction, Bergstein stole more than $3.5 million of funds also purportedly meant, in part, for investments in medical-billing businesses."[5] The assets allegedly stolen by Bergstein were used "for purchases with a firearms dealer, an antique watch and jewelry retailer, and a bonsai tree nursery."[6]

- **Cybersecurity Enforcement On the Rise**: On December 21, the Financial Industry and Regulatory Authority (FINRA) issued $14.4 million in fines to a dozen broker-dealers for alleged cybersecurity violations.[7] "Each of the 12 firms fined had 'deficiencies' in their WORM — or 'write once, read many' — format affecting millions, in some cases hundreds of millions of 'pivotal' records, according to FINRA. WORM format is required for business-related

electronic records under federal securities laws and FINRA rules because it's meant to prevent alteration and destruction of those records."[8] Wells Fargo & Co. and RBC Capital networks, RBS Securities Inc., SunTrust Robinson Humphrey Inc., LPL Financial, Georgeson Securities Corp. and PNC Capital Markets were among the firms fined by FINRA.[9]

[1] *Ernst & Young to Pay 11.8 Million for Audit Failures*, United States Securities & Exchange Commission (October 18, 2016)
[2] *Id.*
[3] *Id.*
[4] *Movie Producer Charged With Defrauding Hedge Fund Investors*, United States Securities & Exchange Commission (November 9, 2016)
[5] *Id.*
[6] *Id.*
[7] *FINRA slaps 12 Firms with $14.4 Million Fine for Cybersecurity Violations*, Investment News (December 21, 2016)
[8] *Id.*
[9] *Id.*

The SEC Solicitor Rule: Looking at Client Referral Arrangements

Growing one's client base is a fundamental issue facing today's investment advisers. However, advisers that enter into client referral arrangements may need to consider the regulatory and compliance ramifications of such agreements. What follows is a brief overview on the regulatory impact of third-party referral arrangements—or "solicitor" arrangements—for advisers looking to leverage these contacts into new client opportunities.

Controlling Law: Navigating the SEC's Solicitor Rule

Rule 206(4)-3 (Solicitor's Rule) under the Investment Advisers Act of 1940 (Advisers Act) generally prohibits the payment of "a cash fee, directly or indirectly, to a solicitor with respect to solicitation activities."[1] The key here is compensation —any agreement that provides compensation to an outside third-party, for the receipt of client referrals, will fall under the rule.

However, Rule 206(4)-3 goes on to allow client referral-for-compensation arrangements for registered investment advisers under the following narrow circumstances:

1. **Firm Employee**: The solicitor is a partner, officer, director or employee of the investment adviser.[2]
2. **Incidental to Advisor Services**: The solicitation activities are incidental to "impersonal advisory services," defined in the act as:[3]
   - Written materials or oral statements which do not purport to meet the objectives or needs of the specific client;
   - Statistical information containing no expressions of opinions as to the investment merits of particular securities; or

    - Any combination of the foregoing services.
3. **Solicitor Agreement/Disclosure**: Solicitor compensation is paid pursuant to a written agreement[4] between the solicitor and the investment adviser. Such an agreement must contain the following items:[5]
    - The scope of solicitation activities to be engaged on behalf of the investment adviser;
    - The terms of the solicitor's compensation arrangement;
    - An assurance that the solicitor will, at the time of any solicitation activities for which compensation is paid or to be paid by the investment adviser, provides the prospective client with a current copy of the investment adviser's written disclosure statement (i.e. the adviser's Form ADV Part 2A);
    - An assurance that the solicitor will provide potential clients with a separate written disclosure document (hereafter "Solicitor's Disclosure") outlining the adviser and the solicitor's arrangement.

Advisers should also take note that Rule 206(4)-3(b) outlines certain required provisions for the Solicitor's Disclosure to be offered to potential clients:[6]

1. The name of the solicitor;
2. The name of the investment adviser;
3. The nature of the relationship, including any affiliation, between the solicitor and the investment adviser;
4. A statement that the solicitor will be compensated for his solicitation services by the investment adviser;
5. The terms of such compensation arrangement, including a description of the compensation paid or to be paid to the solicitor; and
6. The amount, if any, for the cost of obtaining his account the client will be charged in addition to the advisory fee, and the differential, if any, among clients with respect to the amount or level of advisory fees charged by the investment adviser if such differential is attributable to the existence of any arrangement pursuant to which the investment adviser has agreed to compensate the solicitor for soliciting clients for, or referring clients to, the investment adviser.

Investment advisers must have a reasonable basis for believing that the third-party solicitors they work with are in compliance with the terms of the solicitor agreement.[7]

Additional Investment Adviser Compliance

Notwithstanding the aforementioned responsibilities of the solicitor, investment advisers are also subject to the following compliance practices under Rule 206(4)-3:

- **Signed Client Acknowledgement**: Investment advisers should receive a signed acknowledgement from any client referred by a third-party solicitor. The acknowledgement must be signed and dated, stating that the client has received the adviser's Form ADV 2A and required Solicitor Disclosure described above. Rule 206(4)-3 requires this acknowledgment to be executed before the client enters into a contract for advisory services.[8]

- **Disqualified Persons**: Rule 206(4)-3 prohibits the following disqualified persons from being a part of any third-party referral arrangement for compensation:[9]
    - An individual barred or suspended by the SEC under Section 203(f) of the Act from associating with an investment adviser;

- An individual convicted within the previous ten years of any felony or misdemeanor involving conduct described in Section 203(e)(2)(A) through (D) of the Act;
    - An individual who has been found by the SEC to have engaged, or has been convicted of engaging, in any of the conduct specified in paragraphs (1), (5) or (6) of Section 203(e) of the Act; or
    - An individual that is subject to an order, judgment or decree described in Section 203(e)(4) of the Act.

- **Form ADV Disclosure**: Investment Advisers that maintain third-party client referral arrangements for compensation must disclose those arrangements on Form ADV 1 (Section 7B.1 if they manage any private funds) and Form ADV 2A (Item 14).

Final Thoughts

Investment advisers that leverage third-party client referral relationships are in a unique position to reach a wide variety of clients. However, advisers should be mindful of the required practices under Rule 206(4)-3. As with many Advisers Act provisions, the SEC's Solicitor's Rule is written to provide transparency for advisory clients—to make investors aware of the services they are receiving and the fees tied to those services. Disclosure requirements of Rule 206(4)-3 are designed to mitigate conflicts of interest between solicitors and advisers, to ensure potential clients are informed as part of the adviser's overall fiduciary duty to its clients.

For firms considering the establishment of a third-party referral arrangement, please contact your Gordian consultant.

[1] 17 CFR 275.206(4)-3(a)

[2] It is important to note that executive officers and employees of the investment adviser are not outside third-parties. Thus, they are not subject to the Solicitor's Rule given their position at the investment adviser. As this article outlines, Rule 206(4)-3 only targets outside third-parties that receive compensation for client referrals.

[3] 17 CFR 275.206(4)-3(d)(3)

[4] Investment advisers should maintain copies of all third-party solicitor agreements as a required record under Rule 204-2 of the Advisers Act.

[5] 17 CFR 275.206(4)-3(a)(2)(iii)(A)

[6] 17 CFR 275.206(4)-3(b)

[7] 17 CFR 275.206(4)-3(a)(2)(iii)(C)

[8] 17 CFR 275.206(4)-3(a)(2)(iii)(B)

[9] 17 CFR 275.206(4)-3(a)(1)(ii)

OCIE Whistleblower Risk Alert

On October 24, 2016, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a risk alert focusing on Whistleblower compliance according to Dodd-Frank.[1] The OCIE's alert centered on "Rule 21F-173 under the Exchange Act, which provides that 'no person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement...with respect to such communications."[2]

As part of its Rule 21F compliance focus, the OCIE noted it's comprehensive examination of the following documents for whistleblower compliance:[3]

- Compliance Manuals
- Codes of Ethics
- Employment Agreements
- Severance Agreements

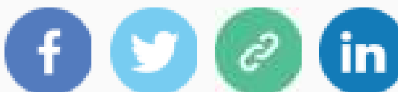
The OCIE noted that potential Rule 21F violations could occur if the above documents contain provisions that:[4]

- Require an employee to represent that he or she has not assisted in any investigation involving the registrant;
- Prohibit any and all disclosures of confidential information, without any exception for voluntary communications with the Commission concerning possible securities laws violations;
- Require an employee to notify and/or obtain consent from the registrant prior to disclosing confidential information, without any exception for voluntary communications with the Commission concerning possible securities laws violations; or
- Purport to permit disclosures of confidential information only as required by law, without any exception for voluntary communications with the Commission concerning possible securities laws violations.

The OCIE's risk alert serves as a helpful reminder that the SEC is carefully scrutinizing investment advisers to ensure proper whistleblower protections are afforded to firm employees. The risk alert coincides with a perceptible rise in whistleblower deficiencies and enforcement actions throughout 2016. Chief Compliance Officers and compliance professionals should review their current policies surrounding whistleblower reporting, and ensure the firm's practices comport with Rule 21F.

Please contact your Gordian consultant with any questions pertaining to your firm's whistleblower policies and procedures.

[1] *Examining Whistleblower Rule Compliance*, Office of Compliance Inspections & Examinations (October 24, 2016)
[2] *17 CFR § 240.21F-17*; *See also* *Examining Whistleblower Rule Compliance*, Office of Compliance Inspections & Examinations (October 24, 2016)
[3] *Examining Whistleblower Rule Compliance*, Office of Compliance Inspections & Examinations (October 24, 2016)
[4] *Id.*



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