Official Newsletter of Gordian Compliance Solutions, LLC.

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INVESTMENT ADVISER NEWS UPDATES

New Proposal to Delay DOL Fiduciary Rule

The United States Department of Labor ("DOL") issued a proposal to further delay the full application of the Fiduciary Rule for retirement account advisors until July 1, 2019.[1] The proposed rule would have no effect on the Fiduciary Rule's Impartial Conduct Standards, which are currently in place.

Under the DOL Fiduciary Rule, retirement account advisers, who provide investment advice for compensation must meet one of the rule's Best Interest Contract ("BIC") Exemptions, or the Principal Transactions Exemption, to avoid violating ERISA's prohibited transaction rules.[2] Adviser compensation structures will likely determine the applicable exemption, which among other things, may require advisers to inform clients of their fiduciary status, disclose any conflicts of interests, and receive no more than reasonable compensation.[3]

Currently, advisers to retirement accounts need only comply with the Fiduciary Rule's Impartial Conduct Standards, which went into effect on June 9, 2017. The Impartial Conduct Standards require advisers to act in the client's best interest, only receive reasonable compensation, and not make materially misleading statements.[4]

Inconsistencies and competing interests from investor advocates and industry professionals have continued to delay the Fiduciary Rule's applicability, creating confusion surrounding the DOL's enforcement policies. For example, the DOL recently stated it would not bring enforcement against advisers limiting a client's ability to participate in class actions or other court representative actions—an action which would ordinarily make BIC and other exemptions unavailable under the current rule.[5]

Gordian will continue to monitor developments surrounding the DOL Fiduciary Rule and issues updates as applicable.

[1] *Extension of Transition Period and Delay of Applicability Dates*, 82 Fed. Reg. 41365; see also *DOL Issues Proposed Delay of Fiduciary Rule Compliance Date and Enforcement Relief*, Morgan Lewis & Bockius LLP

(September 6, 2017)

[2] *Best Interest Contract Exemption*, 81 Fed. Reg. 21007 (to be codified at 29 C.F.R. Part 2550); see also *Upcoming DOL Fiduciary Rule Compliance Deadline*, Shartsis Freise LLP (June 1, 2017)

[3] *Id.*

[4] *Upcoming DOL Fiduciary Rule Compliance Deadline*, Shartsis Freise LLP (June 1, 2017)

[5] *Field Assistance Bulletin No. 2017-03*, United States Department of Labor (August 30, 2017): "Sections II(f)(2) of both the BIC Exemption and the Principal Transactions Exemption, which are currently scheduled to become applicable on January 1, 2018, make the exemptions unavailable if, *inter alia*, the financial institution's contract with a retirement investor includes a waiver or qualification of the retirement investor's right to bring or participate in a class action or other representative action in court."

OCIE Issues Advertising Risk Alert

On September 14, 2017, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued an advertising risk alert relating to Rule 206(4)-1 of the Investment Advisers Act of 1940.[1] The alert focused on issues surrounding the OCIE's "Touting Initiative" which examines investment advisers "use of accolades in their marketing materials"[2] as well as issues frequently identified in deficiency letters to SEC-registered advisers ("advisers").

The Touting Initiative is designed to ensure that advisers disclose all necessary material facts when using accolades in describing their advisory business, to prevent potential clients from receiving misleading information about the firm's status or performance. Potentially misleading accolades include awards or rankings, professional designations, and testimonials. The OCIE's risk alert noted the following compliance violations uncovered by the Touting Initiative:[3]

Violations regarding third party awards and rankings

- Publishing stale rankings that no longer reflect the adviser's current status
- Submitting false information in award applications
- Failing to disclose the selection criteria for awards
- Failing to disclose who conducted the survey and whether a fee was paid to participate

Violations regarding professional designations

- False or misleading references in Form ADV Part 2B Brochure Supplements
- Lapsed professional designations
- Failing to explain the minimum qualifications required for the designation

Violations regarding client testimonials

- Publishing client endorsements of the firm's services in firm websites, social media pages, reprints of third party articles, or pitch books.

In addition, the OCIE's alert also highlights six common areas where advisers failed to comply with Rule 206(4)-1:[4]

1. Advertising performance results that exclude advisory fees or comparing performance results to benchmarks that were materially different from the advertising strategy.
2. Conducting misleading one-on-one presentations where performance results don't include fees and other expenses.

3. Claiming to comply with voluntary performance standards such as the Global Investment Performance Standards ("GIPS") that were not in fact adhered to. [5]
4. Only mentioning profitable stock selections in presentations, newsletters, and websites while omitting unprofitable selections.
5. Partially listing profitable stock recommendations without listing an equal number of unprofitable selections[6] and failing to disclose that recommendations listed did not reflect all securities invested while advertising the profits realized by the partial list of recommendations.[7]
6. Failing to implement compliance policies and procedures such as reviewing advertising materials before publication; determining parameters for which accounts are included or excluded from performance calculations; and confirming the accuracy of performance results.

Given the SEC's focused attention on advertising compliance, advisers are urged to keep these concerns in mind and either remove misleading language from their advertisements or add disclosures that prevent their advertisements from being misleading

[1] *The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers*, Office of Compliance Inspections & Examinations (September 14, 2107).

[2] *Id.*

[3] *Id.*

[4] *Id.*

[5] *ZPR Investment Mgmt., Inc.*, Advisers Act Rel. No. 4249 (October 30, 2015) (SEC Opinion)

[6] *The TCW Group*, SEC Staff No-Action Letter (November 7, 2008)

[7] *Franklin Management, Inc.*, SEC Staff No-Action Letter (December 10, 1998)

Compliance in Advertising: Charts, Graphs, Formulas and Other Devices

Gordian's Compliance in Advertising series takes a look at specific marketing and advertising issues that arise under Rule 206(4)-1 and other relevant SEC guidance. We hope our in-depth look at specific advertising issues can assist investment advisers and financial industry professionals in developing informative marketing materials and practices that withstand regulatory scrutiny.

This current installment focuses on the SEC's prohibition against the use of unqualified charts, graphs, formulas and other devices.

The Advertising Rule: 206(4)-1(a)(3)

Under the Investment Advisers Act of 1940, Rule 206(4)-1(a)(3), the SEC will consider advertisements to be fraudulent or manipulative if they represent:

"...directly or indirectly, that any graph, chart, formula or other device being offered can in and of itself be used to determine which securities to buy or sell, or when to buy or sell them; or which represents directly or indirectly, that any graph, chart, formula or other device being offered will assist any person in making his own decisions as to which securities to buy, sell, or when to buy or sell them, without prominently disclosing in such advertisement the limitations thereof and the difficulties with respect to its use.[1] "

For discussion's sake, this article will consider graphs, charts, formulas and related devices under the catch-all of "visual aids" as this is the most common scenario under which advisers run up against Rule 206(4)-1(a)(3). Further, breaking down Section (a)(3)'s restrictions on visual aids can help us focus on the following three areas:

- Visual aids should not "in and of themselves" be used to determine which securities to buy or sell, or when to buy or sell;
- Visual aids cannot be used to assist clients in making any investment decisions;
- Visual aids must prominently disclose their limitations.

With these restrictions in mind, it's clear the focus of Rule 206(4)-1(a)(3) rests with providing sufficient context for visual aids in advertising materials. The discussion that follows provides some practical guidance in ensuring these visual aids provide essential context.

Clarifying Visual Aids: Avoiding Section (a)(3) Pitfalls

Unlike testimonials or past specific recommendations, which are covered elsewhere in Rule 206(4)-1,[2] the language of Section (a)(3) paints visual aids in broad strokes. Therefore, Chief Compliance Officers and other compliance professionals should take care when assembling or using these items in firm advertising materials. Given Section (a)(3)'s focus on providing appropriate context for visual aids and their limitations, the following provides a rundown of common issues that arise when preparing these materials:

- **Attribution & Sourcing**: Proper attribution and source credit for information in visual aids (even if compiled through proprietary methods) provides clients or investors with additional information to evaluate the credibility of the data presented. Where the visual aid is a model created through proprietary means, limitations, assumptions, or key variables used in creating the model should be explained.
- **Clear Labels, Legends, or Keys**: For graphs or charts with axes and other symbols, it's imperative that these items be properly defined. Keys or legends may be useful to help orient clients.
- **Date Range**: Timing may be a material limitation on the data presented. This is an item that should always be included for a visual aid.
- **Market Index Comparisons**: When comparing client accounts, composites, or fund performance against market indices, it is critical that advisers note the inherent limitations resulting from that comparison. A non-exhaustive list is as follows:
  - Unmanaged indexes have different instrument compositions (they may be more diversified);
  - Indexes are not charged advisory fees/expenses;
  - Client portfolios may include options or other derivatives not tracked on an index.

The takeaway for compliance professionals is that market indexes will not be a one-to-one match against client accounts, and such facts should be disclosed prominently.

- **Material Market Events or Limitations**: Any relevant market events or trends that could affect the data presented may be necessary to include with the visual aid.
- **Avoid Promises, Guarantees, and Recommendations**: Under no circumstances should visual aids provide a promise, guarantee, or recommendation to buy or sell and specific security at a given time.

- **Applicable Disclosure Language**: Many of the items discussed above can be explained or clarified through carefully drafted disclosure language. While there is not a "one-size-fits-all" disclosure statement that will satisfy all visual aids—disclosures will be content specific—but it's always important to note that such visual aids are provided for informational purposes only and should not be relied upon when making an investment decision.

Final Thoughts

As with all advertising materials, providing appropriate context for the limitations surrounding visual aids requires thorough compliance review. Chief Compliance Officers should ensure their review approaches visual aids with a critical eye towards Rule 206(4)-1(a)(3), and from the perspective of what a client or an investor may need in order to have the necessary context surrounding these materials. Above all, this is one area where over disclosure can mitigate confusion, while providing advisers with an engaging method to discuss their advisory business.

[1] Rule 206(4)-1(a)(3)

[2] And corresponding guidance from the SEC.

Expanded Form ADV Available

Investment advisers may now use the updated Form ADV, effective as of October 1, 2017.[1]

Back in our July newsletter, we noted the United State Securities & Exchange Commission ("SEC") provided a redlined document describing the new changes to Form ADV, which can be accessed here.

As noted in SEC Release IA-4509, the updated Form ADV will require investment advisers to provide additional "information about their separately managed account business, [and] incorporate[s] a method for private fund adviser entities operating a single advisory business to register using a single Form ADV…"[2] among other clarifying and technical amendments.

The SEC has also updated its FAQ page to include the recent Form ADV Part 1 changes as of June 20, 2017. Investment advisers should review both the new FAQs and the SEC's redlined document to see what, if any, impact the updated Form ADV Part 1 will have on their internal reporting processes.

No immediate action is required as of this time (unless changes to your business necessitate an other-than-annual amendment).

Advisers will likely encounter the expanded Form ADV as part of their firm's annual amendment, which must be filed within 90 days of the fiscal year end.

[1] *Release IA-4509*, United States Securities & Exchange Commission (August 25, 2016)

[2] *Id.*

Enforcement Actions

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

- **Jeremy Drake Fee Scam**: The SEC charged investment advisor Jeremy Drake for lying to a high-profile couple regarding management fees. Drake said he would charge the clients a "VIP" annual rate of 0.15 to 0.20 percent of assets under management but actually charged them 1 percent, resulting in an overcharge of $1.2 million.[1] To hide the fraud, Drake sent false and misleading emails, deceptive fee reports, and other fabricated documents. When questioned by the clients about the overcharge, he proceeded to create a fake persona to corroborate his story. The SEC is seeking a permanent injunction, return of ill-gotten gains plus interest, and penalties.
- **Deerfield Insider Trading**: Hedge fund advisory firm Deerfield Management Company, L.P. ("Deerfield") settled a SEC insider trading investigation for $4.6 million given evidence that it knew the political research firm it hired received insider information from a government employee.[2] The SEC charged Deerfield with failing to "establish, maintain, and enforce policies and procedures reasonably designed to prevent the misuse of insider information"[3] by conducting "only an initial review of the research firm's own policies and procedures."[4] This case is a good reminder that firms must maintain and enforce effective policies and procedures for engaging with third-party vendors.
- **Federal Employee Benefits Counselors**: The SEC charged brokerage firm Federal Employee Benefits Counselors ("Benefits Counselors") with fraudulently inducing federal employees to roll their federal Thrift Savings Plan ("TSP") retirement funds into higher-fee, variable annuity products.[5] Benefits Counselors falsely claimed to be affiliated with the federal government and misled investors about fees and returns. Using these tactics, the firm sold approximately 200 annuities with a value of $40 million and made $1.7 million in commissions. This enforcement action is a reminder of the SEC's increased focus on protecting retiree investments under the Retirement Targeted Industry Reviews and Examinations ("ReTIRE") initiative.
- **DAO Report**: In its investigative report on the Decentralized Autonomous Organization ("DAO"), the SEC stated that digital tokens are securities and require registration under federal securities law unless a valid exemption applies.[6] All issuers of distributed ledger or blockchain technology based securities must comply with this new standard. The SEC did not to charge or fine the DAO in this case, but instead opted to inform markets that the virtual nature of such offerings does not remove the need for securities regulation.

[1] *SEC Charges Investment Adviser With Defrauding Professional Athlete and His Wife*, United States Securities & Exchange Commission (August 22, 2017)

[2] *Hedge Fund Adviser Charged for Inadequate Controls to Prevent Insider Trading*, United States Securities & Exchange Commission (August 21, 2017)

[3] *Id.*

[4] *Id.*

[5] *SEC Files Fraud Charges Against Former Brokers Targeting Federal Retirees*, United States Securities & Exchange Commission (August 21, 2017)

[6] *SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities*, United States Securities & Exchange Commission (July 25, 2017)

Website

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