BEST OF 2015
NSCP ✦ CURRENTS

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FOR COMPLIANCE ✦ BY COMPLIANCE

BEST OF 2015

The Publications Committee is proud to present NSCP's annual "Best of" for 2015. For the past several years, we have looked back at everything published during a particular year, and chosen articles that showcase issues raised during that year, and 2015 is no exception. While our selection certainly doesn't cover everything discussed in the compliance and regulatory forum this year, they are representative of some of the challenges we all face regardless of our respective business lines.

On behalf of the entire NSCP membership, the Publications Committee thanks all of our authors for their outstanding contributions to *Currents* this year. We value your time and expertise, and hope you will consider writing for us again in the future. Speaking of writing and 2016, we are always looking for authors to share their experience and skills with all of us, and you don't need an invitation. Contact currents@nscp.org, and give us an idea of what you'd like to write about. Don't forget to consider partnering with a colleague. It's a great way to share in more ways than one!

Finally, let us know what you'd like *Currents* to cover this year. We all need to stay tuned into the regulatory landscape and not be distracted by the noise of the presidential race, and the only way we can do that is to know what you are thinking!

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WHAT'S NEW!

Are you a compliance professional with 1-5 years experience in the financial services industry looking to network with peers of similar experience? NSCP is establishing a Young Professionals Roundtable for NSCP members, and for non-members a six-month trial basis. The roundtable will meet telephonically. The inaugural meeting call will take place Thursday, February 11, 2016 from 1:00 pm - 2:00 pm. EST. If you are interested in joining the Roundtable please contact Kim McNutt at kim@nscp.org.

UPCOMING WEBINAR!
Thursday, February 11, 2016 :: Time: 2:00 – 3:00 p.m. EST
Blind Spots in Operational Risk
Are blind spots in your firm's operational processes leaving you open to regulatory risk?

NSCP and Assette have teamed up to offer a webinar designed to help you identify common blind spots in data gathering and communications that can leave your firm open to operational risk and regulatory scrutiny. This one-hour webinar will feature experts in compliance and regulatory oversight: Richard Kerr, a partner in the law firm of K & L Gates LLP and Amy Jones, CIPM, founder and principal at Guardian Performance Solutions LLC.

Recent webinar recordings are available under Member Resources once you log into your NSCP account.

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TORONTO :: April 4, 2016 — Canadian Conference – Stickhandling Compliance Challenges

DENVER :: April 18, 2016 — Juggling Compliance Risks – Maintaining the Balance

CHICAGO :: May 2, 2016 — Contemporary Compliance: From the Foundation Up

NEW YORK :: May 17, 2016 — Juggling Compliance Risks – Maintaining the Balance

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SAVE THE DATE for our 2016 National Conference in Washington, D.C. October 17-19, 2016

The Misnomer about Cyber

By Andrew J. Fotopulos & E.J. Yerzak

Originally Published March 2015

When investment advisers use the cloud, they are making a conscious, informed decision to outsource tasks to vendors who may have particular expertise or infrastructure in place to handle such tasks. From hosted email archiving to compliance reporting, and from hosted back- ups to client communication portals, moving data to the cloud can help many firms address business needs while enabling them to focus more on their core business – providing investment advice. However, the Securities and Exchange Commission has made it clear that while financial professionals can outsource processes, they cannot delegate the ultimate responsibility for the performance of those functions. After all, it is the investment adviser who is in the trusted position of a fiduciary with respect to the adviser's clients.

It is a mistaken assumption that if the cloud provider has a failure such as a data breach, outage, or failing to perform the contracted level of service, the cloud provider bears all the blame as well as all costs the adviser may suffer as a result of the vendor's failure. During our initial conversations with firms within the investment community, we discover a misguided belief that their liability is eliminated when utilizing a cloud provider. This article addresses that misnomer and ways to protect your firm.

From contractual arrangements pertaining to data breach expenses to encryption of data by cloud providers, and from written assurances to insurance, here are 10 tips to protecting and transferring risk.

1. Inventory and Classify Your Data

Know what data your firm collects, processes, and maintains. Does it contain personally identifiable information (PII) about your clients? Have you classified your data based on its con- tents (e.g. public, sensitive, or confidential)? In which states do your clients reside? State regulations may differ with respect to their definitions of PII.

2. Inventory Your Systems

Understand what computing systems you have, and where your data is stored on such systems. Which information is stored in which places?

3. Perform a Gap Analysis

Are your information safeguards for various systems com- mensurate with the level of protection required for the type of data stored on these systems? What do your policies and procedures require with respect to encryption and access controls? Are you complying with your stated procedures?

4. Identify the Business Need

If considering a third party service provider, establish a sound business case for the use of the vendor. Moving data to a hosted environment, for example, may save the firm money in terms of office space for server equipment and the need for in-house IT expertise to update and maintain the hardware. You may be considering the vendor to mitigate business continuity and disaster recovery risk because the vendor may have more resilient backup processes or be better positioned than your firm as an adviser to detect and respond to network intrusion events.

5. Know Your Risk Management Options

Risk assessments and gap analyses are useful in identifying the vulnerabilities and risks of your firm, and which can be addressed by implementing additional controls or outsourcing functions to a third party provider. Generally, risks can be addressed through four means: (1) avoiding the risk, (2) accepting the risk, (3) mitigating the risk, or (4) transferring the risk. Avoiding risk is difficult and generally involves abstaining from a line of business or practice associated with the risk. Third party service providers can assist in mitigating risk. Firms can also choose to transfer some risk to another party, such as through one or more insurance policies. Finally, firms may be forced to accept certain risks at the point when the cost of additional controls exceeds the expected liability for a security incident.

6. Map Data Flows and Information Sharing

Know what information you will be sharing with the third party service provider. Does it contain personally identifi- able information (PII) about your clients? Does it contain sensitive intellectual property belonging to your firm? If a breach does occur, you will want to know the general nature of the information which was compromised in order to properly assess response strategies.

7. Do Your Due Diligence

Your clients entrust you with their information, and they expect you to safeguard it from misappropriation and misuse. It is therefore critical that you perform adequate due diligence on any third party service provider you are considering granting access to this information. Ask sufficient questions in order to obtain assurances that the service provider will safeguard the data, such as the following:

- Does the vendor encrypt your data in transit and at rest?
- What is the vendor's privacy policy?
- Does the vendor have an adequate business continuity plan?
- What information security controls does the vendor have in place? Review the vendor's SSAE-16 or other similar internal controls report, if available to you.

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8. Review Service Level Agreements

It is imperative that you review Service Level Agreements (SLAs) carefully and ensure that you understand what the vendor is promising in terms of uptime, availability, and responsiveness. The contract negotiation stage is the best time to document in writing whether and how promptly the vendor will notify you in the event of a breach or incident impacting its systems, and which parties are liable for breaches and related expenses when the data is stored on the vendor's systems.

9. Monitor Third Party Providers

Ongoing monitoring and due diligence is essential to obtain assurances that your vendors are adhering to their SLAs, and that any changes in the vendor's business, operations, hiring practices, or financial condition do not adversely impact your firm's ability to serve your clients. Periodically assess whether your vendors have experienced any data breaches or cybersecurity incidents.

10. Consider Transferring Risk

After your firm's risks have been addressed through cost-effective controls, what remains is called residual risk. If the residual risk is more than your firm is willing to accept as within its risk appetite, transferring some risk to another party through one or more insurance policies may be appropriate. You may have coverage for certain types of risks under Directors and Officers (D&O) policies, Errors and Omissions (E&O) policies, and general liability policies. However, some specific risks such as cybersecurity breaches at your firm or at your third party vendors may fall outside the scope of coverage provided by these policies, and you may wish to consider a Cyber Liability Policy to offer protection to your firm. Please see the following discussion of important things to consider in a Cyber Liability Policy. ✦

UNDERSTANDING THE SCOPE OF A CYBER LIABILITY POLICY

Yerzak: *Are regulatory defense costs, fines, and penalties covered under a Cyber Liability Policy?*

Fotopulos: The answer is case by case or policy by policy. However, the majority of policies provide coverage for defense costs and fines/penalties for violations of privacy regulations, including the Identity Theft Red Flags Rule.

Yerzak: *Is there first party coverage (financial harm to you, the insured financial institution) or third party coverage (damages to others based on your actions or inaction)? What about coverage for external hackers, coverage for malicious insiders, or inadvertent breaches by employees?*

Fotopulos: Again, this is a (insurance) policy by policy consideration when determining which insurance protections to purchase for your firm. The policies for Cyber Liability are not generic and are ever evolving. Another issue to consider when deciding among policies is what coverage may already be in place under other insurance policies such as a Fidelity Bond or D&O/E&O Liability policy as to whether you need these coverages under your Cyber Liability Policy. For instance, the primary intent of a Fidelity Bond or Commercial Crime Policy is to protect your firm against financial loss due to a dishonest act of an employee. The D&O (Directors & Officers Liability) policy is designed to protect your firm against loss for issues such as lack of due diligence or breach of duty by your firm and its employees. In other words, what due diligence have you done to ensure that your clientsí personally identifiable information is secure with the vendors or independent contractors utilized?

Yerzak: *What minimum insuring agreements should be included?*

Fotopulos: Again, this is a factor influenced by the existence of other insurance contracts you may have in place. Some of the basic insuring agreements under a Cyber Liability Policy include Network Security & Privacy, Breach Response Costs, Network Asset Protection, Reputational Expense, Regulatory Defense & Penalties, Multimedia Insurance, as well as Cyber Extortion and Cyber Terrorism. Buyer beware, all insurance policies have an "other insurance" provision within the policy that states that their policy may not apply or only apply as excess to any other collectible insurance policy. Coordinating coverage can prevent disputes among carriers.

Yerzak: *Does the adviser need to encrypt everything in order to be approved for a policy?*

Fotopulos: Whether the insurance policy itself goes into "encryption" requirements or not, every policy has what we refer to as the "Uniform Commercial Code" Exclusion. Common policy language states, there is no coverage for loss based upon, arising from, or in any way involving the actual or alleged government enforcement of any state or federal regulation including, but not limited to, regulations promulgated by the United States Federal Trade Commission, Federal Communications Commission, etc. Article 4A, under the Uniform Commercial Code requires encryption when it comes to Wire Transfers.

Yerzak: *Generally, who should report a cybersecurity incident to the carrier, and what is the timing for such reporting?*

Fotopulos: There is no standardized wording but the more narrow the definition of "who becomes aware of the situation" before the reporting requirement kicks-in, the better. Some policies state that you have to report within 60 days when an employee becomes aware of the event that may cause a loss. If the event is not immediately brought to the attention of the person familiar with the insurance policy requirements, policy provisions may be violated thus void coverage. Other insurance policies state that the Risk Manager, General Counsel, or a senior officer or director of the firm must first become aware of the event before the reporting provision clock starts ticking. This is also where your firm's Written Policies and Procedures' escalation requirements need to be coordinated with your insurance policy reporting provisions. Coverage for forensic investigation and data breach notification costs are essentials when purchasing a Cyber Liability Policy, but you need to be aware of whether or not the limits are within or in addition to the policy limit of liability. Specific to data breach notification, there may be restrictions in terms of the number of individuals, records or a sub-limit of liability that applies.

Yerzak: *Are policies calculated based on number of clients, number of records, number of employees, type of data?*

Fotopulos: The insurance industry has not come-up with a unified method of determining the cost for this policy. Employee count, records, transactions, and annual revenues are some of the various factors insurer's utilize to rate a risk. The key is coordinating your various insurance policies to ensure you have the right protection for your unique risk and that the firm's Written Policies and Procedures are coordinated with your insurance policies. Due diligence is a continuous process and needs to be performed at many and various levels not only to properly protect your firm but you as CCO.

So You Have a Canadian Client For Your Funds – Now What?

By Matthew P. Williams

Originally Published March 2015

With so many Canadian pension plans and other institutions shifting their investment mix to include more offshore products, foreign fund managers are increasingly looking to Canada to sell their products. But be careful before you do, as you will have to navigate the securities regulatory landscape in Canada. Even the simple task of marketing your fund to a Canadian investor can put you offside the law, if you don't have a dealer that is authorized or exempt in the relevant jurisdiction of Canada with you at the pitch meeting(s). And with certain pre- and post-closing filings that must be made, the regime in Canada has several steps which foreign managers can easily miss.

The various registration, disclosure and filing obligations that exist when selling funds into Canada are not particularly onerous. However, they must be complied with or you risk regulatory sanctions in Canada that are likely also reportable to your home regulator. In this article, we highlight the key areas that often trip up foreign managers.

Securities laws in Canada are regulated at the provincial level. Accordingly, the requirements set out below must be reviewed and, if applicable, met in each province and territory of Canada in which prospective investors reside. For the most part, these laws are harmonized; however there are some differences that need to be considered if a fund product is marketed to investors in multiple provinces and territories.

The prospectus regime

In Canada, as elsewhere, interests in funds are securities. Absent an exemption, sales of securities to investors in Canada may only be made by way of a prospectus that has been vetted by the applicable Canadian securities regulatory authority, and there are investment restrictions and ongoing regulatory compliance and reporting requirements applicable to funds (and their managers) that are sold to the general public.

Much like in the U.S., there are a variety of exemptions from the above prospectus requirement available in Canada that can be used for the private placement of fund products to investors. Chief among these for funds are the exemptions for sales to accredited investors (without any minimum purchase requirement) and/or to non-individual investors purchasing securities of a single class or series with an aggregate purchase price of C$150,000 or more. Accredited investors include financial institutions, pension funds, government agencies, various entities and high net worth individuals.

Registration of the fund manager and intermediaries – Dealer Registration

The marketing of securities in Canada to prospective investors is, broadly speaking, a registrable trading activity for which the entity that is doing the marketing – be it the fund, the fund manager or an intermediary (e.g. a placement agent) – could require registration as a dealer with the applicable securities commission(s), or an exemption therefrom. (The manager of the fund that is being marketed in Canada may also become subject to a separate registration requirement – in the category of "investment fund manager" – as a result of these marketing activities, even if it is not doing the marketing. That is outlined in more detail below.)

The need for dealer registration in Canada is determined via a "business trigger" test. An entity that is "in the business" of trading in securities must be registered as a dealer (or avail itself of an exemption from same), or act solely through an agent who is so registered or exempt.

Open-ended "investment funds" (or closed-end "investment funds" when in the course of their distribution period) are generally considered to be "in the business" of trading in securities in Canada, and so must ensure that they – and their agents – are aware of the dealer registration requirements. An "investment fund" is, essentially, a commingled vehicle that holds a basket of underlying issuers for passive investment purposes. It does not invest for the purposes of exercising or seeking to exercise control of an issuer in which it invests or being actively involved in the day-to-day management of such an issuer. Broadly speaking, "investment funds" encompass typical '40 Act' funds, other pooled and hedge funds and UCITs, among others. Venture capital funds, private equity funds and real estate/infrastructure funds would likely not be considered to be "investment funds" under Canadian law and, as such, are not generally deemed to be in the "business of trading" in securities in Canada, though that doesn't mean that the manager and/or any intermediaries involved in their marketing in Canada automatically avoid registration! There are a variety of factors that must be examined in each case to determine what parties are caught by the rules – and to what extent.

While the actual distribution of fund interests to an investor in Canada is certainly caught by the definition of "trading" (and thus will generally require that the distribution be processed through a dealer that is registered or exempt in Canada to transact in such interests), any act, advertisement, solicitation, conduct, or negotiation – directly or indirectly – in furtherance of that distribution is also caught.

Accordingly, firms and individuals that participate in the marketing and sale of a fund's securities to potential investors in Canada must determine whether they trigger the dealer registration requirement in the relevant jurisdiction(s) of Canada, and, if they do, they must register as a dealer in the applicable jurisdiction(s) (or be exempt from registration) or the fund must be sold through another third party registered dealer, where required. The most common of these exemptions is the so-called "international dealer exemption" which permits registered dealers (e.g., FINRA members) to market, sell and distribute non-Canadian funds to institutional and super high net-worth investors in Canada.

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It is important that foreign fund managers do not market their funds directly to potential investors in Canada without the involvement of a registered or exempt placement agent where required, unless they themselves are registered or exempt. Note that it may not be enough to bring a registered dealer into the equation only for the purpose of closing the investment. If relying on the dealer registration/exemption of an intermediary, it will be important to involve them in the marketing process as well – involving a dealer of record to "bless" the trade after the marketing and offer have already been initiated does not cleanse the lack of required registration at the marketing stage.

Registration of the fund manager and intermediaries – Investment Fund Manager Registration

Another registration requirement that must be examined when selling funds into Canada is whether the entity that directs the business, operations or affairs of an "investment fund" that is marketed and sold in Canada requires registration as an "investment fund manager". The regime is similar to the AIFMD regime in Europe, in that Canada regulates the administrative manager of the fund, except that Canada has generous exemptions from registration when dealing only with institutional investors.

In 3 provinces of Canada (Ontario, Québec and Newfoundland & Labrador), simply having a fund investor resident in the province triggers the requirement for the manager of the fund to register as an investment fund manager or find an exemption from it (in the remaining jurisdictions of Canada, foreign managers will typically not trigger the registration requirement).

There are only 2 exemptions from the investment fund manager registration requirement in the above 3 provinces – (i) where neither the manager nor the funds has actively solicited investors in the relevant province(s) since September 28, 2012 (or paid any third party to do so) or (ii) where active solicitation has taken place, but the fund is only marketed and sold in the above province(s) to investors that qualify as "permitted clients" (essentially, a QIB or QP standard). The exemption referred to in (ii), above, requires that certain filings be made to the authorities in order to rely on it, which must be renewed annually, and you will pay fees in Ontario to maintain it each year.

Registration of the fund manager and intermediaries – Adviser Registration

Finally, portfolio managers to investment funds must consider whether they require registration themselves as an adviser in Canada. Generally, they do not. This is because where both the portfolio manager and the fund are domiciled outside of Canada and all portfolio management activities take place outside of Canada, adviser registration is not triggered. However, advisers outside of Canada who wish to offer their services to Canadians through separately managed accounts must either register as an adviser in Canada or rely on an exemption from such registration that is available to "international advisers" or to certain non-resident sub-advisers to registered portfolio managers in Canada.

Disclosure, Reporting and Filing Obligations

There are certain pre- and post-closing disclosure and filing obligations that exist when selling funds into Canada especially where an offering document is provided to prospective investors.

There is no *requirement* in any province or territory of Canada to provide an offering memorandum (OM) or equivalent disclosure document to an investor in connection with the sale of a fund where the prospectus exemptions discussed earlier in this article are used. However, in most provinces of Canada, where a document that meets the definition of an OM under Canadian securities laws is provided to an investor in connection with the sale of fund units (e.g., to an accredited investor), there will be statutory liability for any misrepresentation in that OM. Most foreign offering documents will meet such definition. In many of these provinces, these statutory rights must actually be described in the OM itself. This is customarily accomplished through a Canadian supplement or "wrapper" to the OM, so that the non-Canadian offering document need not be amended for Canadian investors. The wrapper also contains certain representations and warranties that the manager and the fund will want from its Canadian investors, as well as certain disclosures that the fund and/or manager must make to such investors.

Certain provinces also require that any OM (and its concomitant wrapper) be formally filed with the securities regulatory authority in that province after closing.

Finally, sales of fund units in Canada must typically be reported to the securities regulatory authority in each province in which it was sold by completing a detailed form. There are filing fees in most provinces for this filing. In certain provinces, late fees may also be applicable.

In addition to the above, there may be monthly filings under Canadian anti-money laundering legislation in connection with the manager's activities in Canada. ✦

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Marketing and Advertising Considerations for Investment Advisers

By Mark Lawler and Robert Walters

Originally Published April 2015

Registered investment advisers under the Investment Advisers Act of 1940 ("Advisers Act") will likely engage in marketing or advertising activities that require knowledge of and compliance with Rule 206(4)-1 under the Advisers Act (the "Advertising Rule") and related guidance from the U.S. Securities and Exchange Commission ("SEC") concerning advertising and marketing issues. Communicating with prospective clients and investors is a critical component of many advisers' business development programs. To accomplish this, firms employ materials such as presentation (or pitch) books, requests for proposals ("RFPs"), due diligence questionnaires ("DDQs"), quarterly newsletters, strategy fact sheets, and websites, to name a few.

In this article, we examine Advisers Act requirements and SEC guidance regarding an adviser's use of marketing materials with prospective clients. We also provide information on common SEC examination deficiencies and discuss a few recent SEC enforcement cases.

The Advertising Rule

The Advertising Rule prohibits investment advisers from distributing advertisements that contain any or all of the following content:

1. A testimonial of any kind concerning the investment adviser or relating to the advice or services provided by the adviser;
2. Past specific recommendations of the investment adviser that were or would have been profitable unless the adviser provides all recommendations for the preceding year with certain disclosures;
3. Graphs, charts, formulas, or other devices represented as being able to determine which securities to buy or sell;
4. Statements to the effect that any report, analysis, or other service will be provided free of charge unless these items will be provided entirely free and without any obligation; and
5. Any statements that are untrue regarding a material fact or otherwise false or misleading.

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The Advertising Rule defines an advertisement as:

> any notice, circular, letter, or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers (1) any analysis, report, or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (2) any graph, chart, formula, or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (3) any other investment advisory service with regard to securities.

Testimonials

As noted above, the Advertising Rule prohibits the use of testimonials in advertisements because they can imply or infer falsely or in a misleading manner that the experience of the individual providing the testimonial is typical of the experience of all the adviser's clients. One example of a client testimonial would be a direct quote from a client stating his or her approval of the adviser.

In social media, such testimonials can take a different form. In this regard, a January 2012 OCIE National Examination Risk Alert titled "Investment Adviser Use of Social Media" states the following:

> "The term "testimonial" is not defined in Rule 206(4)-1(a)(1), but SEC staff consistently interprets that term to include a statement of a client's experience with, or endorsement of, an investment adviser. Therefore, the staff believes that, depending on the facts and circumstances, the use of "social plug-ins" such as the "like" button could be a testimonial under the Advisers Act."

As a result, advisers should consider implementing a policy requiring employees to disable the endorsement feature on websites like LinkedIn to reduce the risk of violating the Advertising Rule.

Regarding other online advertising, the SEC recently cited an adviser for including various testimonials on its website from executives of portfolio companies. The executives made statements that complimented the adviser on its management skills and ability to create and maintain successful short and long-term support relationships with portfolio companies.

The SEC opined that these statements, which described a service provided by the adviser, constituted testimonials prohibited under the Advertising Rule because they were implied endorsements.

Past Specific Recommendations ("PSRs")

As part of marketing presentations such as pitch books, advisers often like to demonstrate their research process using case studies of actual portfolio holdings (current or past) that describe how the adviser made the determination to invest in a particular company. In other instances, advisers may include in pitch books a selective list of current or past holdings that may or may not include performance, also to demonstrate the adviser's investment style.

Rule 206(4)-1(a)(2) prohibits using PSRs that were or would have been profitable in advertisements unless the adviser provides all recommendations made over the preceding year accompanied by certain disclosures. For current holdings, it may be a violation of Rule 206(4)-1(a)(5) to provide a selective list of profitable holdings in an adviser's marketing presentation. Such "cherry-picking" would be considered false or misleading.

In addition to these restrictions, the SEC has provided some flexibility for advisers that wish to discuss current and past portfolio holdings in marketing presentations. In a letter to *Franklin Management, Inc.* (December 10, 1998) ("*Franklin*"), the SEC staff indicated that an adviser may include PSRs and current recommendations in marketing materials provided that they:

- Use objective, nonperformance-based criteria to select the PSRs or current recommendations;
- Use the same selection criteria for each time period (e.g., monthly, quarterly);
- Do not discuss directly or indirectly the amount of profits or losses realized or unrealized on the specific securities; and
- Maintain records to support the selection criteria.

One common example of nonperformance-based selection criteria used to comply with *Franklin* is the adviser's top 10 portfolio holdings by market value.

Also, in a letter to *The TCW Group, Inc.* (November 7, 2008) ("*TCW*"), the SEC staff indicated that advisers could advertise the holdings, 10 at minimum, that contributed most positively and most negatively to an adviser's investment strategy over a designated period. To comply with *TCW*, advisers must, among other things, ensure that:

- The performance calculation consistently takes into account the weighting of every holding in each representative account that contributed to that account's performance during the measurement period and that the holdings presented consistently reflect the results of the calculation,
- The presentation shows at least 10 holdings divided equally between examples that earned positive returns and examples that earned negative returns,
- Each presentation of holdings is consistent from measurement period to measurement period in terms of the information and number of holdings included,
- Each presentation provides the average weight of the holdings during the measurement period and the contribution these holdings made to the representative account's return,
- Each page presenting representative holdings discloses how an investor or prospective investor can obtain the performance calculation methodology and documentation showing every holding's contribution to the overall account's performance during the measurement period; and
- Each page containing a presentation of holdings provides the following disclosures in close proximity to the performance information:
    - A disclosure that the holdings in the presentation do not represent all securities purchased, sold, or recommended for advisory clients; and
    - A disclosure that past performance is not indicative of future results.

Advisers that intend to discuss portfolio holdings in their marketing presentations should review the *Franklin* and *TCW* SEC staff letters to ensure full compliance with their requirements. Taking this measure will reduce the risk of receiving an SEC deficiency letter or becoming the object of an SEC enforcement action for using misleading or materially false information.

The SEC often refers to *Franklin* when discussing alleged violations in deficiency letters. For example, in one instance the SEC found that an advisor had referenced an investment example in a pitch book appendix without disclosing the objective, performance-based criteria used to select the investment. The SEC also noted that the disclosure included did not fully represent all securities purchased, sold, or recommended and that the adviser failed to insert the required disclosure into a legend as discussed in *Franklin*.

In another example, a 2014 SEC enforcement action alleged that Navigator Money Management violated the Securities Act of 1933, the Advisers Act, and parts of the Investment Company Act of 1940 when, among other violations, it distributed newsletters and maintained a website that included potentially misleading statements. These statements included PSRs that allegedly did not comply with SEC guidance. The SEC found the statements made in the newsletter and website to be misleading because they failed to include a list presenting all recommendations made by the fund within the past year by security and market process (i.e., purchased or sold) and a legend with the required disclosure statement.

Performance Disclosures

When marketing investment advisory services, advisers often provide performance results for their investment strategies. In order to do so, advisers must comply with specific disclosure requirements highlighted in various SEC staff letters. In general, all performance included in marketing presentations considered to be advertisements must be shown net of fees. In certain circumstances, performance may be shown gross of fees. In all cases, every chart, graph, or table displaying performance results should be labeled gross or net of fees. The adviser must also include the required disclosures on the same page as the performance figures or insert a reference (link) to the page containing these disclosures.

The SEC provided guidance on using performance results in advertising in a letter to *Clover Capital Management, Inc.* (October 28, 1986) ("*Clover*"). Specifically, the SEC staff indicated that the SEC prohibits advertisements that, among other things,

- Do not disclose the effect of material market or economic conditions on the returns shown (e.g., if an adviser discloses that its strategy has appreciated 25% over the period but does not disclose that the general market was up 35% during that same period);
- Show performance that does not reflect the deduction of advisory fees and other expenses (net of fees);
- Do not disclose the way in which dividends and interest are treated;
- Suggest or make claims about profit potential without also disclosing the possibility of loss (e.g., disclosures should state that past performance is not indicative of future results);
- Compare returns to an index without disclosing the material facts relevant to the comparison;
- Fail to disclose any material conditions, objectives, or investment strategies used to obtain the performance results presented; and

- Fail to disclose prominently, if applicable, that the performance results presented relate only to a select group of the adviser's clients along with the methodology for making the selection and the effect of this methodology on the results presented, if material.

In cases where an adviser discloses performance results from a model portfolio, *Clover* includes additional disclosure requirements that should be reviewed and included by advisers, where applicable.

As noted above, in certain situations, advisers may want to present performance results on a gross-of-fees basis to prospective clients. In a letter to *Association for Investment Management and Research* (December 18, 1996) ("*AIMR*"), the SEC staff indicated that gross-of-fees performance may be shown in an advertisement if they appear in equal prominence with net-of-fees performance. In another letter to the *Investment Company Institute*, (September 23, 1988) ("*ICI*"), the SEC staff indicated that gross-of-fees performance may be shown exclusively to a wealthy prospective client in a one-on-one presentation as long as the presentation discloses that:

- Performance figures do not reflect the deduction of advisory fees,
- Client returns will be reduced by investment advisory fees and other expenses that may be incurred during account management,
- The adviser's investment advisory fees are described in its Form ADV, Part 2A, and
- A representative example (e.g., a table, graph, chart, or narrative) of how an investment advisory fee, compounded over a period of years, will affect the total value of a client portfolio.

Of late, the SEC has shown a propensity to scrutinize gross-of-fees performance presentations in accordance with *AIMR* and *ICI*. In a recent deficiency letter, the SEC found that an adviser's gross-of-fees presentations did not abide by *AIMR* and *ICI*. The SEC noted that the adviser's advertising material included only gross-of-fees performance results and allegedly did not disclose that these results did not reflect the deduction of advisory fees as required by *ICI*. In addition, the adviser's employees appeared unsure of how to use and disseminate the advertising material, potentially providing gross-of-fees performance results in situations that were not one-on-one presentations to potential clients. In this instance, the SEC recommended that the adviser amend the presentations to comply with *AIMR* as well by presenting gross and net-of-fees performance with equal prominence, formatted to facilitate an easy comparison and to prevent the comparison from being misleading.

The SEC has also brought enforcement actions against advisory firms that do not follow previously issued guidance related to performance. *In the Matter of Modern Portfolio Management, Inc.* (October 23, 2013), ("*MPM*") , the SEC alleged that *MPM* included misleading firm assets under management ("AUM") on its website, and omitted required disclosures and made misleading statements in its performance information by providing model results that did not deduct advisory fees.

The SEC does not exclude individuals from liability, either. *In the Matter of Brian Williamson* (January 22, 2014), the SEC alleged that, among other violations, Williamson, a former portfolio manager at Oppenheimer & Co., sent or directed to be sent prospective marketing materials that reported a misleading internal rate of return ("IRR") that did not take into account fees and expenses that would have greatly lowered it.

Another instance of a performance-related enforcement action appears in the SEC press release regarding *In the Matter of Oppenheimer Asset Management Inc. and Oppenheimer Alternative Investment Management, LLC* (March 11, 2013):

> An SEC investigation found that Oppenheimer Asset Management and Oppenheimer Alternative Investment Management disseminated misleading quarterly reports and marketing materials stating that the fund's holdings of other private equity funds were valued "based on the underlying managers' estimated values." However, the portfolio manager of the Oppenheimer fund actually valued the fund's largest investment at a significant markup to the underlying manager's estimated value, a change that made the fund's performance appear significantly better as measured by its internal rate of return.
>
> Oppenheimer agreed to pay more than $2.8 million to settle the SEC's charges. The Massachusetts Attorney General's office today announced a related action and additional financial penalty against Oppenheimer.
>
> "Honest disclosure about how investments are valued and how performance is measured is vital to private equity investors," said George S. Canellos, Acting Director of the SEC's Division of Enforcement. "This action against Oppenheimer for misleadingly writing up the value of illiquid investments is clear warning that the SEC will not tolerate lax disclosure practices in the marketing of private equity funds."

In yet another enforcement case, this one from 2014, the SEC took action against an investment adviser for misrepresenting its compliance with the Global Investment Performance Standards ("GIPS") In *In the Matter of ZPR Investment Management, Inc. and Max E. Zavenelli* (May 27, 2014) ("*ZPR*"), the SEC alleged, among other things, that ZPR and its owner, Max Zavanelli, misrepresented and omitted important data in newspaper advertisements, newsletters, and Morningstar reports, falsely implying that ZPR was GIPS compliant. The administrative judge hearing the case found that Zavanelli wanted more institutional investors and lied about being GIPS compliant because GIPS compliance "has become almost mandatory" for obtaining these investors.

Hypothetical/Backtested Performance

In some situations, advisers that historically have managed portfolios using one strategy (e.g., large-cap domestic growth) see opportunities in another market segment (e.g., small-cap international growth) and seek to market this new strategy to prospective clients. Without an actual performance track record, an adviser may create a hypothetical/backtested track record that illustrates how a portfolio would have performed had it existed over a period going back, say, five or ten years. Results produced from such backtested models may draw increased regulatory scrutiny, however, because investors have no guarantee that the adviser used the signals generated by these methods in real time, because such performance results can be generated with hindsight and adjusted to fit the data, and, finally, because an adviser's proprietary trading systems cannot be independently verified to substantiate the results presented and reporting results based on this method is subject to abuse.

With this in mind, advisers that use hypothetical/backtested performance in marketing materials should include the following disclosures (see *In the Matter of Patricia Owen-Michel*, Release No. IA-1584, September 27, 1996):

- A disclosure that the results do not represent the results of actual trading using client assets but were calculated by retroactively applying a model designed with the benefit of hindsight

- A disclosure describing any limitations inherent in the backtested model
- A disclosure that the returns should not be considered indicative of the adviser's skill
- A disclosure that the client may experience a loss
- A disclosure that the results may not reflect the impact that any material market or economic factors might have had on the adviser's use of the backtested model if the model had been used during the period to actually manage client assets
- A disclosure, if applicable, that the adviser, during the period in question, was not managing money or was not managing money according to the strategy depicted
- A disclosure that the backtesting is for a described or specific strategy that the client accounts will follow or a description of what the difference will be if the strategy is not followed
- Any additional disclosures required to ensure the presentation is not considered potentially false or misleading (for example, the *Clover* disclosures)

On the enforcement side of this issue, the SEC, for example, cited an adviser in a 2010 deficiency letter for comparing its hypothetical results to an index without disclosing all material facts regarding the comparison, including limitations inherent to model results and whether investment results could be materially different from model results. The SEC recommended that the adviser include appropriate disclosures or omit hypothetical performance data.

The SEC has also brought enforcement actions against advisers using backtested performance results. *In the Matter of Market Timing Systems, Inc. et al.* (August 28, 2002) ("*MTS*"), the SEC alleged that MTS distributed materially false and misleading advertisements. The advertisements promoted returns of over 70% for a 13-year period for one of its models. However, the advertisements did not disclose that this result was hypothetical and generated by a retroactive application of the model.

In *In re Jason A. D'Amato* (August 31, 2012) ("*D'Amato*"), the SEC alleged that D'Amato fraudulently misrepresented the performance of an allocation program run by his employer in pitch books distributed to clients. Specifically, the SEC alleged he used unaudited performance data from 2000 through 2004 supplemented by audited data from 2005 going forward. The performance data was called "historical performance" but did not mention that the data from 2000 through 2004 was backtested.

Portability of Investment Performance Achieved at Another Investment Adviser

Investment advisers may often hire experienced portfolio managers that have generated performance results while employed at another adviser. The acquiring firm may want to continue advertising the performance generated by the new portfolio manager at his or her previous advisory firm. In a letter to *Horizon Asset Management, LLC* (September 13, 1996) ("*Horizon*"), the SEC staff indicated that advertising such results would not be considered misleading under Rule 206(4)-1(a)(5) provided that:

- The individuals managing the accounts at the adviser were also primarily responsible for achieving the prior performance results;
- Accounts at the previous firm were so similar to accounts currently under management that the performance generated at the prior firm provides relevant information to prospective clients;
- All accounts that were managed in a similar manner are advertised, unless the exclusion of any account would not result in materially higher performance;
- The advertisement is consistent with SEC staff interpretations with respect to performance advertisements; and
- The advertisement includes all relevant disclosures, including one stating that the performance results provided were achieved at another investment advisory firm.

In a letter to *Great Lakes Advisors, Inc.* (April 3, 1992), the SEC staff indicated that if the previous adviser's portfolio management decisions were made by committee, it may not be misleading for the successor adviser, whose portfolio management decisions are also made by committee, to use the performance achieved at the previous adviser if there was "a substantial identity of personnel among the predecessor's and successor's committees." Also, in order to continue advertising performance from a predecessor entity, all records must be maintained in compliance with Rule 204-2(a)(16).

In a letter to *Bramwell Growth Fund* (August 7, 1996) ("*BGF*"), the SEC indicated it would allow BGF to include in its prospectus the performance information from Ms. Bramwell's prior tenure as portfolio manager at another firm. The SEC stated that Section 206 does not prohibit this inclusion provided that:

- No other person played a significant part in achieving the stated performance, and
- The performance information is not presented in a misleading manner and does not obscure or impede the understanding of the information required to be included in the prospectus.

In another example of a past performance deficiency, in 2006 the SEC cited an adviser for marketing its fund performance beginning one year prior to the establishment of the advisory firm. Here, the adviser pooled personal and family wealth and began a fund. A year later, the adviser merged with another adviser to establish the advisory firm. It then presented the performance of the fund prior to the merger in marketing materials for the new advisory firm. The SEC referred to *Horizon* in its deficiency letter and noted that the firm's marketing practices would not be misleading if the materials presented are accompanied by the appropriate disclosures.

Representative or Partial Client Lists

On occasion, investment advisers may want to provide a list of clients in marketing materials to demonstrate to prospective clients the caliber of their current clientele and thus establish credibility. In a letter to *Denver Investment Advisers, Inc.* (July 30, 1993) ("*DIA*"), the SEC staff indicated that investment advisers would be allowed to disclose partial client lists with the following conditions:

- Performance-based criteria cannot be used to determine which clients are included in the list.
- A disclaimer must be included that states, for example, that "it is not known whether the listed clients approve or disapprove of Denver Investment Advisers or the advisory services provided."
- Each client list will include a statement describing the objective criteria used to select the clients listed.

In a letter to *Cambiar Investors, Inc.* (August 28, 1997) ("*Cambiar*"), the SEC staff indicated it would allow disclosure of a partial client list as long as the list "is not presented in a false or misleading manner and the advertisement contains no untrue statement of material fact and is not otherwise false or misleading." To protect client confidentiality, advisers should always obtain permission

before disclosing their names in any marketing presentation. However, in *Franklin* the SEC staff agreed not to recommend enforcement action against *Cambiar* so long as the selection criteria for the partial client list were objective and unrelated to client account performance, and the advertisement contained disclosures and the disclaimer set forth in *DIA*.

Items Considered Potentially False and Misleading

As noted above, the Advertising Rule prohibits any advertisement that "contains any untrue statement of a material fact, or which is otherwise false or misleading." This definition covers many types of statements, terms, or practices that may appear in an adviser's marketing materials or advertisements. Here are three examples :

- **Use of Superlative Statements** – The SEC has indicated that statements in marketing materials such as "Adviser has a proven ability to preserve wealth and grow clients' investment capital" or "Adviser has generated superior investment returns for its clients during all market cycles," that is, statements that include words such as "superior," "exceptional," "best," "proven," and other superlatives to describe performance or other firm attributes, may lead clients to believe an adviser is the only firm capable of providing adequate advisory services or infer something about future investment results that may not be warranted. In addition, the use of superlative statements or terms may lead prospective clients or investors to conclude erroneously that comparable opportunities cannot be found elsewhere. Thus, advisers should avoid using superlative statements in its marketing materials.

  In a 2012 deficiency letter, for instance, the SEC noted marketing materials with potentially misleading language. The adviser used promissory language and superlative terms such as "unmatched," "enviable," and "industry leading" in reference to investment performance or factors that may lead to investment performance. The SEC staff commented that these words may be misleading and inconsistent with Rule 206(4)-1(a)(5) as they may imply a guarantee or cause an investor to conclude that comparable opportunities could not be found elsewhere.

- **Use of Subjective Terms such as "Substantial" and "Significant"** – In statements such as "Adviser intends to position its portfolios to earn substantial returns over a three to five year period" or "Adviser has committed significant resources to its research staff," the use of the words "substantial" and "significant" may be deemed false or misleading due to their subjective nature or due to the lack of further definition. By their nature, such words can mean different things to different prospective clients. What one prospective client may deem to be substantial or significant, another may not. Without further definition, statements such as these may be considered misleading under Rule 206(4)-1(a)(5). Thus, their use in marketing materials should be avoided unless a more specific definition is provided.

- **Referring to an Adviser as a "Registered Investment Adviser" or "RIA"** – Release No. IA-3060 states that "If an adviser refers to itself as a 'registered investment adviser,' it also must include a disclaimer that registration does not imply a certain level of skill or training." Footnote 29 in the same release states that the SEC has "observed that the emphasis on SEC registration, in some advisers' marketing materials, appears to suggest that registration either carries some official imprimatur or indicates that the adviser has attained a particular level of skill or ability. Section 208(a) of the Advisers Act [15 U.S.C. 80b-8(a)] makes such suggestions unlawful." Advisers should remember to include the disclaimer noted above if they describe themselves as RIAs in their marketing materials.

  In a 2010 deficiency letter, for example, the SEC noted that an adviser's presentation described a principal as having the following designations: CPA, PFS, and RIA. The SEC wrote that while the adviser as a firm was a registered investment adviser, the employees were not. The SEC staff ultimately asked the adviser to remove the RIA designation from all publicly available material.

Claiming Use of Algorithmic Models: An Additional Enforcement Case

In the Matter of Chariot Advisers, LLC and Elliot L. Shifman (August 21, 2013) ("*Chariot*")

In this case, the SEC settled action against Chariot and its owner, alleging they falsely claimed the use of an algorithmic model in currency trading when in fact they did not do so. The action against Chariot was brought under Section 15(c) of the Investment Company Act, which imposes a duty on investment advisers to furnish all reasonably necessary information for the fund directors to evaluate investment management contracts. The SEC charged that Chariot and its owner misrepresented their capabilities in gaining approval from a fund's board.

Going Forward/Conclusion

The SEC will continue to evaluate investment adviser marketing and advertising materials for compliance with the Advertising Rule and related SEC guidance. To avoid deficiency letters and enforcement actions such as those noted above, advisers should ensure that all language in marketing materials is fair and balanced and that all performance results presented are accurate and include all required disclosures. ✦

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Secondary Trading in JOBS Act Securities

By Richard Chase and Shannon Fitzgerald

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I. Background

The Jumpstart our Business Startups – or JOBS – Act[1] has opened up new opportunities for emerging companies to raise capital through primary offerings. Title III of the JOBS Act establishes an entirely new offering format – called "crowdfunding" – for new entrepreneurs seeking to raise relatively small amounts of capital, while Title IV directs the U.S. Securities and Exchange Commission (the "SEC") to adopt rules to broaden the size and availability of an existing registration exemption. In late March 2015, the SEC adopted final rules to implement this Title IV directive. This article describes Titles III and IV of the JOBS Act, and discusses opportunities, and challenges, in integrating these vehicles for issuers to raise capital through primary offerings into the secondary trading markets.

The JOBS Act is a striking, even startling, piece of legislation. In response to the 2008 financial crisis, which was arguably the most significant U.S. and global economic upheaval since the Great Depression, the Congress in 2010 enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[2]. Over 2200 pages long, and requiring regulatory agencies to adopt literally hundreds of new rules, Dodd-Frank has imposed new requirements and mandated rigorous new regulations that touch on virtually all elements of the financial markets. By contrast, enacted just two years later, the JOBS Act is profoundly de-regulatory. It is intended to exempt emerging growth companies from registration obligations and unshackle financial firms from restrictions that could hinder their support of those companies' financing efforts.

How did this turnabout occur? The seeds were seemingly planted in the year after Dodd-Frank was enacted. In a March 22, 2011 letter from Cong. Darrell Issa to former SEC Chair Mary Schapiro, Cong. Issa raised deep concerns about the impact of U.S. securities regulations on capital formation in the U.S., especially for early stage companies, and cited a number of disturbing trends. The letter began by noting that the number of initial public offerings ("IPOs") in the U.S. declined from an annual average of 530 during the 1990's to 126 per year since 2001, with only 38 IPOs in all of 2008 and 61 in 2009. As a result, the overall number of exchange-listed companies in the U.S. fell from over 7000 at its peak to about 4000 in 2011 (a number that has continued to fall). Cong. Issa further surmised that foreign issuers have come to shun the U.S. markets. According to Cong. Issa, U.S. exchanges were once globally dominant, capturing 77.3% of global foreign issuer IPOs in 1996. By 2008, however, the U.S. exchange market share of these foreign issues was just 1.9%. Conversely, U.S. issuers who chose to list solely on foreign exchanges, once virtually unheard of, increased from 0.3% in the period from 1996-2002 to 8.6% in 2007 and 20% in 2008. Cong. Issa concluded his letter by requesting responses from the SEC on 32 detailed questions, including several questions related to early stage capital formation.

Over the course of the next year, concerns regarding regulatory burdens on entrepreneurship and small business capital formation grew in Congress on both sides of the aisle. In response, several bills were introduced in both the House and the Senate beginning in late 2011, including the JOBS Act, which was introduced in March 2012. The JOBS Act, in particular, captured strong bi-partisan support, and was quickly endorsed and signed into law by President Obama.

Support, however, was not universal. In a letter to the Senate Banking Committee sent the week before the JOBS Act's enactment, SEC Chair Schapiro expressed serious reservations about the law, warning, "Too often, investors are the target of fraudulent schemes disguised as investment opportunities. . . . [I]f the balance is tipped to the point where investors are not confident there are appropriate protections, investors will lose confidence in our markets, and capital formation will be made more difficult and expensive."[3] SEC Chair Schapiro opined that the crowdfunding provisions of the law, in particular, needed "additional safeguards."[4]

These reservations on the part of the SEC, the regulator charged with implementing and enforcing the JOBS Act, have had significant consequences, both on the content of the law and on its subsequent implementation by the SEC and use by the industry. One noteworthy impact has been a failure to completely integrate the capital raising provisions of the JOBS Act into the entire fabric of the securities laws, which cover not just initial distributions of securities, but their trading in the aftermarket as well. In the following sections, we discuss the principal capital raising provisions of the JOBS Act, namely, Title III (crowdfunding) and Title IV (Regulation A+), and how those provisions tie in to the overall securities market structure.

II. Title III – Crowdfunding

A. Registration and Central Clearing

In addition to providing a mechanism for the initial distribution (underwriting) of securities, the architecture surrounding the public securities markets involves centralized research, transaction hubs, the consolidated tape, the Depository Trust & Clearing Corporation (the "DTCC"), and several other tightly integrated points of integrity.[5] By contrast, beyond the initial placement of securities with investors, the online private securities market presently lacks

1. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

2. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

3. David S. Hilzenrath, *JOBS Act Could Remove Investor Protection SEC Chair Schapiro Warns*, Wash. Post (Mar. 14, 2012), http://www.washingtonpost.com/business/economy/jobs-act-could-open-a-door-to-investment-fraud-sec-chief-says/2012/03/14/gIQA1vx1BS_story.html.

4. *Id.*

5. Matt Dellorso, *The Promise – And Challenges – Of Equity Crowdfunding*, Forbes (June 25, 2014, 9:13AM), http://www.forbes.com/sites/groupthink/2014/06/25/the-promise-and-challenges-of-equity-crowdfunding/.

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a robust organizational and support infrastructure.[6] With respect to crowdfunded equities and peer-to-peer ("P2P")[7] debt, there is no central data repository to store and manage position and transaction data related to these asset classes, nor facilities or processes for the efficient clearance and settlement of resales (secondary market transactions). Lacking such a repository, and since these securities are restricted, it is difficult for funding portals[8] or brokers to determine what individual investors have invested during the previous 12-month period.[9] As it stands, investors have typically been required to self-certify their compliance with the investment limitations of these securities.[10]

The best way to assure actual compliance with the resale restrictions of crowdfunded equities and P2P loans would be to form a central data repository.[11] Data on participating investors could be provided by an intermediary to a clearinghouse after each successful issue. Such a clearinghouse could also be used to maintain data, including each investor's net worth and annual income, as well as certifications that they have completed their investor education requirements.[12] This would enable investors to provide such information annually to the clearinghouse rather than to each funding portal for every investment made. Logical choices for operating such a clearinghouse include the SEC, FINRA or the DTCC, or a private body such as Dealogic.[13]

The DTCC already provides a central data repository for other types of unregistered securities, as well as maintains a clearance and settlement program for alternative investment products. As such, it is the fastest, easiest and most cost-effective solution to implementing a crowdfunding clearinghouse. There is no indication that issuers, intermediaries or regulatory authorities have approached the DTCC to organize or operate such a facility, however. Likewise, there is no evidence that the DTCC has affirmatively offered its central data repository or post-trade services to crowdfunding issuers. Nevertheless, nothing in Title III of the JOBS Act prohibits crowdfinanced assets from being accepted by the DTCC.[14] It thus remains feasible that the DTCC could seek to register crowdfunded securities as a secondary market for this asset class evolves.[15]

B. Secondary Market Trading

Since crowdfunded securities are restricted, there will be very limited (if any) secondary trading activity during the first year following their issuance.[16] Furthermore, under Title III of the JOBS Act, the most that can be raised in a crowdfunding offering is $1 million.[17] That may not constitute a sufficient public float to pass muster for secondary trading for many issuers. It is, therefore, critical to the establishment of a successful secondary trading market that issuers' market values rise above this threshold once they have sufficient seasoning to trade on an unrestricted basis. Secondary trading markets have begun to emerge for crowdfinanced assets, but they are still in the "embryonic stage."[18] For P2P debt in particular, investors should expect to hold their loans to maturity (typically, 36 to 60 months).[19]

C. Funding Portals and Settlement Risk

Folio Institutional[20] is one funding portal that appears to be leading the way with respect to conducting post-trading activities for crowdfinanced products. Unless and until a central clearinghouse emerges, however, it is essential that all funding portals be able to clear and settle securities transactions executed on their respective platforms. It is further critical that all funding portals are able to temporarily gain control of funds once the obligations have become final, in order to clear and settle transactions.[21] This will ensure safe, efficient and effective clearance and settlement throughout the market.[22]

Similarly, in order to clear and settle an initial offering, as well as to facilitate secondary trading, it may be advisable for funding portals to operate book-entry systems in which dematerialized securities are held.[23] In order to maintain a simple shareholder structure for companies that raise capital through a crowdfunding offering, funding portals should also be able to serve as a single shareholder (or holder of record) for purposes of an issuer's register/shareholder structure.[24] This can be easily accomplished via the book-entry system. As is currently the case in many crowdfunding transactions outside of the U.S., funding portals would then communicate with the individual shareholders (or beneficial holders of shares).[25]

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6. John Kuo, *Equity Crowdfunding Is Now Legal. How Can You Get Your Piece of the Action?*, Nerdwallet (Sept. 25, 2013), http://www.nerdwallet.com/blog/investing/2013/equity-crowdfunding-legal-piece-action/.
7. Peer-to-peer lending is the practice of lending money to unrelated individuals, or "peers," without going through a traditional financial intermediary such as a bank.
8. A funding portal is any person acting as an intermediary in a crowdfunding transaction that does not: (i) offer investment advice or recommendations; (ii) solicit purchases, sales or offers to buy the securities displayed on its platform or portal (iii) compensate employees, agents or other persons for such solicitation or the sale of securities; or (iv) hold, manage, process or otherwise handle investor funds. Funding portals that engage in crowdfunding on behalf of issuers relying on the JOBS Act's "crowdfunding exemption" must register with the SEC and become a member of a national securities association. See James M. Harrigan, *FINRA Proposes Funding Portal Rules under the JOBS Act*, O'Melveny & Myers LLP (Nov. 11, 2013), http://www.omm.com/finra-proposes-funding-portal-rules-under-the-jobs-act-11-11-2013/. See also FINRA Regulatory Notice 13-34 (Oct.2013), http://www.finra.org/sites/default/files/NoticeDocument/p370743.pdf (FINRA Requests Comment on Proposed Funding Portal Rules and Related Forms) for more information on funding portals.
9. *See* letter from Neal C. McCane, risingtidefunding.com, to SEC, (Sept. 26, 2012), at 2, https://www.sec.gov/comments/jobs-title-iii/jobstitleiii-158.pdf.
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.* at 3. Dealogic, a private company, operates a repository that warehouses certifications made by broker-dealers, banks and investors representing that they are "qualified institutional buyers" or "QIBs" under SEC Rule 144A. An investor that participates in numerous 144A offerings is thereby able to submit a single QIB certification to Dealogic, rather than having to submit separate certifications for each transaction. *See also* Dealogic, http://www.dealogic.com/ (last visited May 28, 2015).
14. *See* Securities Act Release No. 33-9470 (Oct. 23, 2013), 78 FR 66427 (Nov. 5, 2013), https://www.sec.gov/rules/proposed/2013/33-9470.pdf.
15. CUSIP Global Services provides the CUSIP identifiers for crowdfunding offerings. Such identifiers are known as CUSIPS for Crowdfunding. They feature the same 6-character issue and 9-character issue format used for regular CUSIPs. CUSIPs for Crowdfunding are available upon request for most crowdfunding offerings with valid support documentation.
16. Under new Section 4A(e) of the Securities Act of 1933, broad restrictions on resales are imposed during the first 12 months following their initial issuance. Transfers (resales) by the original purchasers are only permitted as follows: back to the issuer, to an accredited investor, to a family member, or in a registered offering.
17. The ceiling is raised to $2 million for issuers with audited financials.
18. Dara Albright, James A. Jones and Chris Staples, *The Financial Advisor's Guide to P2P Investing*, (Apr. 13, 2015), at 13, https://daraalbright.files.wordpress.com/2015/04/the-financial-advisors-guide-to-p2pi-final.pdf.
19. *Id.*
20. *See* Folio Institutional, https://www.folioinstitutional.com/about-institutional.jsp (last visited May 28, 2015).
21. Letter from Jouko Ahvenainen, Valto Loikkanen and the Grow VC legal team, Grow VC Group, to SEC (Jun. 15, 2012), at 5, https://www.sec.gov/comments/jobs-title-iii/jobstitleiii-88.pdf.
22. *Id.*
23. *Id.*
24. *Id.*
25. *Id.*

Capital requirements represent one major regulatory difference between equity and debt-based crowdfunding platforms.[26] Unlike debt-based platforms, capital requirements for equity platforms have not to date been a serious consideration. They generally do not manage investor money for extended periods of time, apart from facilitating capital transfers after completion of the crowdfunding transaction lifecycle.[27] In addition, there are no ongoing cash flows to manage after an equity crowdfunding campaign ends and the initial capital transfer is made.[28] However, as the volume, size and complexity of deals grows on equity-based platforms, the turnaround time for completing transactions could be expected to increase. As a result, the length of time crowdfunding platforms end up holding client funds could increase.[29] This effect could then introduce potential settlement risks down the line, and commensurately increase the benefits of having a central repository for the custody, clearance and settlement of crowdfunded securities transactions.

D. The Future of Crowdfunding

As noted in Section II.B. above, embryonic secondary market in some crowdfunded assets has begun to emerge. In the end, however, we have serious reservations as to whether crowdfunding will ultimately turn out to be much more than an historical curiosity. To date, established banks and broker-dealers have largely avoided involvement with crowdfunding initiatives. This is undoubtedly in part a function of such small issues not being "worth the bother" for firms accustomed to dealing in transactions in the 100's of millions of dollars, not the 100's of thousands. They cannot be unmindful, however, of the SEC's firmly stated reservations regarding crowdfunded securities and the perils of fraud their abbreviated disclosures and offering procedures present. They are limited in size, launched without the imprimatur of established firms, considered suspect by their primary regulator, disconnected to the architecture of the existing public securities markets, and lack the prospect of any secondary market liquidity. Inevitably, some (perhaps most) crowdfunding ventures will prove financially unsuccessful, and some may even turn out to be far worse – a ponzi scheme or some other form of fraud or swindle. While established markets and institutions can withstand an occasional hit to their credibility, we are concerned that this array of strikes may prevent the nascent crowdfunding market from ever taking off. Time will have to tell.

III. Title IV – Regulation A+

A. Key Elements

Registration for smaller issuers of securities has historically been encumbered by Blue Sky review. This has effectively destroyed the efficacy of the original Regulation A exemption to registration available to small issuers.[30] The JOBS Act thus included a section requiring the SEC to adopt rules to implement an updated and expanded version of Regulation A, and provided an effective pre-emption of state Blue Sky regulation of certain offerings made under this expanded authority. The resulting rule amendments, often collectively referred to as Regulation A+, were issued by the SEC in mid-March and become effective on June 19, 2015.[31] The new registration exemption provided by Regulation A+ has been described as a mini-IPO, in that it allows for a cost-effective, streamlined registration process.[32] The Regulation A+ exemption is limited to companies organized in and with their principal place of business in the U.S. or Canada.[33] Crowdfunding platforms, in particular, are expected to leverage Regulation A+.[34]

Regulation A+ provides for two tiers of offerings. Tier 1 consists of securities offerings of up to $20 million in a 12-month period, with not more than $6 million in offers by selling security-holders that are affiliates of the issuer.[35] Tier 1 essentially mirrors the exemption available under current Regulation A.[36] Tier 2 consists of securities offerings of up to $50 million in a 12-month period, with not more than $15 million in offers by selling security-holders that are affiliates of the issuer.[37]

In addition to the limits on secondary sales by affiliates, the new rules limit sales by all selling security-holders to no more than 30% of a particular offering in the issuer's initial Regulation A offering, and subsequent Regulation A offerings for the first 12 months following the initial offering.[38] Further, if an issuer has (1) more than 500 unaccredited shareholders of record, or 2,000 shareholders of record, and (2) at least $10 million in assets, it will generally be required to file periodic reports with the SEC (e.g. Form 10-K's and 10-Q's).[39]

For offerings of up to $20 million, an issuer could elect to proceed under either Tier 1 or Tier 2.[40] Both tiers would be subject to basic requirements as to issuer eligibility, disclosure and other matters, drawn from the current provisions of Regulation A.[41] Both tiers would also permit issuers to submit draft offering statements for nonpublic review by SEC staff before formal public filing, permit the continued use of solicitation materials after filing the offering statement, require the electronic filing of offering materials, and otherwise align Regulation A with current practices for registered offerings.[42]

In addition to these basic requirements, issuers conducting Tier 2 offerings would be subject to additional disclosure and ongoing reporting requirements. Specifically, they would be required to: (i) provide audited financial statements; (ii) file annual, semiannual and current event reports; and (iii) limit the amount of securities non-accredited investors can purchase to no more than 10% of the

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26. Avtar Sehra PhD, *The Subtle Risks in Equity Crowdfunding the Industry is Ignoring*, Innovation Insights (Jan. 26, 2015, 10:35AM), http://insights.wired.com/profiles/blogs/the-subtle-risks-in-equity-crowdfunding-the-industry-is-ignoring#axzz3Y5KJvzUP.
27. *Id.*
28. *Id.*
29. *Id.*
30. *JD Alois, Reg A Plus & Developing Venture Exchanges (Webinar)*, Crowdfund Insider (Mar. 16, 2015, 5:55PM), *available at* http://www.crowdfundinsider.com/2015/03/64507-reg-a-plus-developing-venture-exchanges-webinar/.
31. Securities Act Release No. 33-9741 (Mar. 25, 2015) 80 FR 21805 (Apr. 20, 2015), http://www.sec.gov/rules/final/2015/33-9741.pdf.
32. Milken Inst. Ctr. for Fin. Mkts., Summary of *Regulation A+ and the Mini-IPO – A Roundtable Discussion of Title IV of the JOBS Act*, McCarter & English, available at http://www.mccarter.com/Regulation-A-and-the-Mini-IPO--A-Roundtable-Discussion-of-Title-IV-of-the-JOBS-Act-02-10-2014/.
33. Press Release, SEC, SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital (Mar. 25, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-49.html.
34. JD Alois, *FACT SHEET: Regulation A+, Title IV of the JOBS Act*, Crowdfund Insider (Mar. 29, 2015, 12:02PM), http://www.crowdfundinsider.com/2015/03/65172-fact-sheet-regulation-a-title-iv-of-the-jobs-act/.
35. *SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital*, *supra* note 33.
36. Alois, *supra* note 34.
37. *SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital*, *supra* note 33.
38. *Id.*
39. Sam Guzik, *New SEC Regulation A+: Everything You Need to Know*, Onevest Blog (Mar. 27, 2015), http://blog.onevest.com/blog/2015/3/27/new-sec-regulation-a-everything-you-need-to-know.
40. *SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital*, *supra* note 33.
41. *Id.*
42. *Id.*

greater of the investor's annual income or net worth (excluding primary residence).[43]

Regulation A+ exempts securities in a Tier 2 offering from the mandatory registration requirements of Exchange Act Section 12(g) if an issuer meets all of the following conditions: (i) engages services of a transfer agent registered with the SEC; (ii) remains subject to a Tier 2 reporting obligation; (iii) is current in its annual and semiannual reporting at fiscal year-end; and (iv) has a public float of less than $75 million as of the last business day of its most recently completed semiannual period, or, in the absence of a public float, had annual revenues of less than $50 million as of its most recently completed fiscal year.[44]

Tier 1 offerings remain subject to state registration and qualification requirements, and issuers may take advantage of the coordinated review program developed by the North American Securities Administrators Association (NASAA).[45] However, the new rules provide for the preemption of state securities law registration and qualification requirements for securities offered or sold to "qualified purchasers," which are defined as any persons to whom securities are offered or sold under a Tier 2 offering.[46]

B. Implications

a. Positive Impacts

By making it easier for small and medium-sized companies to issue securities without meeting full-blown SEC registration requirements, while creating greater transparency and openness in the market for such securities, Regulation A+ may serve as an important catalyst for increased capital raising by such companies, and thereby contribute to overall growth for the U.S. economy.[47] Securities sold pursuant to Regulation A+ will not be restricted securities and may be immediately resold. Regulation A+ securities may be offered and sold publicly, so long as the securities are offered or sold on a national securities exchange, or offered or sold to qualified purchasers.[48]

Regulation A+ will require the filing of an offering circular with the SEC, but this disclosure will be far less onerous and expensive than the disclosures required in a conventional registration statement for a traditional IPO.[49] An issuer will also be permitted to "test the waters," and solicit interest in its securities before filing the offering circular.[50] This will allow issuers to gauge interest in the securities before bearing the expense of complying with Regulation A+.[51] Furthermore, while the upfront information delivery requirements may be more burdensome than in crowdfunding, issuers would be able to raise far larger dollar amounts without concern for individual investment caps.[52]

Regulation A+ is a step in the right direction, and may be a viable alternative to the mid- to late-stage funding rounds.[53] Additionally, compliance with Regulation A+'s offering circular, financial and other disclosure requirements may be considered a dress rehearsal for a full-blown registered public offering for later-stage companies.[54] Nevertheless, Regulation A+ also presents some challenges.

b. Limitations

Since Tier 1 offerings are not exempt from Blue Sky filings, Tier 1 issuers will need to file documentation with each state in which they plan to raise capital. Although Tier 2 offerings are exempt from Blue Sky filings, Tier 2 issuers are subject to ongoing reporting requirements in perpetuity (i.e., either until they go public or fail).[55] Specifically, issuers must make semi-annual and annual filings with the SEC that include audited financial statements for the two most recent years, along with narrative disclosures. This effectively subjects private companies to many of the same regulatory burdens carried by public companies.[56]

While the SEC did include a provision in Regulation A+ that allows issuers to validate investor demand prior to preparing full-blown offering circulars, this process will still be more expensive and time consuming than filing a Form D, which is the only comparable requirement in Regulation D offerings.[57] Given the opportunity to raise an uncapped amount of capital under Rule 506 of Regulation D with limited SEC reporting requirements, it is then possible that Regulation A+ may not enjoy much more popularity than Regulation A.[58]

At the very least, early adoption of Regulation A+ by startup companies appears to be unlikely.[59] Access to capital via private markets is currently plentiful across the growth stages.[60] At the early stage, new micro venture capitalists and seed funds pop up regularly, and raising a seed round is far easier today than in years past. Further, the time and monetary costs associated with Regulation A+ offerings may not make sense for the amount of capital raised at

43. *Id.*
44. *Id.*
45. *Id.*
46. *Id.*
47. *See* Press Release, Allegiancy, Allegiancy CEO Steve Sadler to Speak About Potential of New Regulation A+ Rules at Upcoming Securities Conferences (Sept. 22, 2014), *available at* http://www.allegiancy.us/press-release/allegiancy-ceo-steve-sadler-speak-potential-new-regulation-rules-upcoming-securities-conferences.
48. Paul Bork and Dean F. Hanley, *JOBS Act – Small Company Capital Formation – Regulation A+*, Foley Hoag LLP (Apr. 24, 2012), http://www.foleyhoag.com/publications/alerts-and-updates/2012/april/jobs-act-small-company-capital-formation-regulation-a.
49. *Id.*
50. *Id.*
51. *Id.*
52. Corporate Advisory, *"Private" Capital-Raising Under the JOBS Act*, Sullivan & Worcester LLP (Jul. 2012), *available at* http://www.sandw.com/assets/htmldocuments/CLIENT%20ADV.%20-%20Private%20Capital-Raising%20Under%20the%20JOBS%20Act%20B1451937.PDF.
53. Shri Bhashyam, *Regulatory Alert: Regulation A+ and What It Means For Startups*, EquityZen Blog (Mar. 27, 2015), https://equityzen.com/blog/regulation-a-plus-what-it-means-for-startups/. Indeed, at least some commentators have suggested that Regulation A+ effectively obviates the need for further implementation of Title III of the JOBS Act. See Michael Raneri, *Who Needs Equity Crowdfunding? 3 Critical Questions about Title III of the JOBS Act*, Forbes (Apr. 16, 2015, 4:30PM), http://www.forbes.com/sites/mraneri/2015/04/16/who-needs-equity-crowdfunding-3-critical-questions-about-title-iii-of-the-jobs-act/. (Some commentators view definition of Title III – crowdfunding – rules by the SEC as the logical next step in a steady, if slow, progress toward full implementation of the JOBS Act. Others expect the SEC to wait and see, in particular with regard to how the newly defined Title IV rules will be put into use, before making any progress on new crowdfunding rules.)
54. *JOBS Act – Small Company Capital Formation – Regulation A+, supra* note 48.
55. Rory Eakin, *The JOBS Act is Progress But Much Remains To Be Done*, TechCrunch (Mar. 29, 2015), http://techcrunch.com/2015/03/29/the-jobs-act-is-progress-but-much-remains-to-be-done/.
56. *Id.*
57. *Id.*
58. *"Private" Capital-Raising Under the JOBS Act, supra* note 52.
59. Bhashyam, *supra* note 53.
60. In Cong. Issa's letter to SEC Chair Schapiro, he noted that, from 2009 to 2011, transactions in private shares almost tripled from $2.4 billion to $6.9 billion, and private funding has skyrocketed since then. In the six months from June to December 2014, just one private issuer, Uber, was able to raise more than $2 billion in private funding, and as of in May 2015, was in discussions to raise $1.5 billion more. See Mike Isaac and Michael J. de la Merced, Investments in *Start-Ups Pick up Pace*, N.Y. Times (May 11, 2015) at B1, available at http://www.nytimes.com/2015/05/11/technology/uber-valuation-highlights-the-speedy-pace-of-investments.html.

seed or Series A rounds of investments. At later stages, capital also proliferates, especially with mutual and hedge funds increasingly investing in the late- and/or growth-stage, with numerous reports of start-ups successfully raising from $50 million to $500 million or more in multiple rounds of financing.[61] This capital is available at favorable valuations, so unless that "spigot" dries up, there may not be much incentive to be an early adopter of Regulation A+, with its funding limits of $20-50 million and attendant regulatory financial and reporting requirements.[62]

c. Exchange Trading and Venture Capital Exchanges

Regulation A+ aims to do a lot of things, but it only scratches the surface with respect to aftermarket support issues. The SEC received a broad spectrum of views from commentators on secondary trading issues under Regulation A+, from commentators urging a ban on resales by non-affiliates as well as affiliates, to commentators urging the SEC to foster the creation of venture exchanges specifically to facilitate secondary trading.[63] In the release adopting Regulation A+, the SEC recognized that "allowing selling security holders access to avenues for liquidity will encourage them to invest in [Regulation A+] companies."[64] In the final rules, the SEC took limited steps to facilitate exchange registration of Regulation A+ securities. The SEC permits an issuer seeking exchange registration of Tier 2 Regulation A+ securities to register them on Form 8-A, which is somewhat less onerous than full Form 10 registration, so long as the exchange registration is undertaken concurrently with the issuer's qualification of the securities under Regulation A+ (or concurrently with re-qualification of previously qualified securities). The SEC notes that this approach results in more extensive reporting obligations on the issuer than the Regulation A disclosure regime alone, but concluded that this additional disclosure would benefit investors.[65]

61. Bhashyam, *supra* note 53.
62. *Id.*
63. *See* Securities Act Release No. 33-9741 (Mar. 25, 2015), 80 FR 21805 (Apr. 20, 2015), pp. 33-34.
64. *Id.* at 33.
65. *Id.* at 191.

To date, the SEC has been unwilling to adopt further measures that might facilitate exchange trading of Regulation A+ securities. For example, in explaining its decision to permit exchange trading, the SEC made reference to the benefit to investors of such issues needing to comply with the qualitative and quantitative requirements of exchange initial and continuing listing standards, including size, financial, minimum distribution and corporate governance criteria.[66] This suggests that the SEC may be reluctant, until it has gained some favorable experience under the new rules, to consider proposals to relax those listing standards to accommodate Regulation A+ issuers. In a similar vein, some commentators have urged the SEC to consider allowing or facilitating the development of venture capital exchanges. In response, the SEC stated that it was "considering" the idea of venture exchanges and "contemplating" their use for Regulation A+ securities.

This is consistent with the incremental approach the SEC has taken more broadly with respect to market structure issues, particularly for smaller issuers and lower priced securities.[67] The SEC's recently adopted tick size pilot, for example, is intended to test quotation and trading increments and other structural issues (possible "trade at" requirements) for several broad test groups of securities in the near term. We applaud SEC Chair Mary Jo White's willingness to tackle complex market structure issues, and support measures such as the modest relief provided in Regulation A+ and the tick size pilot. Ultimately, however, given the breadth and pace of change in our rapidly evolving securities trading markets, we believe there needs to be a more focused and holistic approach taken to address the need for secondary market liquidity. ✦

66. *Id.*
67. Public Statement, *Opening Remarks at Meeting of SEC Advisory Committee on Small and Emerging Companies*, Statement by SEC Chair Mary Jo White (Mar. 4, 2015), *available at* http://www.sec.gov/news/statement/opening-remarks-to-acsec.html.

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Liability Exposure of Chief Compliance Officers

By Rita Dew, Founder and President, National Compliance Services (NCS)

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Chief Compliance Officers ("CCOs") for Registered Investment Advisers ("RIAs") take on an enormous amount of responsibility. Compliance missteps can expose CCOs to liability, regulatory sanctions, and serious damage to their careers. CCOs can also subject their firms to liability, reputational damage, and regulatory consequences.

Introduction

During Fiscal Year 2014, the SEC filed a record 755 enforcement actions and obtained orders adding up to over $4 billion in disgorgement and penalties. By way of comparison, the SEC filed 686 enforcement actions during fiscal year 2013 and obtained orders totaling $3.4 billion in disgorgement and penalties.

The SEC's aggressive approach to enforcement conveys the message that CCOs might be held accountable for compliance meltdowns. State securities regulators are also likely to deal harshly with compliance deficiencies. The purpose of this white paper is to make advisory personnel, CCOs, and RIAs, aware of the potential issues they might encounter and to help them avoid compliance pitfalls.

Rule 206(4)-7 and Chief Compliance Officers

Rule 206(4)-7 under the Investment Advisers Act of 1940 requires each SEC-registered advisory firm to appoint a CCO who will administer its compliance program. The rule also mandates that RIAs must conduct an annual audit of their policies and procedures to ensure that they are thorough and effective. Many states impose similar requirements on investment advisers registered in their jurisdictions.

To comply with the guidance found in the Adopting Release for Rule 206(4)-7 (http://www.sec.gov/rules/final/ia-2204.htm), it is imperative that CCOs are competent and knowledgeable regarding their regulatory obligations. CCOs should be given full responsibility and the requisite authority to develop and implement policies and procedures for the RIA. The Adopting Release for Rule 206(4)-7 stated that CCOs should hold a position of sufficient authority and seniority, so they possess the power to enforce compliance policies and procedures.

CCOs are not responsible, however, for every compliance problem that arises. Footnote 73 in the Adopting Release defined the parameters of the CCOs' responsibility:

> *Having the title of chief compliance officer does not, in and of itself, carry supervisory responsibilities. Thus, a chief compliance officer appointed in accordance with rule 206(4)-7 (or rule 38a-1) would not necessarily be subject to a sanction by us for failure to supervise other advisory personnel. A compliance officer who does have supervisory responsibilities can continue to rely on the defense provided for in section 203(e)(6) of the Advisers Act[15 USC 80b-3(e)(6)]. Section 203(e)(6) provides that a person shall not be deemed to have failed to reasonably supervise another person if: (i) the adviser had adopted procedures reasonably designed to prevent and detect violations of the federal securities laws; (ii) the adviser had a system in place for applying the procedures; and (iii) the supervising person had reasonably discharged his supervisory responsibilities in accordance with the procedures and had no reason to believe the supervised person was not complying with the procedures.*

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To avoid liability, CCOs should implement and enforce robust and meaningful policies and procedures.

CCOs Must Be Proactive To Avoid Liability

According to the SEC's Director of Enforcement, Andrew Ceresney, in his keynote address at Compliance Week 2014, CCOs should be proactive in attempting to resolve potential compliance problems:

> *I hope to use my current role to further promote a strong, empowered legal and compliance presence at firms, in part by encouraging legal and compliance personnel to engage and become involved when they see an issue that raises a concern. You should not hesitate to provide advice and help remediate when problems arise. And I do not want you to be concerned that by engaging, you will somehow be exposed to liability. As recent SEC staff guidance makes clear, compliance personnel do not become supervisors solely because they provide advice to, or consult with, business line personnel and the staff does not view compliance or legal personnel generally as supervising business personnel.*

Nevertheless, Ceresney warned that the SEC will continue to bring actions against legal and compliance officers when warranted. Typically, these actions will be brought:

- When the Division believes legal and compliance personnel have affirmatively participated in the misconduct;
- When personnel have been involved in misleading regulators; or
- When they clearly owe a duty to implement compliance programs or policies and fail entirely to carry out that responsibility.

CCOs will make matters worse for themselves and their firms if they shirk their responsibilities and then try to cover-up those failures.

Action Taken Against Compliance Officer for Altering Records

Being untruthful in dealings with examiners will almost always lead to an enforcement action against a CCO or other compliance personnel. On October 15, 2014, the SEC announced an enforcement action brought against a compliance officer for a dually registered broker-dealer/investment adviser. The compliance officer allegedly altered a document that was turned over to the SEC during an examination. The enforcement proceeding alleged that the compliance officer willfully aided and abetted and caused the firm

to violate Rule 204(a) under the Investment Advisers Act, as well as Section 17(a) of the Securities Exchange Act of 1934 and Rule 17a-4(j).

The SEC further alleged that the compliance officer was responsible for identifying suspicious trading by the firm's personnel and its clients. She was then required to analyze whether the trades made use of material nonpublic information.

The compliance officer prepared a document that summarized the results of her review of a registered representative's trading. Her review was closed with no findings of misconduct by the representative. Over two years later, the compliance officer learned that the SEC was investigating the representative for insider trading. The SEC's enforcement action claimed that the compliance officer altered the document to give the impression that she had performed a more thorough review than was actually the case. The SEC enforcement team discovered the alteration of the summary and questioned the compliance officer regarding the document.

Although the compliance officer initially denied altering the document, she subsequently admitted to the alteration after being confronted with additional documentation and metadata produced by the firm to the SEC. The SEC's order instituting the administrative proceeding can be found at http://www.sec.gov/litigation/admin/2014/34-73350.pdf.

Compliance Failures Fall On the Shoulders of CCOs

While altering documents will clearly expose a CCO to liability, misleading clients and prospects might also lead to charges. In September 2014, the SEC settled an action against an RIA and its CCO in Gig Harbor, Washington. The CCO was Chief Executive Officer of the firm, as well as a 50 percent owner. The CCO was ordered to pay a penalty of $50,000 to the SEC. Along with other sanctions, the firm was told to pay a civil money penalty of $200,000.

In addition to other compliance violations, the SEC alleged that the firm's advertisements materially overstated its investment performance, because the RIA failed to disclose that the advertised returns did not reflect the impact of advisory fees. The SEC claimed that the advertisement violated Section 206(4) of the Investment Advisers Act and the advertising rule, which is found in Rule 206(4)-1.

CCOs should be aware that when RIAs advertise their performance, they should present those results on a net-of-fees basis.

The guidance in the Clover Capital no-action letter also requires that performance returns be accompanied by robust disclosures.

Aside from false advertising, the RIA engaged in hundreds of securities transactions with advisory clients on a principal basis through its affiliated broker-dealer without providing written disclosure to, or obtaining consent from the clients. Furthermore, the RIA stated on several occasions in its Form ADV that neither the firm nor any related person engaged in principal transactions. The RIA also failed to seek best execution of client trades.

The CCO possessed the responsibility and authority to develop and implement the RIA's policies and procedures. Moreover, the CCO was required to conduct an annual review of those policies and procedures to ensure that they were thorough and effective. The RIA's compliance manual also contained detailed policies and procedures for approving advertisements. Because the CCO failed to implement those policies and procedures, he caused the RIA's compliance failures and was held accountable. The enforcement action can be found at http://www.sec.gov/litigation/admin/2014/ia-3924.pdf.

Missing Compliance Deadlines Will Cause Problems for CCOs

On October 29, 2014, the CCO for a New York-based RIA was named as a defendant in an enforcement action brought by the SEC for repeated violations of the Custody Rule. An RIA takes custody of clients' assets in situations where the firm holds them either directly or indirectly, or has the ability to access them. The risk to investors is significantly higher when an RIA has custody of clients' assets.

The Custody Rule provides an alternative for advisers to pooled investment vehicles in order to comply with the Custody Rule. They must distribute audited financial statements to fund investors within 120 days after the end of the fiscal year. Because of a 2006 SEC no-action letter, an adviser to a fund of funds that relies on the annual audit provision has 180 days to distribute audited financials to fund investors. The purpose of these requirements is to ensure that investors receive regular independent verification of their assets and are protected against misuse or theft.

The Enforcement Division alleged that this RIA was repeatedly late in providing investors with audited financial statements of its private funds. Furthermore, the RIA's co-founders, CCO, and others were responsible for the firm's compliance failures. The Commission alleged that the RIA and its most senior officers persistently ignored their compliance obligations and left their clients waiting for months to receive the materials they need to verify the existence and value of fund assets.

According to the SEC's order instituting an administrative proceeding, the RIA was chronically late in distributing audited financial statements to investors in 10 private funds. The next year, audited financial statements for those same funds were delivered six months to eight months late. The same materials for the next fiscal year were distributed to investors approximately three months late. The SEC further alleged that the RIA was previously sanctioned for Custody Rule violations in 2010.

The complaint alleged that the CCO knew or was reckless in not knowing about the RIA's violations of the Custody Rule and was deeply involved in causing them. Notable, the CCO executed the notarized offer of settlement with the SEC of the 2010 Order on the RIA's behalf. Furthermore, the RIA's compliance manual obligated the CCO to engage auditors for full audits. He also signed representation letters to, and was a principal contact for, the auditors. In addition, the CCO knew that the audited financial statements were not being distributed on time.

Despite his awareness of these problems, the CCO continued to miss the RIA's Custody Rule deadline year after year. The CCO did not take any substantive action to ensure compliance with the Custody Rule. He made no attempt to notify SEC staff members of any difficulties the RIA encountered in complying with the Custody Rule deadlines. The enforcement action can be found at http://www.sec.gov/litigation/admin/2014/ia-3960.pdf.

Meaningless Policies and Procedures Will Not Help CCOs

Too many firms mistakenly believe that examiners will be satisfied if an RIA presents them with voluminous policies and procedures. RIAs and their CCOs have been sanctioned for utilizing boiler-plate policies and procedures manuals. A firm's compliance manual must address the unique risks and conflicts of interest raised by the RIA's business model.

CCOs will not be insulated from liability by merely enacting copious policies and procedures. Policies and procedures must be reasonably designed to prevent violations of the securities laws, as well the rules and regulations that interpret them. It is also imperative that associated persons of an RIA abide by those policies and procedures.

It is not enough for an RIA's policies and procedures to reiterate the Commission's rules without tailoring them to the firm's activities. As Norm Champ, the SEC's former Director of the Division of Investment Management, said in his remarks to the 2014 IAA Investment Adviser Compliance Conference on March 7, 2014, "It is crucial that policies and procedures be reviewed and updated as your business changes, as regulations change, as new guidance is issued." According to Champ, "Compliance policies and procedures should evolve and grow with your business."

Examiners are likely to be very wary of policies and procedures that are stagnant. When policies and procedures stay the same from year to year, examiners will question the efficacy of the firm's annual review. Egregious compliance lapses can lead to sanctions against a CCO who is responsible for the RIA's compliance manual.

Policies and Procedures As a Defense to CCO Responsibility

While robust policies and procedures will not let CCOs and RIAs skate away from responsibility for compliance violations, they do offer some measure of protection. It is not enough, however, to give lip service to compliance. An RIA in Denver fell far short of the mark when it adopted a code of ethics and an insider trading policy. Firms typically incorporate a code of ethics into their policies and procedures.

On June 11, 2014, the President/CCO of the Denver firm was sanctioned for violating the Code of Ethics Rule and failing to supervise an employee who committed insider trading violations. The President/CEO also failed to conduct an annual review of the firm's policies and procedures.

In its enforcement action, the SEC accused the RIA's President/CEO of failing to reasonably supervise the firm's former vice president in order to prevent violations of the Investment Advisers Act and its rules. As mentioned above, RIAs can defend themselves from these allegations if they have established policies and procedures and applied them to prevent and detect violations. To qualify for this safe harbor, they must discharge their duties without having reasonable cause to believe that violations of policies and procedures are occurring. The President/CEO of the Denver-based RIA could not rely on that safe harbor, because he did not have reasonable cause to believe that the firm was in a position to prevent and detect the insider trading violations.

The SEC came to this conclusion, because the President/CEO of the RIA:

- Had a personal relationship with the father of the person involved in insider trading and was aware of the unique risks arising from this individual's misuse of material, non-public information;
- Failed to adequately collect and review records of personal trading by RIA employees;
- Did not maintain restricted or watch lists of stocks, which was required by the RIA's policies and procedures; and
- Did not investigate trading, which was also required by the RIA's policies and procedures.

The President/CCO committed other violations of the firm's code of ethics. The SEC alleged that he only conducted cursory scans of accounts and did not review transaction reports systematically.

The SEC's enforcement proceedings took note of the RIAs recidivist violations. The Commission had sent a deficiency letter to the RIA in 2011, which directed the firm to conduct quarterly reviews of all holdings and quarterly securities transactions reports or monthly statements and trade confirmations. In spite of this warning, the President/CCO continued his arbitrary practice of only conducting cursory reviews of employee transactions.

The SEC's sanctions make it clear how important it is for RIAs to enforce their codes of ethics, as well as all of their policies and procedures. Along with other remedial sanctions, the President/CCO was censured and barred from serving in a compliance or supervisory capacity with any broker-dealer or RIA. He was also fined $100,000. The enforcement action can be found at http://www.sec.gov/litigation/admin/2014/ia-3855.pdf.

In its enforcement proceeding, the SEC alleged that employees received no training regarding the RIA's policies and procedures. Employees were on their own to review the firm's policies and procedures and self-report violations.

Lack of Knowledge Might Not Diminish CCOs' Liability

Sometimes, the CCO for an RIA is in desperate need of training. An SEC enforcement action on January 21, 2015, was brought against a New York RIA whose weak policies and procedures led to numerous compliance problems. The firm's two principals performed the compliance responsibilities for the RIA. The head of the advisory firm possessed little knowledge about the Investment Advisers Act and had inadequate training. The RIA eventually hired an employee to be a compliance officer, but he also had little compliance experience or training.

In addition, the firm failed to provide adequate training to employees regarding its policies and procedures. Although employees took a yearly computer-based training course dealing with the firm's policies and procedures, the RIA did not provide initial training for new employees or periodic training sessions. The enforcement action can be found at http://www.sec.gov/litigation/admin/2015/ia-4004.pdf.

Just as ignorance of the law is no excuse, examiners are likely to have little sympathy for CCOs who lack knowledge of their compliance obligations. One deficiency letter criticized a CCO who lacked familiarity with the Investment Advisers Act. The CCO also failed to accurately identify those activities that put investors and clients at risk.

Even in small RIAs where CCOs have many responsibilities in addition to compliance, examiners have high expectations. One examination team criticized a sole practitioner who was also the CCO for his lack of compliance knowledge. The team observed that he did not appear to be fully engaged with compliance matters.

In another deficiency letter, examiners took note of the CCO's limited knowledge and the fact that he could not respond to their questions. The CCO relied entirely upon another individual in the firm to answer examiners' questions. That individual was designated to handle almost every compliance task. The CCO's designee had done all of the work relating to the firm's policies and procedures. The SEC's deficiency letter requested that the firm reconsider its choice of CCO and implied that he should be replaced by his subordinate who answered all of the examiner's questions.

Get Smart About Compliance or Face Liability

CCOs can avoid sanctions and harsh words from the SEC by documenting their efforts to increase their knowledge of their compliance obligations. CCOs can increase their compliance knowledge by participating in the SEC's Compliance Outreach Program (formerly called CCOutreach). As part of this program, the SEC holds regional conferences and a national seminar each year at the Commission's headquarters in Washington, DC. In addition,

CCOs may contact their local SEC office with compliance questions. Local office contact information is available at http://www.sec.gov/about/offices/ocie/ocie_org.htm. State securities regulators also sponsor compliance education conferences for RIAs.

CCOs can also demonstrate their efforts to satisfy their compliance obligations by providing training to advisory firm personnel. Some advisers send compliance alerts on a regular basis to members of their staff. RIAs will also benefit from taking an inclusive approach to creating policies and procedures, so members of the firm can be a part of the process. This approach helps to increase the likelihood that policies and procedures are meaningful, and associated persons are aware of their compliance obligations.

An effective compliance program can help RIAs and CCOs avoid complaints and litigation. In addition, they might be able to avoid disciplinary events that must be disclosed on the RIA's Form ADV. Even worse, the compliance violations might be reported in newspapers and/or online. When prospects conduct an Internet search of the RIA, these disciplinary events might be at the top of the search results.

Paying a Fine Will Not Get CCOs and RIAs Off The Hook

Some firms make business decisions to engage in activity that might be noncompliant. Their logic is that the potential rewards outweigh the possibility of regulatory sanctions. They might believe that they can simply pay a fine to atone for their compliance mistakes. The SEC is now far less likely to let violators escape culpability.

In his speech at Compliance Week 2014, Ceresney made it clear that enforcement actions might require CCOs to admit wrongdoing:

> *One of the first changes implemented after Chair White and I arrived at the SEC last year was to modify the SEC's longstanding no admit/no deny settlement protocol by requiring admissions in certain types of cases. Our prior practice had been to settle all cases, except those with a guilty plea or criminal conviction, on a no admit/no deny basis. This practice had served the SEC well for many years. When we settle enforcement cases on a no admit/no deny basis, we often are able to get the same – or even higher – penalties than we would have if we litigated and won the case. Such settlements also speed up our ability to reclaim ill-gotten gains and return funds to wronged investors, avoid the delay and uncertainty inherent in trials, and allow us to use our finite resources more efficiently.*
>
> *But there are some cases where the need for accountability and acceptance of responsibility is critical to the success of our program. In such cases, admissions enhance the message and strength of the action, and enable us to achieve a greater measure of public accountability, which, in turn, bolsters the public's confidence in the safety of our markets.*

According to Ceresney, the SEC's relatively new protocol is working well:

> *We have obtained admissions in eight cases under the new approach – with more in the pipeline. And we have obtained them across a broad spectrum of defendants – against firms and individuals; against regulated and unregulated entities; and in scienter-based, as well as non-scienter, controls-based cases.*
>
> *Many originally doubted our ability to implement this new approach. Some expressed concern that we would not be able to obtain admissions because defendants would be overly concerned about collateral consequences. Others wondered whether our new policy would bog down settlements and cause more parties to go to trial. But these dire predictions have not materialized and we have been able to obtain significant admissions in cases where we thought they were appropriate.*

Ceresney contended that the SEC's approach gives the Commission a powerful tool to use in appropriate cases. Certainly, it sends a message to CCOs that they cannot simply pay a fine or hire a compliance consultant to mollify the SEC.

Willful compliance violations are certain to bring a CCO's career to a grinding halt. In a recent case brought by the Financial Crimes Enforcement Network ("FinCEN"), a CCO for a money transfer firm received a $1 million civil money penalty for failing to ensure that his company complied with the Bank Secrecy Act. Because of the CCO's willful violations, he created an environment where fraud and money laundering thrived. FinCEN is also seeking to prevent the CCO from employment in the financial industry. The action can be found at http://www.fincen.gov/news_room/ea/files/USAO_SDNY_Complaint.pdf.

Implementing a Culture of Compliance

In his speech at Compliance Week 2014, Ceresney discussed a best practice that will benefit RIAs and CCOs. According to Ceresney, "I have found that you can predict a lot about the likelihood of an enforcement action by asking a few simple questions about the role of the company's legal and compliance departments in the firm." Here are the questions that Ceresney recommended that RIAs ask:

- Are legal and compliance personnel included in critical meetings?
- Are their views routinely sought out and followed?
- Do legal and compliance officers report to the firm's CEO and have significant visibility with the board?
- Are the legal and compliance departments viewed as important partners in the advisory business rather than support functions or cost centers?

Ceresney went on to say, "Far too often, the answer to these questions is no, and the absence of real legal and compliance involvement in company deliberations can lead to compliance lapses, which, in turn, result in enforcement issues."

Ceresney did, however, give assurances to CCOs:

> *At the end of the day, though, legal and compliance officers who perform their responsibilities diligently, in good faith, and in compliance with the law are our partners and need not fear enforcement action. In fact, we want to use our enforcement program to support your efforts. Last year, for example, we filed our first-ever charge against an individual for misleading and obstructing a compliance officer of an investment adviser.*

Certainly, all CCOs will protect themselves by giving their best efforts to build a culture of compliance. When advisers make a sincere and good faith effort to abide by their compliance obligations, and promptly correct any deficiencies pointed out by examiners, CCOs and RIAs will be in a far better position to avoid liability and regulatory sanctions. ✦

DISCLOSURE: This article is general in nature, and it should not be construed as legal, compliance, or regulatory advice.

National Society of Compliance Professionals Offers Input to the SEC on CCO Liability

Originally Published September 2015

On behalf of its membership, the National Society of Compliance Professionals (NSCP) has submitted a letter to the Securities and Exchange Commission providing input on emerging enforcement issues of compliance officer liability. NSCP's compliance officer members and the Commission share parallel interests in the values of market integrity and investor protection. Guided by these values and through this letter, NSCP seeks to respectfully provide the Commission the benefit of its members' experience in articulating support for a strong and effective enforcement program, while recognizing the shared mission of compliance officers and the unique role they play in their firms.

August 18, 2015

Andrew Ceresney
Director of Enforcement
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Enforcement Liability for Compliance Officers

Dear Mr. Ceresney,

The National Society of Compliance Professionals ("NSCP) is a nonprofit, membership organization dedicated to serving and supporting compliance officials in the financial services industry in the U.S. and Canada. NSCP is the largest organization of securities industry professionals devoted exclusively to serving compliance officers. The principal purpose of NSCP is to enhance compliance in the securities industry, including firms' compliance efforts and programs and to further the education and professionalism of the individuals implementing those efforts. Accordingly, our sole focus is on the interests of compliance officers and enhancing their effectiveness as they help guide their firms to achieve outcomes that promote investor protection and market integrity.

It is important to note at the outset that NSCP believes deeply in the importance of holding bad actors, which can regrettably include compliance officers, accountable for violations of the securities laws, and we fundamentally embrace the importance of effective enforcement. We also understand that a rogue compliance officer may intentionally violate or participate in a violation of the securities laws. In such instances, there is no reason to differentiate a compliance officer from any other defendant.

We appreciate the recognition by the Commission and the staff that compliance officers play a valuable role in the regulatory ecosystem. The importance of the role was central to the adoption of the various compliance rules, which have greatly enhanced the governance and compliance efforts by investment advisers, investment companies, and broker-dealers.[1] The growing importance of the compliance role has accordingly lessened the burden on the Commission in both its inspection and enforcement programs and has greatly enhanced the protection of the investing public.

Given the proven value compliance officers have added to the Commission's mission, we trust there is agreement that it is in the public interest to support compliance officers and avoid outcomes that undermine their effectiveness. Compliance officers are already highly motivated as crucial instruments of investor protection and do not need the threat of enforcement action to do their jobs well.

As such, we submit that a fundamental policy question is whether enforcement actions against compliance officers will motivate them to greater vigilance or risk a demoralizing belief that even exercising their best judgment will not protect them from the risk of a career ending enforcement action, with the result that many of the best compliance officers will choose to leave the profession rather than face the risks.

This is presented particularly when the compliance officer's liability is based on an alleged failure to prevent a violation by another. Accordingly, we suggest that the Commission, as a matter of policy, decline to bring a proceeding based on simple negligence. Rather, we recommend that the Commission initiate a proceeding on such a theory only if the compliance officer acted intentionally or recklessly to facilitate the underlying violation.

We view your speech last year[2] as consistent with such an approach and are hopeful that Chair White's remarks at the recent Compliance Outreach Program on July 14, 2015 reflect a parallel view. However, the compliance community is concerned that, increasingly, the liability standard being applied is one of simple negligence, where a compliance officer is alleged to have "caused" a primary violation committed by another. *See, e.g., In the Matter of SFX Financial Advisory Management Enterprises, Inc.,* Administrative Proceeding File No. 3-16591 (June 15, 2015); *In the Matter of BlackRock Advisors, LLC,* Administrative Proceeding File No. 3-16501 (April 20, 2015); *In the Matter of Thomas R. Delaney II and Charles W. Yancey,* Administrative Proceeding File No. 3-15873 (Initial Decision, March 18, 2015).

With this in mind, as a policy matter, NSCP would like to respectfully share its concern about enforcement proceedings against compliance officers predicated on a theory that they caused a violation by their firm or its personnel by the manner in which they discharged their responsibilities as a compliance officer.

We are particularly troubled by the liability exposure for compliance officers when, after the fact, someone reviewing an *ex post* record

1 *See* Investment Advisers Act, Rule 206(4)-7; Investment Company Act Rule 38a-1; FINRA Rule 3030.

2 *See* Andrew Ceresney, Director of the Division of Enforcement, "Keynote Address at Compliance Week 2014" (May 20, 2014).

concludes that they should have known that better procedures (particularly where the obligation to execute those procedures rests with the business) or better judgments could have prevented the primary violation. Put simply, in this context, a negligence standard is so amenable to liability by hindsight, we are concerned that compliance officers will face the rigors of an enforcement investigation, and potentially career-altering liability, for simple mistakes or errors of judgment which could somehow be connected to a primary violation committed by others.

There are a couple of points that we would urge you to consider in applying your prosecutorial discretion when considering a charging decision against a compliance officer.

First, compliance officers do not operate the business; they advise and support the business. While compliance officers may administer policies and procedures, they do not implement them. Management does. Compliance officers do not have the bandwidth, resources and authority to, in essence, be accountable for managing a business. Compliance officers are staff functions, not line functions. By definition, they do not have the same responsibilities or access to information about a business process as does a line manager or supervisor. Their resources, duties and expertise do not match those who execute and run the business.

Accordingly, in their organizations, ultimate responsibility to implement policies and procedures rests with the business and not the compliance officer. Considering their staff role, holding compliance officers accountable for a negligent miss that conceivably could be linked to an implementation failure by the firm fails to reflect the realities and limitations of a compliance officer's responsibilities.

In addition, in light of the role of a compliance officer, there is a practical issue as to whether, absent affirmative misconduct, a compliance officer can be seen as truly "causing" a violation. Because of his or her oversight role, in circumstances where registered securities business professionals who are aware of their obligations choose to circumvent those requirements, the notion of a compliance officer "causing" the violation is often inconsistent with common sense. By definition, the most a compliance officer can do is take steps through monitoring and testing, and subsequent escalation to management, to mitigate a violation that already has been committed. While a compliance officer can certainly alert management that a violation needs to stop, the notion that a compliance officer in his or her oversight role contributes to an accountable business person's violation fails to consider the realities of the compliance officer's role. The compliance officer may, after the fact, detect a violation. However, in doing so, he or she did not play a role in its execution.

Second, there is a danger of liability by hindsight that in many cases would be largely unavoidable when considering the realities of the duties of a compliance officer. Particularly under a "cause" scenario where the liability is based upon the actions of another, a compliance officer would face an unavoidable risk that he or she would be held to violate the securities laws for designing a procedure that could have been improved, missing something that could have been caught sooner, or making a judgment later subject to question.

Unless tempered by prosecutorial discretion, a decision to charge a compliance officer with "causing" a violation unduly places compliance officers in harm's way for real-time judgments of a type that they must routinely make. Specifically, under a negligence-based causing standard, a compliance officer can be charged and found liable, absent intentional participation in wrongdoing. Particularly when the compliance officer is not the primary violator, the staff or trier of fact could find liability through their substitution of judgment as how effective or prompt the compliance officer was in assessing and addressing a situation with management.

On this point, we respectfully suggest that charging a compliance officer for designing what, with the benefit of hindsight, turns out to be a less than perfect policy and procedure, fails to acknowledge that policies or procedures are rarely "perfect." They are routinely reexamined and improved based upon lessons learned at the firm. This dynamic does not suggest a control weakness. Indeed, the American Institute of Certified Public Accountants recognizes that controls are limited in nature and may "not prevent or detect and correct all errors or omissions.[3]

Third, assessing liability based on negligence could be construed as inconsistent with policy statements articulated by Commission members and staff. As you suggested in your keynote speech at Compliance Week 2014, compliance officers are important partners in the regulatory scheme, and they should not face liability unless (i) they affirmatively participated in the misconduct, (ii) they helped mislead regulators or (iii) they had a clear responsibility to implement compliance policies and procedures and wholly failed to carry out that responsibility. We very much appreciate this thoughtful effort to articulate an approach to compliance officer liability, but fear holding compliance officers liable based on negligence risks outcomes inconsistent with these principles.

As noted in the beginning of this letter, we strongly support an effective enforcement program. We also appreciate the tough choices that you must make in the public interest. We acknowledge that a theory of "causing" liability is available to the staff. However, particularly in light of our universal agreement as to the crucial role that compliance officers play in the regulatory landscape, as well as recognizing the limitations of their roles and how tough their jobs are, we urge restraint in authorizing a case unless the facts suggested an egregious or intentional facilitation of the misconduct.

In this regard, as a matter of policy, we respectfully suggest that the staff adopt internal guidelines that would inform its prosecutorial discretion to avoid these outcomes. As such, we would accordingly urge you to consider an internal guideline based upon the standard for aiding and abetting. These elements: (i) a primary securities law violation, (ii) knowing or extremely reckless conduct, and (iii) substantial assistance to the primary violator appear to capture the spirit of the principles you have articulated. *See Graham v. SEC,* 222 F.3d 994, 1000 (D.C. Cir 2000).

We appreciate your consideration of our views. We would be delighted to have the opportunity to discuss these matters and would be pleased to address any questions.

Lisa D. Crossley
Executive Director

Cc: ***SEC Chairman Mary Jo White***
Commissioner Luis A. Aguilar
Commissioner Daniel M. Gallagher
Commissioner Kara M. Stein
Commissioner Michael S. Piwowar

Andrew Ceresney's keynote speech for the 2015 NSCP National Conference was published in the November issue of *Currents*.

3 *See* Statement on Standards for Attestation Engagements (SSAE-16), *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801.A68).

Establishing a Retail Surveillance Program

By Jim Downing and Jennifer Bures

Originally Published October 2015

There are numerous reasons to develop a robust surveillance program, not the least of which is to ensure compliance with our regulators in today's ever more stringent environment. A well-executed surveillance program will protect the firm by reducing the opportunity for both financial and reputational risk, and will identify gaps in policies and procedures, leading to more effective controls. A surveillance program will also improve sales practices which will protect clients and ultimately deliver a better service experience.

This article will discuss important factors to consider when developing your surveillance program as well as provide a suggested list of surveillance activities to get you started.

Supervision vs. Surveillance

While it may appear that your supervision reviews and surveillance activities are overlapping, when properly administered, they provide two very different types of results. Daily supervision reviews are critical as they consider the appropriateness of transactions on an individual level. They assess whether a particular transaction is in the best interest of a specific client at that point in time. It is equally important to consider the view from 10,000 feet, which is where surveillance activities come into play. Surveillance activities focus on the bigger picture by considering larger subsets of data in order to expose patterns and trends. Rather than analyzing an individual transaction, the focus is on a specific product, such as advisory accounts; a particular group of similar clients, such as senior investors; or the book of business of an individual advisor.

Do I need a Surveillance Manager or a Surveillance Team?

Dedicating sufficient resources is a critical component of a successful program. The first factor to consider is the size of the organization which includes not only the size of the sales force but the size and complexity of the product offering as well. The second factor is an assessment of available technology. A lone surveillance manager may be able to successfully coordinate the program if the firm has well developed technology and the ability to automate some, or even all, of the required surveillance activities. Plan to dedicate additional resources if the program will be dependent upon silo technology and manual processes.

Surveillance Activities

The primary objective of a surveillance program is to identify patterns and trends within the business that pose a risk to clients and the firm. Be sure you are addressing areas of current and increasing regulatory focus such as protecting elderly investors, prevention and early detection of fraud, and appropriate use of social media.

The following are suggested surveillance activities categorized by product and activity type. Consider including some or all of these activities as you build your program.

Surveillance Activities for Mutual Funds:

- B Shares: Review sales of B shares to look for trends in fund family selection or advisors with a high percentage of B share sales in their book of business.
- C Shares: Examine sales of C shares to look for trends in fund family selection or advisors with a high percentage of C share sales in their book of business.
- CDSC: Review transactions incurring CDSC above a designated threshold to uncover patterns by advisor.
- Breakpoints: Identify patterns of mutual fund trades near breakpoints or across multiple fund families to avoid breakpoints.
- Short Term Trading: Look for patterns of short term trading in mutual funds by identifying clients who bought and sold the same mutual fund within 90 days.
- Switching: Look for patterns of mutual fund switching in order to generate commissions.

Surveillance Activities for Fixed Income:

- Below Investment Grade Concentration: Look for patterns of investors solicited to purchase large amounts of below investment grade debt.
- Mark Up/Down: Review fixed income transactions for trends of mark ups and mark downs that exceed thresholds set by the firm.

Surveillance Activities for Advisory Accounts:

- Investment Advisors Act 206(3)-2 Violations: Review the blotter of daily transactions within the advisory platform to identify Agency Cross and Principal Trades
- Reverse Churning: Examine advisory accounts to identify patterns of reverse churning such as:
    - Advisory accounts with high cash balances outside of the model range
    - Advisory accounts with low trading volume over a specific time frame (e.g. 12 months)
- Management Fees: Review fee based accounts to determine whether the fee is appropriate based on trading volume and

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- account holdings; identify situations where a commission based account would be more appropriate.
- Accounts with Commissions: Look at advisory accounts to determine if commissions are being charged to fee based accounts.
- Unassigned Advisory Accounts: Review house accounts to determine if there are advisory accounts that are not assigned to an advisor.

Surveillance Activities for Variable Annuities:

- 1035 Exchanges: Identify advisors with patterns of frequent 1035 exchanges.
- Variable Annuity Sales to Senior Clients: Review all variable annuity sales to clients age 80 and older.
- Rescinds: Look for advisors with a high number of clients exercising the carrier's free look option to cancel the contract.
- Variable Annuity Surrenders: Look for advisors with a high number of surrenders per review period.

Surveillance Activities for Senior Clients:

- New Accounts: Analyze new accounts opened for clients age 70 and older to confirm that the account type is suitable.
- Money Movements: Identify accounts of clients age 70 and older to determine if elder abuse is occurring as suggested by a significant drop in account value or assets within a short period of time (e.g. 90 days).
- Trading: Review trading activity in accounts for clients age 70 and older for inappropriate activity, focusing on patterns of solicited trades and signs of elder abuse.

Surveillance Activities for All Account Types:

- Prohibited Accounts Review: Look for accounts that have been opened for prohibited account types (e.g. casinos, broker/dealers, banks).
- Blue Sky Transactions: Identify advisors with transactions in states where they are not licensed.
- PO Boxes: Look for accounts using a PO Box as their sole and legal address.

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- As-Of Trades: Look for advisors with patterns of as-of trades.
- Top Commission Accounts: Review high commission accounts to ensure trading was suitable and consider if a fee based account may be more appropriate.
- Active Account Review: Look for patterns and trends of unsuitable recommendations by advisors using multiple factors such as age, rate of return, total commissions and activity inconsistent with stated investment objectives.

Surveillance Activities for Registered Representatives:

- Advisor Designations: Determine if advisor use of approved designations are in compliance with the requirements of the organization that granted the designation; confirm the designation is up to date with the issuing organization.
- Employee Trading Review: Look for improper trading (as defined by firm policy) by employees in their own accounts.
- Social Media: Verify that advisors are using social media in accordance with firm policy by reviewing profiles, posts and communications.

Conducting Surveillance

Once you have determined which activities will be included in your surveillance program, the next step is to establish review procedures. Surveillance review procedures should be documented in detail since the same methodology must be used in each review period. It is essential that your data is consistent and that your results can be easily replicated if necessary.

Consider using the following process flow to ensure successful completion of all surveillance activities.

Step One: Collect and Analyze Data

Most surveillance activities can be successfully completed by using a calendar month as the review period. This tends to provide enough data to allow for the observation of trends and patterns, while still allowing for regular monthly reporting. Depending on your firm, it may make sense to adjust the frequency for some or all of your surveillance activities.

Many firms utilize multiple systems to run their business – one may act as primary books and records, another to manage advisory business, and perhaps a third for relationship management. Your firm may opt to invest in a third party surveillance program that will compile data from multiple sources. Alternatively, you may find it necessary to develop your own data management system.

As you begin to collect and review data, you will get a feel for what typical activity levels look like for your business. Use this knowledge to set acceptability thresholds that will indicate when further review or investigation is required. Consider implementing a Green – Yellow – Red classification system. Be sure to revisit your thresholds regularly and adjust them accordingly to keep in line with changes in your business and the regulatory environment.

Step Two: Generate Useful Metrics and Reporting

Completion of your scheduled surveillance activities will generate a large amount of data making clear and concise reporting critical. It is recommended that you develop a monthly report that will summarize your surveillance activities in an easily digestible format.

The report should include:

- Relevant statistical data - how many transactions, accounts, etc. were included in the review
- Trend reporting to allow for month over month and year over year comparison
- Any findings requiring further action
- Updates on any outstanding findings from prior review periods

Step Three: Investigate Findings

Any activity or transaction that falls outside of the acceptable range should be properly investigated to determine if corrective action is required.

In most instances, investigation will begin with the advisor associated with the transaction. Request an explanation and supporting details from the advisor and engage their supervisor as necessary. As a best practice, consider making your inquiries in writing via email or other electronic communication system and take detailed notes to support any verbal communication. Maintain thorough documentation of all investigations as it may be necessary to support corrective action.

Step Four: Resolution

Resolution can be achieved in a number of different ways based upon the specific details of the situation. In most cases, it will be appropriate to engage the advisor's supervisor to ensure the issue is resolved satisfactorily. For sales practice issues or policy violations, resolution could include coaching, additional training, and if warranted, corrective action. If a client account has been impacted, it may be necessary to reverse a trade or make other adjustments to mitigate any harm. In all instances, the resolution must be documented.

Summary

It is important that your surveillance program continues to evolve with your business. Activities should be reviewed at least annually to ensure that the program remains current and effective. In addition to an annual review, ad hoc reviews should be conducted in accordance with regulatory updates as well as any changes to the firm's business model or product offerings.

Keep in mind that all changes must be back-tested. A change in methodology or the use of a different data source or tool can have a major impact on the outcome of the activity. Recreate your results from past review periods using the updated methodology to enable a side by side comparison to ensure your results are consistent.

Implementing a surveillance program will add a tremendous amount of value to the organization and provide protection to both the firm and client. A strong program will identify potential problems in their early stages, allowing the organization to craft a proactive solution rather than implementing reactive oversight, as well as deter misconduct and improve speed of response to both regulatory and management requests. Top the list with the certainty that the financial services industry will continue to see increased scrutiny by regulators and a well-managed surveillance program secures its place as an essential piece of every organization's compliance puzzle. ✦

DISCLOSURE: The views expressed in this article are those of the authors, and do not reflect the views or opinions of BMO Harris Financial Advisors or BMO Financial Group.

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