Morgan Lewis | Conference Outline

INVESTMENT ADVISORY: REGULATORY, LEGAL AND SUPERVISION ISSUES

SIFMA C&L – ST. LOUIS REGIONAL SEMINAR

June 16, 2015

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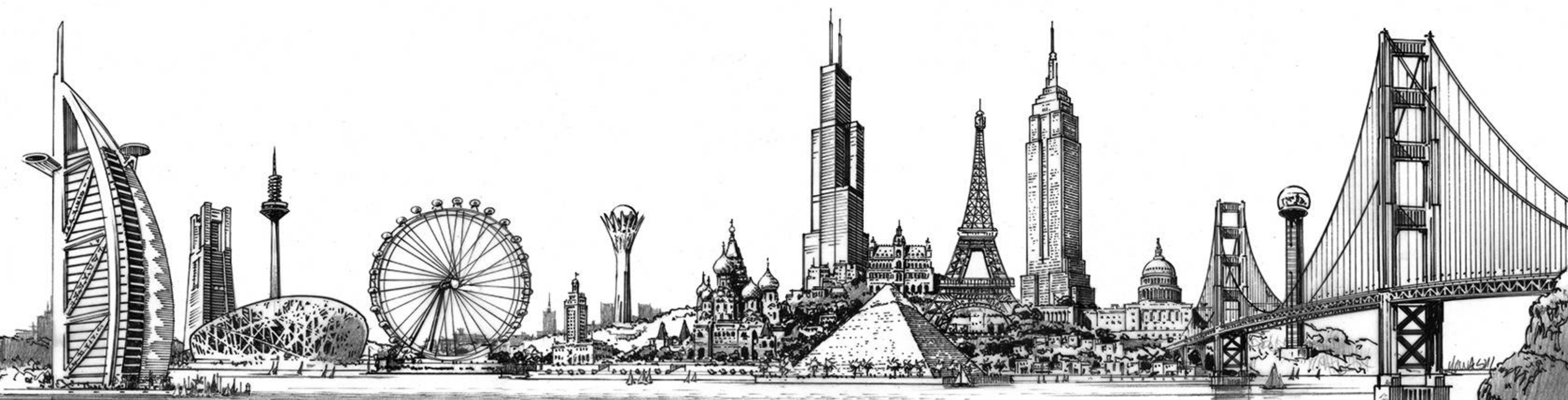

SIFMA Compliance and Legal – St. Louis Regional Seminar
Investment Advisory: Regulatory, Legal and Supervision Issues[1]

June 16, 2015

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I. **Uniform Fiduciary Standard of Care Developments**

A. Dodd-Frank Act Requirements. Section 913 of the Dodd-Frank Act requires that the SEC conduct a study to evaluate the effectiveness of existing legal or regulatory standards of care for providing personalized investment advice and recommendations about securities to retail customers and whether there are legal or regulatory gaps, shortcomings, or overlaps in those legal or regulatory standards.[2]

B. 2011 Staff Study. In early 2011 the staff published its Study on Investment Advisers and Broker-Dealers (the "IA/BD Study"), which recommended, among other things, a uniform fiduciary standard for both broker-dealers and investment advisers, when providing personalized investment advice about securities to retail customers, that is no less stringent than currently applied to investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act").[3]

C. 2013 Benefits and Cost Analysis. In March of 2013, the SEC published a release, entitled *Duties of Brokers, Dealers, and Investment Advisers,* requesting data and other information, including quantitative data and economic analysis, relating to the benefits and costs that could result from various alternative approaches regarding the standards of conduct and other obligations of broker-dealers and investment advisers.[4] The release covered a wide spectrum of points, including inclusion of a number of assumptions designed to provide a framework for meaningful public

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[1] Portions of this outline were drawn from prior outlines developed by Steven W. Stone and Michele Coffey, with significant assistance from others at Morgan Lewis. This material is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It does not constitute, and should not be construed as, legal advice on any specific matter, nor does it create an attorney-client relationship. You should not act or refrain from acting on the basis of this information. This material may be considered Attorney Advertising in some states. Any prior results discussed in the material do not guarantee similar outcomes. Links provided from outside sources are subject to expiration or change.

[2] *See* Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[3] *See* SEC, Staff Study on Investment Advisers and Broker-Dealers (Jan. 2011) *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

[4] *See* SEC, Duties of Brokers, Dealers, and Investment Advisers, Exchange Act Release No. 69013 (Mar. 1, 2013), *available at* http://www.sec.gov/rules/other/2013/34-69013.pdf. (the "March 2013 Release").

comment. The SEC cautioned that "[t]he identification of particular assumptions or parameters, however, does not suggest our policy view or the ultimate direction of any action proposed by us." However, the assumptions and parameters are, at least, an interesting starting point for the discussion.

1. The assumptions articulated by the SEC are the following:

a. Concept of "Personalized Investment Advice" – Assumption that the term "personalized investment advice about securities" would include a recommendation "as interpreted under existing broker-dealer regulation" but would not include "impersonal investment advice" as that term is used under the Advisers Act or "general investor educational tools, provided those tools do not constitute a recommendation under current law."

b. Principal Trades – Assumption that broker-dealers would continue to be permitted to "engage[] in, and receive compensation from, principal trades" and, in that connection, that "Section 206(3) and Section 206(4) of the Advisers Act and the rules thereunder would continue to apply to investment advisers, and would not apply to broker-dealers." In that connection, the SEC said that commenters should assume that "to satisfy its obligations under the uniform fiduciary standard of conduct, however, a broker-dealer would need to disclose any material conflicts of interest associated with its principal trading practices" and "any rule under consideration would treat conflicts of interest arising from principal trades the same as other conflicts of interest."

c. Scope of Responsibility Set by Agreement – Consistent with the language of Dodd-Frank, assumption that "the uniform fiduciary standard of conduct would not generally require a broker-dealer or investment adviser to either (i) have a continuing duty of care or loyalty to a retail customer after providing him or her personalized investment advice about securities, or (ii) provide services to a retail customer beyond those agreed to between the retail customer and the broker-dealer or investment adviser." In that connection, the release includes an assumption that "whether a broker-dealer or investment adviser might have a continuing duty, as well as the nature and scope of such duty, would depend on the contractual or other arrangement or understanding between the retail customer and the broker-dealer or investment adviser, including the totality of the circumstances of the relationship and course of dealing between the customer and the firm, including but not limited to contractual provisions, disclosure and marketing documents, and reasonable customer expectations arising from the firm's course of conduct."

d. New Disclosure Regime – Assumption that "any rule under consideration would expressly impose certain disclosure requirement," including (i) a general disclosure principle; (ii) "[d]isclosure in the form of a general relationship guide similar to Form ADV Part 2A, to be delivered at the time of entry into a retail customer relationship"; and (iii) "[o]ral or written disclosure at the time personalized investment advice is provided of any new material conflicts of interest or any material change of an existing conflict."

e. Ban on Contests – Assumption that any rule used to implement the uniform standard would "prohibit certain sales contests"—specifically, "the receipt or payment of non-cash compensation (e.g., trips and prizes) in connection with the provision of personalized investment advice about the purchase of securities."

2. Among the many fact-finding requests of interest were the following:

a. The SEC asked "How do firms that offer both brokerage and advisory accounts advise retail customers about which type of account they should open?"

b. The SEC requested information on conflicts: "Data and other information describing the nature and magnitude of broker-dealer or investment adviser conflicts of interest and the benefits and costs of these conflicts to retail customers. Also provide data and other information describing broker-dealer or investment adviser actions to eliminate, mitigate, or disclose conflicts of interest." The request went on to include use of disclosure to address conflicts: "Data and other information describing the effectiveness of disclosure to inform and protect retail customers from broker-dealer or investment adviser conflicts of interest. Describe the effectiveness of disclosure in terms of retail customer comprehension, retail customer use of disclosure information when making investment decisions, and retail customer perception of the integrity of the information."

c. The SEC also requested public comment on "whether or to what extent we should consider making other adjustments to the regulatory obligations of broker-dealers and investment advisers, including regulatory harmonization."

D. Recent Developments.

1. To date, the SEC has not enacted a rule addressing a uniform fiduciary standard of care for investment advisers and broker-dealers. However, in its Fiscal Year 2014 Agency Financial Report,[5] the SEC listed focus on the uniform standard of conduct for investment advisers and broker-dealers among its 2015 priorities. The Financial Report noted that the SEC "will strive to advance the final rules required to build a more stable and transparent financial system by . . . evaluating recommendations from a staff report to consider a uniform fiduciary standard of conduct for investment advisers and broker-dealers when providing personalized investment advice to retail investors about securities, as well as ways to better harmonize the regulatory requirements of investment advisers and broker-dealers when they are providing the same or substantially similar services to retail investors."[6]

2. In remarks at the March 17, 2015 SIFMA conference in Phoenix, Arizona, SEC Chair Mary Jo White confirmed that it was her personal view that the SEC should implement a uniform fiduciary standard of care. She also noted that, as part of the fiduciary rule making, the SEC should approve the use of third parties to examine advisers as a method to supplement the SEC's own examination teams.[7]

3. The reference to the use of third parties to examine advisers revives a request for comment that was part of the 2003 proposing release relating to the consideration of Advisers Act Rule 206(4)-7 (the "Compliance Rule").[8] The proposing release for the Compliance Rule

5 *See* U.S. Securities and Exchange Commission Agency Financial Report, Fiscal Year 2014, *available at* http://www.sec.gov/about/secpar/secafr2014.pdf.

6 *Id.* at p. 39.

7 *See* Justin Baer and Andrew Ackerman, SEC Head Backs Fiduciary Standards for Brokers, Advisers, The Wall Street Journal (March 17, 2015), *available at* http://www.wsj.com/articles/sec-head-seeks-uniformity-in-fiduciary-duties-among-brokers-advisers-1426607955.

8 *Compliance Programs of Investment Companies and Investment Advisers*, Advisers Release No. 2107 (Feb. 5, 2003).

requested comment on whether the SEC should leverage private sector involvement to supplement the SEC's examination efforts by requiring investment advisers to hire third parties to perform compliance reviews or engaging independent public accountants to test compliance controls. In the case of the compliance reviews, the third-party firm would produce a report of its findings and recommendations. The examination staff would then use those reports to quickly identify areas that require attention and conduct more efficient examinations. The other alternative would expand the role of the auditors to require an identification of material weaknesses in the internal controls or a report on other aspects of the internal controls that are not required to be reviewed in planning and performing an audit of the financial statements. Chair White has requested that the staff conduct a current evaluation of the third-party compliance review concept.[9]

II. Department of Labor Fiduciary Rule Developments

A. The debate around adopting a uniform fiduciary standard of care for investment advisers and broker-dealers became more complex on April 14, 2015 when the Department of Labor ("DOL") released its reproposed rule "Definition of the Term 'Fiduciary'; Conflict of Interest Rule – Investment Advice." The reproposal would broaden the definition of a fiduciary, narrow exception, and substantially revise prohibited transaction exemptions applicable to current and newly covered fiduciaries. If adopted as proposed, the rule has the potential to profoundly affect how financial services firms provide services to retirement plans and Individual Retirement Accounts ("IRAs"). The deadline for comments was recently extended to fall on or around July 15, 2015. The DOL has announced that it intends to hold a public hearing on the reproposal during the week of August 10, 2015.

B. Please see the attached white paper "DOL's Proposal to Expand Fiduciary Definition Would Bring Many Service Providers into Scope" for more information about the reproposal.

III. Recent SEC and FINRA Regulatory Developments

A. Amendments to Form ADV and Investment Advisers Act Rules.

1. On May 20, 2015 the US Securities and Exchange Commission ("SEC") proposed to expand substantially Form ADV Part 1A to capture more detailed information about separately managed accounts, as well as other aspects of an adviser's business, and to provide a mechanism for certain advisers to make consolidated or "umbrella" registration filings (the "Proposing Release").[10] In addition to facilitating data collection about SMAs, the proposed changes would specifically:

a. enhance the disclosure requirements of Form ADV Part 1A to include additional questions regarding the adviser and certain aspects of its business;

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9 Letter from Mary Jo White, Chair, Securities and Exchange Commission to Jeb Hensarling, Chairman, Committee on Financial Services, United States House of Representatives, Dec. 16, 2014, *available at* https://www.investmentadviser.org/eWeb/docs/Public/141216seclttr.pdf.

10 Amendments to Form ADV and Investment Advisers Act Rules, SEC Release No. IA-4091 (May 20, 2015), *available at* www.sec.gov/rules/proposed/2015/ia-4091.pdf.

b. modify Form ADV to allow for consolidated or "umbrella registrations" for private fund advisers that operate a single advisory business through multiple entities and satisfy certain other conditions;

c. enhance the record-keeping requirements concerning performance information; and

d. make certain technical amendments to Form ADV and Advisers Act rules.

2. The SEC simultaneously issued a companion release proposing to enhance the reporting requirements applicable to registered investment companies.[11] The SEC unanimously approved both proposals, which it noted were intended to further "modernize and enhance" its monitoring and regulation of the asset management industry. In addition to providing more accurate and up-to-date information for investors, the SEC indicated that the proposed forms, rules, and other actions would facilitate its risk-monitoring objectives.

3. Data Collection and Reporting of Separately Managed Accounts. Part 1A of Form ADV requires advisers to provide detailed information about the types of assets, derivatives positions, and borrowings associated with SMAs. Similar to the reporting regime under Form PF relating to private funds, the amount of detail required to be reported would be driven by the level of an adviser's regulatory assets under management ("RAUM") attributable to SMAs. The more SMA assets an adviser has, the more data it would need to provide under the proposal. However, the SMA information would only need to be filed once a year as part of an adviser's annual amendment.

a. Advisers with RAUM of up to $150 million attributable to SMAs – Under the proposal, any adviser that indicates that it has RAUM attributable to SMAs in response to Item 5.K.(1) would need to report the approximate percentage of SMA assets invested in each of 10 broad asset categories.[12] Such information would need to be provided annually as of the end of the adviser's fiscal year.

b. Advisers with RAUM of at least $150 million but less than $10 billion attributable to SMAs – Advisers with at least $150 million but less than $10 billion of RAUM attributable to SMAs would have to provide the information above, as well as to identify the use of derivatives and borrowings in SMAs. Further, such advisers would have to report the number of

11 *Investment Company Reporting Modernization*, SEC Release No. 33-9776 (May 20, 2015), *available at* www.sec.gov/rules/proposed/2015/33-9776.pdf

12 Those categories are exchange-traded equity securities, US government/agency bonds, US state and local bonds, sovereign bonds, corporate bonds that are investment grade (sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time and are subject to no greater than moderate credit risk), corporate bonds that are noninvestment grade, derivatives, securities issued by registered investment companies or business development companies, securities issued by pooled investment vehicles (other than registered investment companies), and other. "Other" must be generally described.

accounts that correspond to certain categories of gross notional exposure[13] and the weighted average amount of borrowings (as a percentage of net asset value) in accounts with a net asset value of at least $10 million. Such information would need to be provided annually as of the end of the adviser's fiscal year.

c. Advisers with RAUM of $10 billion or more attributable to SMAs – Advisers with $10 billion or more in RAUM attributable to SMAs would have to provide all of the same information required for advisers in the two categories described above, as well as the weighted average gross notional value of derivatives (as a percentage of the net asset value) in six different categories of derivatives.[14] These advisers would be required to annually report the foregoing information as of the end of the adviser's fiscal year, as well as its midyear point.

4. All advisers to SMAs would also be required to identify each custodian that holds 10% or more of an adviser's RAUM attributable to SMAs, as well as the amount of SMA assets held by each such custodian. These proposed changes align with the more detailed disclosure currently required by private fund advisers in Item 7.B. of the current Form ADV Part 1A and the corresponding sections of Schedule D.[15]

5. Expanded Information About an Adviser's Business. In addition to the SMA data, the proposal would also amend Part 1A to collect additional information about an adviser and its clients. Below are some of the more notable proposed changes:

a. Social Media – Under the proposal, advisers would be required to disclose whether they maintain a presence on social media and to identify their specific social media addresses (e.g., the firm's Facebook, Twitter, or LinkedIn addresses). Although the SEC stopped short of proposing that an adviser report information about individual employee use of social media for business purposes, it did ask for comment as to whether such disclosure should be required. This is an interesting area of focus that could suggest an increase in interest by the examination staff on the use of social media by advisers and their employees, including the degree to which information that is made available through social media complies with applicable advertising restrictions under the Advisers Act and is consistent with the adviser's Form ADV and other marketing materials.

b. Offices – The proposal would require advisers to identify and disclose the location of their 25 largest offices (measured by number of employees). Advisers would also have to provide information about the advisory, securities-related, and investment-related activities conducted from each office. Currently, an adviser must disclose its top five office locations. This change is notable in light of the examination staff's interest in the supervision of

13 Gross notional exposure would be defined as the percentage obtained by dividing (i) the sum of (a) the dollar amount of any borrowings and (b) the gross notional value of all derivatives by (ii) the net asset value of the account.

14 The derivative types are interest-rate derivatives, foreign-exchange derivatives, credit derivatives, equity derivatives, commodity derivatives, and other derivatives. Each type of derivative has a definition in the new proposed glossary.

15 Such disclosure requirements mandate that an adviser identify the custodian(s) for each private fund it manages.

registered representatives and financial adviser representatives in branch offices.[16] For most advisers, disclosure of the "largest 25 offices" would effectively require disclosure of all offices.

c. Chief Compliance Officer Disclosure – Under the proposal, Form ADV would require an adviser to disclose whether its Chief Compliance Officer ("CCO") is compensated or employed by any person other than the adviser and, if so, the name and IRS Employer Identification Number (if any) of that person or firm. This line of disclosure may imply that the examination staff is noticing a disparity between the compliance programs of firms with full-time CCOs and those with outsourced CCOs. The SEC specifically noted in the Proposing Release that its examination staff has "observed a wide spectrum of both quality and effectiveness of outsourced chief compliance officers and firms."

d. Adviser Assets – Currently under Form ADV, advisers are only required to indicate if their balance sheet assets (as opposed to regulatory assets under management) exceed $1 billion. Under the proposal, the information would be further segmented, and advisers would have to disclose whether their own assets fall into ranges between $1 billion and $10 billion, $10 billion and $50 billion, or $50 billion or more. This proposed change is intended to assist the SEC in implementing rulemaking on methodologies for stress testing financial risk, as required by section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

e. Types of Clients – Item 5 would be amended to require advisers to provide the number of advisory clients and the RAUM attributable to each specific type of client, as opposed to just providing percentage ranges as is currently required. The SEC is also proposing to add two new categories of clients—"sovereign wealth funds" and "foreign official institutions"—and has clarified that government pension plans should be counted as state or municipal government entities, not pension and profit-sharing plans.

f. Wrap Program Disclosure – Although advisers already disclose whether they act as a sponsor or portfolio manager for wrap-fee programs, the amended Form ADV, Part 1A would also require disclosure of the total amount of RAUM attributable to an adviser acting as sponsor and/or portfolio manager of a wrap-fee program. Further, advisers would have to provide the SEC file number and CRD number for sponsors to each wrap-fee program for which the adviser serves as portfolio manager. It is notable that the explanation the SEC provided for this request was to make it easier for the staff to identify whether a particular adviser acts as sponsor or portfolio manager and to "collect information across investment advisers involved in a particular wrap fee program." During its most recent sweep of wrap sponsors and managers, the examination staff may have found it challenging to sort out which wrap programs particular advisers were participating in and whether they were serving as sponsor or portfolio manager. Further, as with much of the other data that would be collected through the updated Part 1A, the staff would have the ability to run analytics against the data and quickly identify and evaluate the relevant relationships among advisers participating in a single wrap program.

6. Umbrella Form ADV Registration. The SEC also seeks to amend Form ADV to better facilitate consolidated or "umbrella registrations" through which a number of private

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[16] *See* National Exam Program - Office of Compliance Inspections and Examinations, Examination Priorities Letter for 2015 (Jan. 13, 2015) *available at* www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf.

fund advisers that operate a single advisory business could register by filing a single Form ADV. The SEC staff first permitted private fund advisers to take advantage of consolidated registrations in certain contexts in a 2012 No-Action Letter issued to the American Bar Association (ABA).[17]

a. The amendments would allow one adviser (the "filing adviser") to file a single Form ADV (an "umbrella registration") on behalf of itself and other advisers that are controlled by, or under common control with, the filing adviser (each, a "relying adviser"), provided that they operate a single advisory business and satisfy the following conditions:

(i) The filing adviser and each relying adviser can only advise private funds and clients in separately managed accounts that are "qualified clients"[18] and otherwise are eligible to invest in the private funds advised by the adviser and whose accounts pursue strategies substantially similar or otherwise related to the private funds managed by the adviser. This condition would limit the universe of advisers able to file an umbrella registration to those managing private funds and certain separate accounts of sophisticated investors. Notably, as proposed, this would largely preclude advisers with multiple lines of business from filing an umbrella registration.

(ii) The filing adviser must have its principal office and place of business in the United States, and, therefore, all of the substantive provisions of the Advisers Act and its rules must apply not only to the filing adviser, but also to each relying adviser's dealings with each of its clients, regardless of whether the relying adviser or the client is a US person. As a result, non-US advisers may be unwilling to take advantage of an umbrella registration, given that the Advisers Act would apply to their dealings with their non-US clients.

(iii) Each relying adviser, its employees, and the persons acting on its behalf are subject to the filing adviser's supervision and control.

(iv) The advisory activities of each relying adviser are subject to the Advisers Act and subject to examination by the SEC.

(v) The filing adviser and each relying adviser operate under a single code of ethics and written policies and procedures, in accordance with Advisers Act Rule 204A-1 and Rule 206(4)-7, respectively, administered by a single CCO.

b. Advisers filing an umbrella registration would need to complete a new Schedule R, which would provide a mechanism for the filing adviser to report the requisite information for each relying adviser. Schedule R would not necessarily require any additional information but would provide more uniformity in the disclosure of information regarding relying advisers than under the current Form ADV.

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17 *See* American Bar Association, Business Law Section, SEC Staff Letter (Jan. 18, 2012), *available at* www.sec.gov/divisions/investment/noaction/2012/aba011812.htm (hereinafter, the 2012 ABA Letter).

18 "Qualified Client" is defined by reference to Rule 205-3 under the Advisers Act.

c. Note that that advisers qualifying for umbrella registration would be permitted, but not required, to file umbrella registrations. In addition, the SEC explicitly stated that umbrella registration is not available for exempt reporting advisers ("ERAs").[19]

7. Proposed Amendments to the Books and Records Rule Concerning Performance. The SEC is proposing to amend the books and records rule on the retention of records relating to advertisements and other written communications. Both proposed changes reflect the examination staff's continued focus on reviewing and evaluating adviser performance claims.

a. Advisers Act Rule 204-2(16) currently requires advisers to retain all documents or records that are necessary to form the basis for, or demonstrate the calculation of, the performance or rate of return of any or all managed accounts or securities recommendations in any communication that an adviser distributes, directly or indirectly, to 10 or more persons. The proposal would remove the "10 or more persons" condition and requirement that advisers retain the requisite performance records for communications that are distributed to *any* person. Although we generally believe that, as a best practice, most advisers retain the relevant records for communications provided to any number of clients and prospective clients (including one-on-one presentations), if adopted, this proposal would make any failure to maintain such records a regulatory infraction.

b. The SEC also proposes to amend rule 204-2(a)(7)[20] to require advisers to maintain originals of all written communications received and copies of written communications sent relating to the performance or rate of return of any or all managed accounts or securities recommendations. This proposed change was precipitated by, among other things, a recent enforcement action wherein the evidentiary record prevented the action from moving forward.[21]

8. Technical Amendments to Form ADV and Advisers Act Rules. Finally, the SEC also proposes numerous minor amendments to Form ADV to clarify areas where it received numerous requests to remove expired provisions and provide further instruction. In addition, the SEC proposes to amend certain Advisers Act rules to remove transition provisions that are no longer applicable.

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19 *See* Proposing Release at footnote 56.

20 Rule 204-2(a)(7) currently requires advisers to make and keep "Originals of all written communications received and copies of all written communications sent by such investment adviser relating to (i) any recommendation made or proposed to be made and any advice given or proposed to be given, (ii) any receipt, disbursement or delivery of funds or securities, or (iii) the placing or execution of any order to purchase or sell any security."

21 *In the Matter of Michael R. Pelosi*, Advisers Act Release No. 3141 (Jan. 14, 2011); Initial Decision Release No. 448 (Jan. 5, 2012); Investment Advisers Act Release No. 3805 (Mar. 27, 2014) (Commission opinion dismissing proceeding against associated person of registered investment adviser charged with providing false and misleading performance information because the record lacked an evidentiary basis from which to determine that the performance information was materially false or misleading).

B. FINRA Proposal on Recruitment Practices.

1. FINRA recently reproposed Rule 2272 (Educational Communication Related to Recruitment Practices and Account Transfers), which would require broker-dealers to provide former customers of a registered representative who is transferring to a new firm an "educational communication" prepared by FINRA.[22] The communication, which would be standardized for all broker-dealers, would highlight the potential implications of transferring assets to the recruiting firm and suggest questions the customer may consider to make an informed decision, such as:

a. whether financial incentives received by the representative could create a conflict of interest;

b. whether certain assets may not be directly transferrable to the recruiting firm and, as a result, whether the customer may incur costs to liquidate and move those assets or inactivity fees to leave them with his or her current firm;

c. what the potential costs might be related to transferring assets to the recruiting firm, including differences in the pricing structure and fees incurred; and

d. what the differences in products and services offered by each firm might be.

2. The educational communication would be delivered at or shortly after (within three days of an oral discussion with a customer about transferring his or her account) contact by the representative, as well as included in the account transfer approval documentation. The delivery requirement would continue for six months after the representative begins employment or associates with the new firm.

3. This approach replaces a prior proposal filed with the SEC in March 2014 that would have required each broker-dealer to provide more detailed disclosure of the range of recruitment compensation that the representative has received or will receive in connection with transferring firms and the basis for that compensation.[23] It would also have required disclosure if a customer would incur costs to transfer assets to the new firm that would not be reimbursed to the customer or if any of the customer's assets were not transferrable.

4. Dual registrants should consider this proposal in connection with Form ADV, Part 2B disclosure for registered representatives who are also providing investment advice and for which the firm is required to deliver a brochure supplement. The examination staff has raised the question of whether advisers are disclosing information about recruiting compensation with the appropriate level of detail in Item 5 of Part 2B.

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[22] *Recruitment Practices*, FINRA Regulatory Notice 15-19 (May 2015), *available at* http://www.finra.org/industry/notices/15-19.

[23] *See Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change to Adopt FINRA Rule 2243 (Disclosure and Reporting Obligations Related to Recruitment Practices)*, Exchange Act Rel. No. 71786 (March 24, 2014) (SR-FINRA-2014-010).

IV. **SEC Examinations – Selected Initiatives**

A. Never-Before-Examined Investment Advisers.

1. Last February, the SEC announced an initiative directed at investment advisers that have never been examined. The announcement followed a prior announcement prioritizing the examination of advisers who have been registered with the SEC for three or more years but had never been examined.[24] Those examinations would "concentrate on the advisers' compliance programs, filings and disclosure, marketing, portfolio management and safekeeping of client assets."[25] OCIE sent letters to all affected advisers, which described two approaches to the initiative: (1) risk assessment, which was designed to give OCIE a better understanding of the adviser and might include an overall review of the adviser's activity, with a focus on compliance and disclosure; and (2) focused reviews, which would include a comprehensive risk-based examination, and would be used in examination of advisers identified has having a high-risk area of business or operation. The letter acknowledged that not all advisers receiving the letter would be examined. This initiative is expected to continue through 2016. In addition, as discussed below under the examination priorities for 2015, the staff is now extending this initiative to never-before-examined investment companies.

B. Examinations of Wrap Accounts.

1. In January 2014, the SEC listed wrap-fee programs among its 2014 examination priorities. It followed up on this priority last summer, when OCIE issued a letter to certain investment advisers, requesting 21 detailed items on wrap-fee programs. The letter requested, among other things, (1) a copy of each wrap-fee program's disclosure brochure furnished to clients; (2) a list of all marketing materials used to promote wrap fee programs; (3) compliance policies specific to monitoring for wrap accounts with high cash balances or low levels of trading; and (4) any analyses to identify wrap accounts with low levels of trading or high cash balances.[26] The focus was consistent with the staff's earlier statement that it would "assess whether advisers are fulfilling their fiduciary and contractual obligations to clients and will review the processes in place for monitoring wrap fee programs recommended to advisory clients, related conflicts of interest, best execution, trading away from the sponsor, and disclosures."[27]

2. In his November remarks at the CFA Institute conference, Bowden stated that, in 30 examinations then to date, OCIE had found issues with respect to the adequacy of certain disclosures and supervision of disclosed practices.[28] In particular, he warned sponsors of wrap-fee

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24 *See* SEC Announces Initiative Directed at Never-Before Examined Registered Investment Advisers, *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540814042.

25 *Id.*

26 *See* http://media.thinkadvisor.com/thinkadvisor/article/2014/08/15/wrap-fee-request-list.pdf.

27 *See* SEC Examination Priorities for 2014, *available at* http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf.

28 *See* Andrew Bowden, *Stakes High to Get GIPS Compliance Right*, *available at* http://blogs.cfainstitute.org/marketintegrity/2014/09/19/sec-to-investment-firms-stakes-high-to-get-gips-compliance-right-video/ (Sept. 19, 2004).

programs to better monitor and disclose the number of "step-out" trades performed by the wrap account's investment managers, as those trades require clients to pay a fee on top of the wrap fee. He noted that sponsors often receive net price information from investment managers that do not break out commissions, and thus may be unaware of how often investment managers are stepping out trades and what the commission cost was.

3. More recently, the focus of these examinations has moved to the manager side, with the examination staff requesting information about how managers who trade away a substantial amount of the time analyze and justify best execution.

C. Automated Investment Tools.

1. The SEC's Office of Investor Education and Advocacy ("OIEA") and FINRA issued a joint investor alert on May 8, 2015, relating to the use of automated investment tools.[29] The alert was designed to address a broad range of advisory services offered by investment advisers, broker-dealers, and dual registrants, including on-line calculators, asset-allocation tools and on-line investment management programs—such as robo-advisers. The alert acknowledged that a growing number of these investment tools are being offered directly to investors and that they have many benefits, including low cost ease of use of broad access. At the same time, the alert suggested that investors should consider the following tips if they are using automated investment tools:

a. Understand any terms and conditions associated with using the tools, including whether the sponsor of the tool receives any form of compensation for offering, recommending, or selling particular services or investments.

b. Consider the tool's limitations, including the criteria and methodology used and any key assumptions. The limitations include that the tools may be designed only to offer limited investment options, such as those offered by a firm that is affiliated with the sponsor of the tools.

c. Recognize that the output of the tool depends on the input it requests and the information the user provides. The alert suggests that investors should be aware that the tool may ask questions that are over-generalized, ambiguous, misleading, or designed to fit the user into the tools' predetermined options.

d. Be aware that the tools' output may not be right for a user's financial needs or goals. According to the alert, a tool may not assess all of a user's particular circumstances, and the resulting investment recommendations, therefore, may not be appropriately customized for each user. Further, the output tools provide is of a particular date and tools may not take into consideration the fact that financial goals may change.

e. Finally, the alert warns investors to be aware that the sponsor of the tool may be collecting personal information for purposes unrelated to the tool and reminds

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[29] *Investor Alert: Automated Investment Tools*, SEC's Office of Investor Education and Advocacy and the Financial Industry Regulatory Authority, Inc. (May 8, 2015), *available at* http://investor.gov/news-alerts/investor-alerts/investor-alert-automated-investment-tools.

investors to be cautious about the information they supply and to take steps to protect their personal financial information.

2. Although this is only an alert, it suggests that both the SEC and FINRA are focusing on automated investment tools and robo-advisers, and this alert may serve as a prelude to examination interest in such products and services.

V. **Selected SEC Examination Priorities for 2015**[30]

In light of the growing number and complexity of investment products available to retail investors and the substantial amount of retirement assets, OCIE's examination focus for 2015 includes a number of priorities affecting investment advisers and dual registrants working with retail investors. The priorities include the following:

A. Fee Selection and Reverse Churning. OCIE noted one of its exam priorities for 2015 as fee selection for retail investors where firms are dually registered. OCIE stated "[w]here an adviser offers a variety of fee arrangements, we will focus on recommendations of account types and whether they are in the best interest of the client at the inception of the arrangement and thereafter, including fees charged, services provided, and disclosures made about such relationships."

B. Sales Practices. OCIE stated that it will assess whether registrants are using improper or misleading practices when recommending the movement of retirement assets from employer-sponsored defined contribution plans into other investments and accounts, especially when they pose greater risks and/or charge higher fees.

C. Suitability. OCIE stated that it will evaluate the investment of retirement assets into complex products and higher-yield securities.

D. Alternative Investment Companies. OCIE plans to continue assessing mutual funds that hold alternative investments, noting that such funds have recently experienced significant growth compared to other mutual fund categories. In particular, OCIE will focus on (i) leverage, liquidity, and valuation policies and practices; (ii) the adequacy of the funds' internal controls; and (iii) how such funds are marketed to investors.

E. Fixed-Income Investment Companies. Given the expectation that the Fed will raise interest rates at some point, OCIE will analyze whether mutual funds with significant exposure to interest rate increases have compliance policies, procedures, and controls in place to ensure that disclosures are not misleading and that investments and liquidity profiles are consistent with disclosures.

F. Branch Offices. OCIE is planning on focusing on registrants' supervision of registered representatives and financial advisers in branch offices. In doing so, OCIE will use data analytics to identify branches that may be deviating from the home office's established compliance practices.

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30 *See* SEC National Exam Program Office of Compliance Inspections and Examinations ("OCIE"): Examination Priorities for 2015 (Jan. 13, 2015), *available at* http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf.

G. Cybersecurity. OCIE will continue its initiative to examine broker-dealers' and investment advisers' cybersecurity compliance and controls, which it began in 2014. OCIE has indicated that IT experts from ADP will start accompanying them on examinations for expertise on cybersecurity issues.

H. Municipal Advisors. OCIE will continue to examine newly registered municipal advisors to assess their compliance with the new SEC and Municipal Securities Rulemaking Board rules.

I. Proxy Services. OCIE will examine advisers' compliance with their fiduciary duty in voting proxies on behalf of investors. It will also examine certain proxy advisory services firms to determine how they disclose and mitigate potential conflicts of interest.

J. Never-Before-Examined Investment Companies. OCIE will conduct risk-based examinations on certain never-before-examined investment companies.

VI. SEC Investment Adviser Enforcement Actions – FY 2014[31]

A. Types and Numbers of Enforcement Cases.

In fiscal 2014, the SEC brought a record 755 cases, a figure likely boosted by the number of open investigations carried over from the prior year. Moreover the SEC's actions resulted in a record tally of monetary sanctions being imposed against defendants and respondents. Chair White stated that "[a]ggressive enforcement against wrongdoers who harm investors and threaten our financial markets remains a top priority," and the SEC will continue to bring "creative and important enforcement actions across a broad range of the securities market."[32]

The major categories of cases and the number of actions for FY 2014 within each are as follows:

Type of Case	Number of Actions	Percentage of Total Actions
Broker Dealer	166	22%
Investment Advisers/Investment Companies	***130***	***17%***
Delinquent Filings	107	14%
Issuer Reporting and Disclosure	99	13%
Securities Offering Cases	81	11%
Market Manipulation	63	8%

31 *See* "SEC's FY 2014 Enforcement Actions Span Securities Industry and Include First-Ever Cases," *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543184660#.VMEkh2xOVFw. The SEC's FY 2014 ended on September 30, 2014.

32 *Id.*

Type of Case	Number of Actions	Percentage of Total Actions
Insider Trading	52	7%
FCPA	7	1%
Municipal Securities and Public Pensions	6	1%
Transfer Agent	7	1%
Miscellaneous	37	5%

In what has become a trend, the SEC brought 7% fewer cases against investment advisers and investment companies—130 cases in FY 2014 versus 140 in FY 2013. This continued reduction is particularly noteworthy in a year when almost every other statistic is marked by increase. By way of contrast, the SEC brought 37% more actions against broker-dealers in FY 2014 than in FY 2013. Taken together, though, the SEC continues to devote significant resources to investigating regulated entities. Cases against broker-dealers and investment advisers represented about 39% of the Commission's docket in each of the last two fiscal years.

B. Select SEC Investment Adviser and Investment Company Cases from 2014.

1. *Western Asset Management Company* (Jan. 27, 2014)[33]

a. The SEC filed a settled administrative proceeding against Western Asset Management Company ("WAM"), a registered investment adviser, for breaching its fiduciary duty in failing to disclose and promptly fix a coding error that resulted in ERISA client accounts being inappropriately invested in a privately placed security in violation of investment restriction rules and in contradiction with the firms' written error correction policy.

b. The SEC alleged that, on January 31, 2007, WAM purchased $50 million of a security in an initial private placement, and coded the security in its system as an asset-backed security not eligible for investment by employee benefit plans subject to ERISA. The following day, in response to an exception report, a compliance officer directed that the security type be changed from asset-backed to corporate debt. This change resulted in the security automatically being designated as ERISA-eligible. Portfolio compliance and trading personnel did not recognize that the security was not ERISA-eligible, and therefore did not advise the back office, instead telling the back office to ignore alerts that were triggered by the security.

c. The SEC alleged that, by October 2008, WAM was notified that the security was not ERISA-eligible. WAM identified 94 affected accounts, and launched a three-month investigation into the issue. Initially, WAM concluded that there was no coding error, as error was defined by its internal error correction policy, and concluded that allocation of the security to ERISA accounts did not violate investment guidelines applicable to those accounts. Even so, it attempted to sell the security position out of all ERISA accounts. WAM subsequently halted those efforts in light of price deterioration and consequent liquidity.

33 *In the Matter of Western Asset Management Company*, Admin. Proc. File No. 3-15689 (Jan. 27, 2014).

d. In May 2009, liquidity and pricing for the security improved, and WAM sold holdings in both ERISA and non-ERISA accounts. The sales were at prices that were inferior to prices at which the accounts purchased the security. WAM did not advise ERISA clients either before or after those sales that it had allocated the security to their accounts as a result of a coding error. The SEC alleged that clients were not informed that the security had been allocated to their accounts in error until August 2010, after it became aware that an SEC investigation had been commenced.

e. The SEC's settled order charged that WAM violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

f. Without admitting or denying the findings in the order, WAM agreed to a censure, a cease-and-desist order, a civil monetary penalty of $1,000,000, and disgorgement of $8,111,582 plus interest of $1,508,810. WAM also agreed to engage an independent compliance consultant to conduct a comprehensive review of its policies and procedures to address the coding errors.

g. In determining to accept WAM's offer of settlement, the SEC considered WAM's prompt remedial efforts.

2. *Transamerica Financial Advisors, Inc.* (April 3, 2014)[34]

(i) The SEC filed a settled administrative proceeding against Transamerica Financial Advisors, Inc. ("TFA"), a dually registered investment adviser and broker-dealer, for allegedly failing to apply certain breakpoint discounts to retail clients in violation of its disclosures and internal policies and procedures. TFA was also alleged to have inadequate policies and procedures to ensure that fees were properly calculated, resulting in overcharges in certain client accounts.

b. The SEC alleged that TFA offered several programs to retail clients and charged them advisory fees based on the amount of assets in the client's accounts. The SEC further alleged that, between January 2009 and June 30, 2013, TFA offered breakpoints for the administrative fee charged to clients in these programs, and informed them of their right to elect to aggregate their accounts to qualify for those breakpoints.

c. The SEC alleged that, in the course of a 2009 TFA branch office examination, the examination staff notified TFA that it may not be aggregating accounts on a systematic basis and recommended that it undertake a review of investment advisory accounts for all branches. According to the SEC, TFA refunded affected clients in the examined branch, but did not conduct a broader review of all branches.

d. After the 2009 exam, TFA took a number of steps to notify clients and its investment adviser representatives of the fact and mechanics of the account aggregation process, and added related disclosures to its Form ADV Part 2. TFA reiterated those disclosures in subsequent filings.

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[34] *In the Matter of Transamerica Financial Advisors, Inc.*, Admin. Proc. File No. 3-15822 (April 3, 2014).

e. According to the SEC, during the course of a firm-wide examination in 2012, examination staff found that certain of the issues identified in the prior branch office examination persisted. The SEC alleged that the ongoing failures were the result of inadequate policies and procedures at the firm level to implement TFA's breakpoint policy. In particular, those policies and procedures were unclear in terms of delineating responsibility for reviewing new account forms for aggregation requests, which resulted in the firm failing to review and link many new accounts for aggregation and breakpoints application. The staff also noted that TFA did not follow through on all the remediation steps it committed to after the 2009 SEC exam.

f. The SEC's settled order charged that TFA violated Sections 206(2), 207, and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

g. Without admitting or denying the findings stated in the order, TFA consented to a censure, and agreed to a civil monetary penalty of $553,624 and certain undertakings, including retention of an independent compliance consultant to conduct a review of specified policies and procedures.

h. In determining to accept TFA's offer of settlement, the SEC considered TFA's prompt remedial efforts, which included refunds and credits to 2,304 accounts, totaling $553,624.32, as well as TFA's cooperation with SEC staff.

3. *UASNM, INC.* (June 9, 2014)[35]

a. The SEC filed a settled administrative proceeding against UASNM, Inc. ("UASNM"), a registered investment adviser, for allegedly (i) allowing its CFO and majority owner, Dennis J. Malouf ("Malouf"), to enter into a commission arrangement with a broker-dealer that created a material conflict of interest; (ii) failing to disclose the arrangement to its clients; (iii) posting misleading information to its website in light of the arrangement; (iv) failing to seek and obtain best execution for its clients; and (v) failing to implement reasonable policies and procedures for best execution and failing to supervise Malouf.

b. The SEC alleged that Malouf, who owned a majority interest in UASNM, entered into a secret agreement with the branch manager of a broker-dealer with which he had had formerly been associated and had owned a branch office. Malouf had terminated his association and branch ownership when concerns were raised about potential conflicts and supervision risks arising from his interest in UASNM.

c. The secret agreement was discovered after the minority owners of UASNM, where Malouf continued to do advisor work, terminated Malouf based on allegations of misconduct, and filed suit against him to enforce that termination. Discovery materials subpoenaed from the broker-dealer with whom Malouf had previously been associated revealed that Malouf placed all UASNM bond trades through the broker-dealer without obtaining competing bids. This resulted in UASNM clients paying unfavorable markups and markdowns totaling approximately $506,083.74. In addition, the broker-dealer branch manager, who earned approximately $1,100,000 in commissions from the UASNM client bond trades, paid approximately that amount to Malouf pursuant to an oral, undisclosed agreement between the two.

35 *In the Matter of UASNM, INC.*, Admin. Proc. File No. 3-15917 (June 9, 2014).

d. The SEC alleged that, between February 2008 and March 2011, UASNM failed to disclose in its Form ADV filings Malouf's arrangement with the branch manager and the conflicts of interest that arose from it. The SEC also alleged that, between 2008 and 2011, UASNM's Forms ADV filings, as well as its website, contained statements regarding the firm's impartial investment advice, best execution, and commissions that were misleading in light of his arrangement with the broker-dealer.

e. Lastly, the SEC alleged that UASNM failed to seek best execution in connection with the bond trades, and that its policies and procedures were inadequate to address its portfolio management practices. The staff contended that, between 2008 and 2011, UASNM failed to conduct reviews of its best execution efforts, allowed Malouf to make most of the fixed-income trading decisions, and had no supervisory system for overseeing Malouf's trades, daily practices, and his bid process.

f. The SEC's settled order charged that UASNM violated Sections 206(1), 206(2), 207, and 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) and 206(4)-7 thereunder.

g. Without admitting or denying the findings in the order, UASNM agreed to pay a civil monetary penalty of $100,000 and undertook to notify clients of the order and pay $506,083.74 to clients who paid excessive markups and markdowns. UASNM also undertook to retain an independent compliance consultant.

h. In a separate case, the SEC filed a settled administrative proceeding against Malouf, for his fraudulent commission scheme. The SEC's action against Malouf is pending.

4. *Lakeside Capital Management, LLC and Dennis H. Daugs, Jr.* (July 17, 2014)[36]

a. The SEC filed a settled administrative proceeding against Lakeside Capital Management LLC ("LCM"), a registered investment adviser, and Dennis H. Daugs ("Daugs"), LCM's sole owner, portfolio manager, and Chief Compliance Officer, for Daugs's alleged failure to disclose conflicts of interest to his clients and conducting undisclosed transactions using client assets, and LCM's inadequate compliance manual and failure to hold client funds with a qualified custodian.

b. The SEC alleged that, during 2008 and 2009, Daugs sold $2,150,000 in securities in the account of a senior citizen client and loaned the funds to himself. Although Daugs paid interest on the loans and eventually disclosed and repaid them, the loans were not in the client's best interest.

c. Daugs was also alleged to have diverted assets in a private fund that he managed—whose clients were principally LCM advisory clients—to settle claims with clients who alleged that he had mismanaged their assets, including by causing the private fund to purchase unwanted investments from complaining clients. Daugs also made loans to himself from the private fund for personal real estate transactions.

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36 *In the Matter of Lakeside Capital Management, LLC and Dennis H. Daugs, Jr.*, Admin. Proc. File No. 3-15976 (July 17, 2014).

d. The SEC alleged that LCM violated the custody rule set forth in Rule 206(4)-2 of the Advisers Act by holding cash belonging to private fund clients in three bank accounts established in the name of law firms employed by the company. In addition, LCM, which relied on the audit approach set forth in the rule, failed to deliver audited financial statements for the private funds it advised by required deadlines. In the relevant period, Daugs was LCM's sole owner, portfolio manager, and chief compliance officer and was responsible for LCM's compliance with the custody rule.

e. The SEC further alleged the LCM's compliance manual lacked policies and procedures to address the firm's extensive involvement in private funds management. Specifically, it had no provisions to address material conflicts of interest or the responsibility to act in the client's best interests.

f. The SEC's settled order charged that LCM and Daugs violated Section 10(b) of the Exchange Act and Rules 10b-5 and 10b-5(c) thereunder, as well as Sections 206(1), 206(2), and 206(4) of the Advisers Act, and Rules 206(4)-2 and 206(4)-7 thereunder, which LCM violated and Daugs aided, abetted, and caused LCM to violate.

g. Without admitting or denying the findings in the order, LCM and Daugs consented to a cease-and-desist order, agreed to pay disgorgement of $302,451 and $37,701 in prejudgment interest, and to pay a civil monetary penalty of $250,000. LCM also consented to winding down its operations under the supervision of an independent monitor, and Daugs was barred from the industry for five years.

5. *The Robare Group, Ltd., Mark L. Robare and Jack L. Jones Jr.* (Sept. 2, 2014)[37]

a. The SEC commenced an administrative proceeding against Robare Group Ltd ("RGL"), a registered investment adviser servicing primarily retail clients, and Mark L. Robare ("Robare"), the founder and majority owner of the firm, for allegedly (i) entering into a commission and servicing fee agreement with a broker-dealer, which created a conflict of interest; (ii) failing to disclose the agreement to clients for several years; and (iii) later making inadequate disclosures about the agreement. The SEC also alleged that Jack L. Jones, Jr. ("Jones"), a limited partner of the firm and a registered investment adviser, aided and abetted RGL's and Robare's violations.

b. The SEC alleged that, in 2004, RGL entered into a commission schedule and servicing fee agreement with a broker-dealer under which it would be compensated based on the level of client assets invested "No Transaction Fee" mutual funds that are unaffiliated with the broker-dealer but are offered on its platform. The amount to be paid to RGL increased when the amount of client assets placed into eligible funds reached specified levels. The SEC alleged that this agreement created a conflict of interest between RGL and its clients, and an incentive for RGL to favor certain funds and the broker-dealer's platform. The agreement remained in effect until 2012.

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[37] *In the Matter of the Robare Group, Ltd., Mark L. Robare, and Jack L. Jones Jr.*, Admin. Proc. File No. 3-16047 (Sept. 2, 2014).

c. The SEC also alleged that, between 2005 and 2011, RGL failed to disclose the agreement, and the conflicts and incentives that it created, in its Forms ADV or in any other manner. The SEC further alleged that, starting in December 2011, RGL disclosed the existence of the fee agreement but did so inadequately, and did not identify the conflicts it created. Further, RGL's December 2011 disclosures contained incorrect and false statements. By June 2013, the firm's Form ADV Part 2A disclosed the conflict of interest associated with its agreement with the broker-dealer, but did identify its magnitude, and not mention the incentive the agreement created to recommend unaffiliated funds offered through the broker's platform.

d. The SEC also alleged that Robare and Jones knew about the fee arrangement and authorized RGL's Form ADV filings, which lacked disclosures about the arrangement.

e. Between September 2005 and September 30, 2013, RGL received approximately $441,000 from the broker-dealer under the commission and servicing fee arrangement.

f. The SEC's order charged that RGL and Robare violated Sections 206(1) and 206(2) of the Advisers Act and Jones willfully aided and abetted RGL and Robare violations of these Sections of the Advisers Act. The SEC also charged that all respondents violated Section 207 of the Advisers Act.

6. On June 4, 2015, the ALJ dismissed this administrative proceeding finding that the Division of Enforcement failed to carry its burden to show that RGL, Robare and Jones violated Sections 206(1), 206(2), and 207 of the Advisers Act.[38]

7. *Barclays Capital Inc.* (Sept. 23, 2014)[39]

a. The SEC filed a settled administrative proceeding against Barclays Capital Inc. ("BCI"), a dually registered investment adviser and broker-dealer, for alleged systemic failures following its acquisition of Lehman Brothers Inc.'s ("Lehman") advisory business in September 2008. Specifically, the SEC alleged that, when integrating the newly acquired advisory business, BCI did not take steps necessary to enhance its infrastructure to support it. In addition, BCI failed to adopt written policies and procedures designed to prevent violations of the Advisers Act, and to maintain certain required books and records. These failures contributed to (i) the firm's participation in 1,500 principal transactions with advisory clients without mandatory disclosures and client consent; (ii) charges of commissions and fees and earned revenues to 2,785 advisory clients that were inconsistent with written disclosures; and (iii) violations of certain of the custody provisions of the Advisers Act. In addition, BCI underreported its assets under management on a March 2011 amendment to its Form ADV by $754 million.

b. The SEC alleged that BCI's platforms were lacking in capturing data necessary for adequate surveillance, review, and ultimately compliance with applicable rules for advisory clients' accounts and accurate filings with regulators. The firm was unable to pull a list of

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38 *In the Matter of the Robare Group, Ltd., Mark L. Robare, and Jack L. Jones Jr.*, Admin. Proc. File No. 3-16047, Initial Decision Rel. No. 806 (June 4, 2015).

39 *In the Matter of Barclays Capital Inc.*, Admin. Proc. File No. 3-16154 (Sept. 23, 2014).

discretionary accounts and documentations to establish what disclosures were made to clients with respect to solicitation fees paid.

c. The SEC also alleged that, between January 2009 and December 2011, BCI effected more than 1,500 principal transactions, earning a total of $2,853,11.62 in revenue, with its advisory client accounts without client consent and without disclosures or with inadequate disclosures. BCI reimbursed affected clients with revenue and interest.

d. The SEC further alleged that, between September 2008 and December 2011, 2,785 advisory clients were charged fees not consistent with disclosures provided to them. Specifically, the staff alleged that BCI's wealth management division (i) charged 31 accounts undisclosed commissions on equity trades on top of wrap fees; (ii) failed to inform clients of 54 accounts referred to BMI by a number of third-party service providers, that they were paying fees higher than client who were not referred; (iii) earned extra revenue from 2,256 advisory retirement accounts in addition to advisory fees already charged on these accounts as a result of placing clients in investments they were not qualified for; (iv) charged 397 clients undisclosed processing fees; and (v) charged 47 clients fees exceeding those that were disclosed. BCI reimbursed affected clients for overcharges and interest.

e. The SEC alleged that BCI's wealth management division's written policies and procedures relating to principal trading, billing, portfolio management, custody, books and records, regulatory filing, marketing, and solicitation arrangements lacked strength to address risks associated with advisory business and to prevent violations of the Advisers Act. For example, BCI's wealth management division failed to identify in excess of 800 advisory accounts, which should have been subject to a surprise annual independent public account's exam.

f. Lastly, the SEC alleged that BCI underreported its assets under management by $754 million in its Form ADV, and provided inaccurate numbers of accounts in various advisory programs, which resulted in reporting of undervalued assets.

g. The SEC's settled order charged that BCI violated Sections 204(a), 206(2), 206(3), 206(4), and 207 of the Advisers Act and Rule 204-2, 206(4) and 206(4)-7 thereunder.

h. Without admitting or denying the findings in the order, BCI agreed to a censure, a cease-and-desist order, and a civil monetary penalty of $15,000,000. BCI also agreed to retain a compliance consultant to conduct a comprehensive review of BCI's policies, procedures, controls, recordkeeping, and systems related to the alleged violations.

i. The SEC considered CI's prompt remedial actions and its cooperation with Commission staff in determining to accept BCI's offer of settlement.

Morgan Lewis | White Paper

DOL'S PROPOSAL TO EXPAND FIDUCIARY DEFINITION WOULD BRING MANY SERVICE PROVIDERS INTO SCOPE

May 20, 2015

www.morganlewis.com

As we previously reported, the US Department of Labor (DOL) released its reproposed rule "Definition of the Term 'Fiduciary'; Conflict of Interest Rule—Investment Advice" on April 14. The initial deadline for comments on the rule was July 6. The DOL recently announced that it intends to extend the deadline by 15 days to fall on or around July 20. The DOL has also announced that it intends to hold a public hearing on the reproposal during the week of August 10.

This White Paper examines the reproposed changes to the definition of an "investment advice fiduciary" for purposes of the Employee Retirement Income Security Act (ERISA) standards of fiduciary conduct and the prohibited transaction rules under ERISA and section 4975 of the Internal Revenue Code (the Code). It also covers the DOL's six proposed "carve-outs" from fiduciary status. Our next White Paper will cover the proposed Best Interest Contract Exemption and Exemption for Principal Transactions in Certain Debt Securities, as well as the proposed amendments to current prohibited transaction exemptions.

The reproposed definition of "fiduciary" is intended to expand the scope of activities that will result in fiduciary status and application of the prohibited transaction rules, particularly covering many services that broker-dealers and other financial advisers provide to plans, plan participants, and Individual Retirement Account (IRA) owners. The DOL has provided exceptions for certain activities that, in its view, should not result in fiduciary status. The reproposal leaves open questions about what types of investment-related activities or communications may still be viewed as nonfiduciary even though they do not fall within one of the six carve-outs.

REPROPOSED DEFINITION OF "INVESTMENT ADVICE FIDUCIARY"

This section provides (1) a brief background on the DOL's regulatory initiative with respect to the definition of "investment advice fiduciary" under ERISA and the Code and (2) an outline of the DOL's reproposed definition and observations.

Background

In addition to persons with investment discretion, the statutory definition of "fiduciary" under ERISA and the Code includes any person who "renders investment advice for a fee or other compensation, direct or indirect," with respect to a plan's assets. When ERISA was enacted, many expressed concern about the scope of activities that would be deemed fiduciary under the statute and the potential to disrupt customary transactions between financial intermediaries, such as between broker-dealers and employee benefit plans.

In 1975, the DOL, in part to address these concerns, issued a regulation that defined the types of advice that would be viewed as fiduciary using a five-part test. Specifically, under this rule (which the DOL's reproposal would replace), a person is an investment advice fiduciary if the person renders advice to a plan that

1. is a **recommendation** on investing in, purchasing, or selling securities or other property, or advice as to their value;

2. is provided on a **regular basis**;

3. is provided pursuant to a **mutual agreement, arrangement, or understanding**, either written or otherwise;

4. will serve as a **primary basis** for investment decisions with respect to plan assets; and

5. is **individualized** to the plan based on the **particular needs** of the plan.

The DOL now believes that changes that have occurred in the retirement market since 1975—particularly the growth of participant-directed plans and IRAs and the "increasingly complex financial marketplace"—warrant revisiting the current definition of "fiduciary" and expanding it to cover a broader array of advice and communications.

In its first effort to revise the definition in 2010, the DOL proposed to define "fiduciary investment advice" to include certain recommendations provided pursuant to an agreement or understanding that the advice may be considered in connection with plan investment-management decisions and would be individualized to a plan. The 2010 proposal would have effectively eliminated the "regular basis" "mutual" agreement, arrangement, or understanding and the "primary basis" prongs of the current test. Further, among other changes, the 2010 proposal would have included recommendations by registered investment advisers and discretionary fiduciaries, regardless of whether the recommendation fit the other requirements of the proposed test. Although the 2010 proposal would have included certain exceptions from the definition of "fiduciary," including for certain selling activities, the DOL did not propose any exemptions from the prohibited transaction provisions of ERISA and section 4975 of the Code, as would have been necessary to allow persons who would have become fiduciaries under the expanded definition to continue their established business practices under existing law.

Following criticism of the 2010 proposal during the comment period and public hearings, the DOL announced that it would withdraw the 2010 proposal and repropose the definition before proceeding to a final rule. In issuing the reproposed rule, the DOL stated that it attempted to address many of the issues identified by commenters regarding the 2010 proposal, including by proposing new prohibited transaction exemptions. Even so, if adopted as proposed, the expansive nature of the reproposal would have a significant impact on many financial services firms, their employees, registered representatives, and other professionals when working with employee benefit plans, plan participants, and IRAs, as well as plan sponsors and their fiduciaries. The next sections of this White Paper summarize key aspects of the reproposed definition and its carve-outs, and include some of our observations regarding potential impacts and questions the reproposal raises.

Reproposed Definition of "Fiduciary"

Under the reproposal, an "investment advice fiduciary" would include a person who

1. provides the following advice directly to a plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner in exchange for a fee or other compensation, whether direct or indirect:

   a. a buy, hold, or sell recommendation (defined below);

   b. a recommendation as to the management of securities or other property (e.g., proxy voting);

   c. a recommendation to roll over or distribute assets from a plan or IRA, and a recommendation as to the investment or management of such assets;

   d. an appraisal or fairness opinion regarding the value of securities or other property in connection with a specific transaction or transactions; or

   e. a recommendation of a person who will receive a fee in connection with any of the above (e.g., selection of investment managers and advisers)

and

2. either directly or indirectly (e.g., through or together with any affiliate):

   a. represents or acknowledges that it is "acting as a fiduciary" with respect to the advice described in 1. above, **or**

   b. provides advice that satisfies the following three primary elements:

      i. it is rendered pursuant to a written or verbal agreement, arrangement, or **understanding**;

      ii. it is **individualized—or specifically directed—**to the advice recipient; and

      iii. it is **for consideration** in making investment or management decisions with respect to securities or other property of the plan or IRA.

Observations

The reproposed definition would substantially expand the types of activities and services that would result in fiduciary status compared to existing law and, unlike the 2010 proposal, would expressly include recommendations on rollovers and plan and IRA distributions (proposing to retract the DOL's position expressed in its Advisory Opinion 2005-23A that a recommendation to distribute assets from a plan is generally not a fiduciary act where there is no preexisting fiduciary relationship). Further, as proposed, the definition could include personnel with customer contact, including call center employees, who make statements viewed as "recommendations" under the definition, unless an exception applies.

Although the definition of "fiduciary investment advice" would be significantly broader under the reproposal, the DOL has made clear (both in the preamble and informally) that fiduciary status would remain a functional test and that the parties would still be able to define the scope of activities with respect to which a person would be acting as a fiduciary. Nonetheless, open questions remain about how a person who sells or offers investment services to a plan can, from an operational perspective, avoid fiduciary status (or otherwise effectively limit the scope of his or her responsibilities as a fiduciary) under the reproposal:

- **Mutual Understanding:** Unlike the current regulation, fiduciary status may result even where there is no "mutual" agreement, arrangement, or understanding between an adviser and a plan or IRA client. The DOL clarified in the reproposal's preamble that removal of the term "mutual" is intended to prevent advisers from marketing retirement investment services "in ways that clearly suggest the provision of tailored or individualized advice, while at the same time disclaiming in fine print the requisite 'mutual' understanding." With limited exceptions, it is unclear when an adviser's marketing or sales activities with respect to a plan, plan participant, beneficiary, or IRA would not give rise to an "understanding" that the adviser is acting as a fiduciary.
- **Specifically Directed To:** The reproposal continues to require that advice be "individualized," but adds an alternative that advice would also be considered fiduciary if it is "specifically directed to" the advice recipient. It is unclear what types of communications may be viewed as "specifically directed to" an advice recipient and under what conditions. More specifically, it is unclear whether this may encompass generalized information about investment options, strategies, or asset allocations that is "specifically" addressed to a particular plan or IRA client, even if, for example, sent by means of a mass mailing.
- **For Consideration:** Rather than requiring that advice serve as "a primary basis" for an investment decision, the reproposal would require that the advice be "for consideration." This proposed change seems to lower the level of importance that advice has in the recipient's investment decision making.
- **Recommendation:** The reproposal defines "recommendation" as "a communication that . . . would reasonably be viewed as a *suggestion* that the advice recipient engage in or refrain from taking a particular course of action." The DOL noted in the preamble that it has based this definition, in part, on Financial Industry Regulatory Authority (FINRA) guidance about what would constitute a recommendation for purposes of FINRA Rule 2111 (Suitability). The proposed definition of recommendation, however, appears to omit certain aspects of that guidance, including that determining whether a communication is a recommendation is an objective rather than a subjective inquiry and that the level of individualization is an important aspect of that determination. The DOL has requested comments regarding whether it should adopt some or all of FINRA's standards to define "recommendation" for purposes of the rule.

  The DOL also noted in the preamble that recommendations related to proxy voting could be fiduciary, but generally, fiduciary status would not result from providing proxy voting guidelines to a broad class of investors without regard to an investor's individual interests and investment policy.

SIX CARVE-OUTS FROM FIDUCIARY STATUS

This section provides an overview and observations regarding each of the DOL's six proposed carve-outs from fiduciary status. Generally, it is unclear from the reproposal whether the DOL views these carve-outs as nonexclusive safe harbors. (Note that the DOL would also preserve without change the current "safe harbor" exception for brokerage execution that was part of the original 1975 regulation.)

1. Seller's Carve-Out

The proposed seller's carve-out would apply to advice provided by a "counterparty" to a large plan or account (i.e., a plan with 100 or more participants, or an account of an independent plan fiduciary with responsibility for managing at least $100 million in employee benefit plan assets) for certain transactions. The covered transactions include a sale, purchase, loan, or bilateral contract. In addition to satisfying other conditions (such as that the person cannot receive a separate fee or compensation from the plan or plan fiduciary for the provision of advice), the person must represent that he or she does not intend to give advice in a fiduciary capacity.

The seller's carve-out would require a person to monitor the number of participants in a plan and a fiduciary's assets under management to ensure that he or she can continue to rely on the carve-out, or might instead need to rely on a prohibited transaction exemption, such as the proposed Best Interest Contract Exemption. For example, issues may arise where a person is relying on a seller's carve-out in its dealings with a plan fiduciary and the number of plan participants falls below 100 or the fiduciary's assets under management falls below $100 million. In such a situation, can the person still rely on the carve-out, or would the person be deemed an investment advice fiduciary (and have to acknowledge fiduciary status to rely on the proposed Best Interest Contract Exemption, to the extent that it is otherwise available)?

Relying on a seller's carve-out may be further complicated where a person previously relied on the proposed Best Interest Contract Exemption with respect to a small plan that subsequently turns into a large plan (by reason of exceeding the 100-participant limit under the Best Interest Contract Exemption), such that the exemption becomes unavailable. Because the Best Interest Contract Exemption requires an affirmative representation of fiduciary status, it is unclear how the person could later rely on the seller's carve-out, which requires a disclaimer of fiduciary status, without otherwise modifying its agreements.

Another question is whether the seller's carve-out covers sales of services. We believe—and the DOL has informally indicated—that the term "bilateral contract" may be interpreted to include contracts for services. Nonetheless, clarified regulatory language would be helpful in this regard.

The DOL has excluded advice to IRAs, plan participants and beneficiaries, and plan fiduciaries of small plans from the seller's carve-out, but has requested comments on whether the scope of the seller's carve-out is appropriate and whether there are additional conditions that could protect these types of investors.

2. Swap and Security-Based Swap Transactions

This exception would permit a swap dealer, security-based swap dealer, major swap participant, or major security-based swap participant to act as counterparty to an employee benefit plan in connection with a swap or security-based swap (as defined in the Commodity Exchange Act and the Securities Exchange Act) where a plan is represented by a fiduciary that is independent of the person relying on the exception. If the person relying on the exception is a swap dealer or security-based swap dealer, it cannot be acting as an "advisor" to the plan, as that term is interpreted by the

Commodity Futures Trading Commission and the Securities and Exchange Commission under the Commodity Exchange Act or the Securities Exchange Act, in connection with the transaction. Further, a person relying on the exception must, prior to making any recommendations, obtain a written representation from the independent plan fiduciary that it will not rely on the person's advice. Note that this carve-out does not apply to IRAs, plan participants, or beneficiaries.

3. Employees of the Plan Sponsor

The DOL included a carve-out for employees of any plan sponsor that provide advice to a plan fiduciary, provided that the employees receive no fee or compensation for the advice beyond their normal compensation. The purpose of this carve-out is to permit a plan sponsor's human resources and other employees to advise the plan's investment committee or other named fiduciaries as part of their employment duties without being treated as paid fiduciary advisers. This carve-out would not appear to cover advice to plan participants or beneficiaries.

4. Platform Providers/Selection and Monitoring Assistance

The DOL has proposed two carve-outs for platform providers to participant-directed plans: One for providing a platform of investment options, and another for selection and monitoring assistance related to the platform. The first carve-out would permit a platform provider to market or provide to an employee benefit plan a platform of securities or other property, such as a mutual fund platform, from which the plan fiduciary may select investment alternatives into which participants may direct the investment of their assets. The platform may not be individualized to the needs of the plan, its participants, or its beneficiaries. Further, the person relying on the carve-out must disclose in writing to the plan fiduciary that he or she is not undertaking to provide impartial advice or to give advice in a fiduciary capacity.

The related carve-out for selection and monitoring assistance is intended to permit a platform provider to identify investment alternatives that meet objective criteria identified by the plan fiduciary (commonly referred to as "screening" or "narrowing" investment options) and to provide objective financial data and comparisons with independent benchmarks to the plan fiduciary.

It is unclear whether either carve-out would be available for persons offering brokerage windows or managed accounts. It is also not clear to what extent the proposed platform carve-out would provide relief for platforms provided to participants in participant-directed plans (i.e., in the context of an open brokerage window). In addition, the DOL indicated that the platform provider carve-out would not apply to IRAs and other non-ERISA plans (such as certain health savings accounts, or "HSAs", and non-ERISA 403(b) plans) and expressed concerns that there would be no independent plan fiduciary interacting with the platform provider in the IRA market. The DOL did, however, request comment on whether (and if so, how) this exception could be extended to the IRA market.

5. Certain Valuations

This exception would cover appraisals, fairness opinions, and statements of value provided to:

1. employee stock ownership plans (ESOPs) regarding employer securities,

2. certain investment funds (such as collective investment trusts and pooled separate accounts) holding plan assets of more than one unaffiliated plan or in which more than one unaffiliated plan has an investment, and

3. plans, plan fiduciaries, plan participants or beneficiaries, or IRA owners, as required under ERISA, the Code, or other federal or state law.

The DOL indicated that separate rulemaking should be expected for ESOP valuations.

Although the proposed carve-out would cover valuations provided to investment funds that hold the assets of multiple plans, it is not clear the extent to which it would include or exclude valuations provided in connection with white label or custom institutional funds, such as custom target date funds and stable value funds structured as a fund-of-one or a separately managed account. Further, it is unclear how valuations that may fall within one of the exceptions, such as the calculation of an alternative asset's value for tax purposes, will be treated where the valuation may also be used as the basis for an investment decision.

6. Investment Education

Finally, the reproposal includes a carve-out for four types of investment education:

1. plan information
2. general financial, investment, and retirement information
3. asset-allocation models
4. interactive investment materials

The carve-out for investment education would supersede the DOL's Interpretive Bulletin 96-1 regarding participant investment education and would make several significant changes affecting the provision of educational materials. For example, although this carve-out would permit the provision of certain general information, any materials provided cannot identify specific investment products (other than as information about what investments are available under a particular plan). This change could have a significant effect on the structure of asset-allocation advice programs and tools.

The proposed carve-out clarifies that the concept of investment education is not limited to plan participants but can also apply to education provided to plan fiduciaries and IRA owners. The carve-out further clarifies that providing certain general information that individuals can use to assess retirement needs and risks, and information on how to manage those risks, is not fiduciary investment advice.

Observations

As indicated in the above summary, each carve-out is limited and raises a number of technical drafting issues and other questions. Because the carve-outs are integral to defining the types of activities that would not be treated as fiduciary investment advice, it will be important to clarify their scope. Also important is their interaction with the newly proposed prohibited transaction exemptions, given that activities that fall outside the carve-outs may, if they are continued, require exemptive relief. In particular, because, as proposed, a plan may not qualify for both the seller's carve-out and the Best Interest Contract Exemption at the same time, it will be important to understand how a firm can move between the two rules without losing the benefits of both.

The next White Paper in our series will examine the DOL's new proposed Best Interest Contract Exemption and Exemption for Principal Transactions in Certain Debt Securities and related changes to current class exemptions.

Morgan Lewis

COMMENT LETTERS

As noted above, the DOL recently announced its intention to extend the initial deadline for comments on the reproposal by 15 days. Comments are expected to be due on or around July 20, with a public hearing to follow the week of August 10. The public record will be reopened for additional comments after the public hearing. We strongly encourage those who would be affected by the rule to consider submitting comments to the DOL regarding anticipated effects on plans, plan participants, and IRA owners as well as current business practices and the availability of products and services, and whether certain aspects of the rule should be clarified or changed.

Read our past publications covering the DOL's fiduciary definition rulemaking:

- DOL Fiduciary Rule to Revamp Regulation of Advice to Plans and IRAs (April 15, 2015)
- Department of Labor Retirement Initiative Fails to Consider Current Regulatory Regime, Which Comprehensively Protects Investors, Including IRA Investors, and Preserves Investor Choice (March 23, 2015)
- DOL Sends Proposed Conflict of Interest Rule to OMB for Review (March 5, 2015)
- DOL Announces Intent to Repropose Rule on Definition of "Fiduciary" (September 21, 2011)
- DOL Proposes Significant Changes to "Investment Advice" Fiduciary Status Definition (November 1, 2010)

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