COMPLIANCE INFORMER

REGULATORY UPDATE

December 1, 2018

Provided by Hardin Compliance Consulting LLC

Advisers Fall Short on Referral Arrangements, Mutual Fund Exams Planned, Updates to Annual and FOCUS Reports Finalized, and Compliance Program Fails: Regulatory Update for December 2018

For Investment Advisers: SEC Actions

Risk Alert - Investment Adviser Compliance Issues Related to the Cash Solicitation Rule: The Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert with a list of top deficiencies under Rule 206(4)-3 (the "Cash Solicitation Rule") of the Investment Advisers Act. The biggest problems? Failing to have a referral agreement in place, and either failing to give disclosure to clients about the arrangement or failing to have signed proof from clients that they received the disclosure. Check out our blog post for in-depth advice on avoiding Cash Solicitation Rule pitfalls. *Contributed by Jaqueline Hummel, Partner and Managing Director*

SEC Enforcement Division Issues Report on FY 2018 Results: The Securities and Exchange Commission's Enforcement Division issued its Annual Report, stressing the five qualitative principles it uses to assess its performance as well as providing quantitative data results. They continue to emphasize that protecting retail investors is their highest priority.

The five principles include:

1. Focus on Main Street Investors- The Division created two initiatives in 2018, the Retail Strategy Task Force and the Share Class Selection on Disclosure Initiative to protect retail investors.
2. Focus on Individual Accountability- The Commission charged individuals in more than 70% of the stand-alone enforcement actions with a concentration on CEOs and CFOs.
3. Keep Pace with Technological Change- The Cyber Unit became fully functional in 2018 and became a leader in addressing misconduct relating to digital assets and initial coin offerings.
4. Impose Remedies that Most Effectively Further Enhancement Goals- The Division used creative techniques to supplement financial remedies to address underlying charges. In one example, the Commission's settlement stripped a CEO of her super-majority voting control and ensured she would not benefit from a future sale or liquidation until shareholders were made whole.
5. Constantly Assess the Allocation of Our Resources- The Division shifted its limited resources (headcount is down 10% since 2016) into market segments with emerging risks and was also pragmatic regarding its case selection.

To summarize the quantitative effects of its activity in 2018, the Division issued 821 enforcement actions, returned $794 million to investors, received $3.945 billion in disgorgement and penalties, suspended 280 companies and issued 550 individual bars and suspensions. It's also worth noting that enforcement actions in Securities Offerings and Investment Advisers /Investment Company led the list at 25% and 22%, respectively. *Contributed by Heather Augustine, Senior Compliance Consultant*

For Broker-Dealers: FINRA Actions

BDs and RIAs, Mark Your Calendars for December 17, 2018: Log into your E-Bill account and review your 2019 Preliminary Renewal Statement. Payment-in-full is due Monday, December 17th! There are many payment options available. Late fees will be assessed. Don't forget, certain jurisdictions (such as Illinois) may require additional documentation to be submitted directly to their office. Please refer to the NASAA Regulator directory. *Contributed by Rochelle Truzzi, Senior Compliance Consultant*

SEC Approves Amendments to the Financial Reporting Requirements impact FOCUS and Annual Audit Requirements: Broker-dealers should be aware that these amendments apply to FOCUS reports and Annual Audit Reports filed for the period ending January 31, 2019 and after. FOCUS reports have been updated to reflect GAAP requirements. The Statement of Financial Condition and the Statement of Income will include new line items to report details of comprehensive income and will eliminate references to extraordinary gains/losses and the cumulative effect of changes in accounting principles. The Annual Audit report must contain a Statement of Comprehensive Income, in place of a Statement of Income, where comprehensive income exists in the reporting period. *Contributed by Rochelle Truzzi, Senior Compliance Consultant*

Heads-up BDs - Regulation NMS Amended to Require Additional Disclosures on Order Handling:
Beginning in June of 2019, Rule 606 of Regulation NMS will require broker-dealers to provide, at the request of a customer who places not-held orders (firm has price and time discretion), certain individualized disclosures regarding the handling of the customer's orders. The new and enhanced disclosures are intended to provide the customer with a better understanding of how their firm routes their orders so that the customer can evaluate the execution quality of such orders. Exceptions to the Rule are available at both the firm and customer levels.

In addition, the quarterly public reports required under Rule 606 will cover NMS stock orders of any size that are submitted on a held-basis and will require information to be reported in a new manner. The quarterly public reports on order execution and routing, required by Rules 605 and 606, must be free and posted on a website readily accessible to the public for a period of three years.

Introducing firms should discuss the implementation process with their clearing firms. The Rule amendments become effective on January 18, 2019, with a compliance date of June 18, 2019. *Contributed by Rochelle Truzzi, Senior Compliance Consultant*

For Mutual Funds: SEC Actions

OCIE Risk-Based Exam Initiatives for Investment Companies: In a continued focus on retail investors, OCIE announced new exam initiatives applicable to certain investment companies in a Risk Alert. The alert highlights the types of funds and key areas of interest OCIE will be exploring during these exams.

OCIE is interested in the following types of funds: smaller, low trading volume ETFs; index funds tracking custom indexes; mutual funds with underperformance relative to peer groups or have high allocations to securitized assets (such as certain securitized loans, credit card receivables, or mortgage-backed securities). OCIE is also looking at advisers that are either new to mutual funds or that provide 'side-by-side' advice to mutual funds and private funds. Based on the Risk Alert, funds and advisers selected for examination should expect the Staff to dig into whether risks and conflicts are appropriately reflected within fund and adviser policies and procedures, and disclosed to shareholders and fund boards. OCIE will also be reviewing the evaluation and oversight processes used by funds, advisers and fund boards to mitigate their risks and conflicts.

Finally, OCIE proactively shared what it views as the material risks and key areas of exam focus unique to each type of fund in scope – with emphasis again placed on the potential for harm to retail investors. Advisers to mutual funds cited in the alert should address the conflicts discussed in the Risk Alert as part of the firm's annual compliance program review, risk assessment and testing program. *Contributed by Cari Hopfensperger, Senior Compliance Consultant*

Investment Company Reporting Modernization Frequently Asked Questions: The SEC recently updated its FAQs related to the Investment Company Reporting Modernization Act reforms. Most relevant to advisers will be information related to Form N-PORT and N-CEN, though the FAQ also addresses Regulation S-X. Given the phased approach to implementation and the amendments adopted, funds are encouraged to use this resource to help interpret and understand the requirements and timelines that apply to their specific circumstances. *Contributed by Cari Hopfensperger, Senior Compliance Consultant*

Save Some Trees! Optional Internet Availability of Investment Company Shareholder Reports: Funds interested in taking advantage of the new option for internet delivery of mutual fund shareholder reports under the SEC's Rule 30e-3 may wish to re-visit our prior write up on the topic, given the Rule's effective date of January 1, 2019. Although the earliest that shareholder reports may be delivered online is January 1, 2021, the Rule requires that funds prominently disclose their intent to pursue online delivery in summary and statutory prospectuses, and the annual and semiannual reports for two years beforehand. Interested funds and their advisers may wish to raise the topic with fund administrators to evaluate their plans to facilitate this option and the expected costs. *Contributed by Cari Hopfensperger, Senior Compliance Consultant*

For Hedge Fund Managers:

CFIUS Establishes Critical Technology Pilot Program – Impacts on Investment Funds: The Department of Treasury released interim rules in mid-October establishing a pilot program (the "Pilot Program") that requires parties to notify the Committee on Foreign Investment in the United States (CFIUS), prior to closing, of certain foreign investments in US business involved in "critical technologies" within 27 specified industries. This is the first mandatory filing requirement imposed by CFIUS. The rule implements portions of the Foreign Investment Risk Review Modernization Act (FIRRMA), meant to address national security concerns resulting from foreign investments in U.S. companies. Applicable transactions are subject to mandatory reporting to CFIUS for a review of their potential impact on national security. The pilot program runs from November 10, 2018 through March 5, 2020, and filings, when warranted, will be required 30-45 days in advance of the transaction, depending on the type of filing being made.

The Pilot Program applies to foreign investments in U.S. businesses that "produce, design, test, manufacture, fabricate or develop one or more criticial technologies." The program applies to 27

industries identified by their classifications under the North American Industry Classification System Code and includes a wide range of industries inlcuding not only those that have obvious national security applications, but many others such as power distribution, battery manufacturing, nanotechnology, biotechnology, and wireless equipment manufacturing.

Investments subject to the pilot program include those where a foreign investor has "(i) access to material nonpublic technical information held by the Pilot Program U.S. Business; (ii) membership or observer rights on the board of directors or similar governing body of the Pilot Program U.S. Business; or (iii) the right to appoint a member of the Pilot Program U.S. Business' board of directors; or (iv) any involvement, beyond the mere voting of shares, in substantive decision-making regarding the Pilot Program U.S. Business." (See text of Interim Rule)

Passive investments by foreign persons in U.S. managed investment funds are generally exempt from requirements of the pilot program, provided that the foreign person does not generally have the ability to control the fund or the investment decisions of the fund manager, or have access to material nonpublic technical information of the U.S. business covered by the Interm Rule.

While the Interim Rule includes practical examples, the applicability of the pilot program to a US fund manager with foreign investors investing in the covered industries depends on several nuanced definitions in the Interim Rule. Penalties for noncompliance can be steep and include a civil monetary penalty up to the value of the transaction, or require the unwinding of the transaction. See the decision flowchart in this informative article and the CFIUS Critical Technology Pilot Program Fact Sheet for additional details. *Contributed by Cari Hopfensperger, Senior Compliance Consultant*

Lessons Learned from Recent SEC and FINRA Cases:

Case regarding Thaddeus J. North, CCO, appeal from FINRA Disciplinary Action: In an "uncomfortably timed release," this opinion regarding Thaddeus J. North, former Chief Compliance Officer for FINRA member Southridge Investment Group LLC ("Southridge") was posted on the SEC website the night before SEC Commissioner Hester M. Peirce's speech to the National Society of Compliance Professionals. Although she agreed with former Commissioner Dan Gallagher's position that the SEC should be careful when bringing cases against compliance personnel and not impose "strict liability for CCOs under Rule 206(4)-7," she was forced to provide some explanation for the Commission's decision against North.

In this case, the SEC upheld a FINRA disciplinary action against Mr. North, CCO for a small broker-dealer, for his failure to (i) establish a system for the review of electronic communication and (ii) review such correspondence as required under the firm's policies and procedures, and (iii) to report to FINRA his firm's relationship with a statutorily disqualified person. The sanctions imposed included a two-month suspension from all principal and supervisory capacities and a total of $40,000 in fines. FINRA found that North reviewed email infrequently, and failed to review any instant messages or chats archived from Bloomberg for 26 months, which accounted for about 80% of the firm's electronic communications. He was also made aware of a service agreement between a registered representative's outside business and an individual who had been statutorily disqualified and failed to investigate it further.

North made some egregious errors in this case which all CCOs should keep in mind. First, he was responsible for reviewing the firm's supervisory procedures, which he did in 2010. Unfortunately, he

left in the following bracketed boilerplate language, '"[a]n appropriate random sampling (ENTER PERCENTAGE OR OTHER DEFINABLE SAMPLE SIZE) of all copies of email will be reviewed." Leaving in boilerplate language is a huge tip off to regulators that the reviewer is not doing a thorough job. Make sure your compliance manual reflects your actual practices and replace any bracketed boilerplate language.

Second, he testified that "all email review is boring" at a hearing as his justification for failing to review Bloomberg instant messages. Admittedly, this statement has the ring of truth, but it is not a valid excuse for ignoring electronic communications. In upholding FINRA's sanctions, the SEC stated that North's failure to review the firm's Bloomberg message or chats, which made up 85% of the firm's electronic communications, "is sufficient to sustain FINRA's findings." Mr. North's cavalier attitude in front of the regulators cost him dearly.

FINRA and the SEC were also unmoved by North's claim that he didn't understand the email retention system and consequently failed to review the separate repositories containing Bloomberg communications. The Commission found this failure underscored the "extent to which he acted unreasonably." CCOs should make it a priority to understand the systems used to support the compliance program.

Finally, North should have paid more attention to the financial information requested by FINRA in its investigation of Southridge in 2010. If he had done so, he might have discovered the fact that one of the firm's registered representatives had entered into an agreement with a statutorily disqualified person and could have taken steps to remedy the situation. The SEC noted that North had prior knowledge regarding the relationship between the registered representative and the disqualified individual. This red flag, combined with FINRA's interest in a somewhat fishy service arrangement of the registered representative's outside business, should have caused North to investigate the situation further. CCOs should closely review information requested by regulators and undertake an internal review. It appears that the SEC and FINRA punished North for his inaction. *Contributed by Contributed by Jaqueline Hummel, Partner and Managing Director*

CEO Hit with SEC Fine for Failing to Support Compliance Program: This has to be one of my favorite cases because of the astounding facts. An investment adviser, Pennant Management, Inc. ("Pennant") and its CEO, Mark Elste ("Elste") let clients down in many ways, including failing to perform initial due diligence and ongoing monitoring for investments it recommended to its clients and ignoring CCO warnings and requests for compliance resources. The most fascinating aspect of this case for me was the fact that a portfolio manager (!) willingly accepted the role of interim CCO, on the condition that he could hire outside counsel and compliance consultants as needed. Not only that, but the portfolio manager educated himself about his compliance responsibilities and reviewed the firm's compliance policies and procedures. He even went further by telling (in writing!) Elste that the compliance program was deficient. The CCO's responsibilities were expanded over the next two years, although Elste continuously denied requests for additional compliance resources. It wasn't until mid-2014 that Pennant finally hired another full-time compliance analyst and engaged an outside compliance consultant to conduct a gap analysis of the firm's compliance program.

Ultimately the SEC ended up fining Elste $45,000 for violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 (the Compliance Program Rule). The firm was fined an additional $400,000 for making misrepresentations to clients and its failures concerning the compliance program. The firm withdrew from SEC registration in 2015. *Contributed by Jaqueline Hummel, Partner and Managing Director*

SEC Issues What May be the First of Many Enforcement Actions Regarding Unregistered Exchanges Trading Digital Assets: Zachary Cobern, founder of EtherDelta will pay $388,000 in disgorgement, penalties and pre-judgment interest to the SEC for causing EtherDelta to violate Section 5 of the Exchange Act of 1934 (the "Exchange Act"). EtherDelta is an online trading platform that allows investors to buy and sell digital tokens in the secondary market. Under Section 5 of the Exchange Act, any trading system that meets the criteria of an "exchange" set forth under the Exchange Act Rule 3b-16(a) must register as an exchange or operate under an exemption (e.g., a registered Alternative Trading System). Because EtherDelta provided multiple investors with website access to its order book, containing official listings of tokens available for trade, and buyers and sellers utilized a "smart contract" to agree to and execute the trades, it was deemed to be a national securities exchange requiring registration. EtherDelta operated the exchange without registration or exemption for a period of 15 months.

Digital assets are new to the broker-dealer world, its regulators and investors. The regulators are taking a deep dive to determine how the securities laws apply to these new digital products that seem to be developing overnight, all in the name of investor protection. The compliance and legal departments are key components in a firm's development of new products and services. A firm must understand exactly what it is offering to investors to determine what securities laws govern the offering and execution of the product. FINRA provides guidance regarding due diligence on new products in Notice to Members 05-26 and Regulatory Notice 12-03. *Contributed by Rochelle Truzzi, Senior Compliance Consultant*

Terminator 2: Judgment Day - same make, same model, new mission! In this case, the Commodity and Futures Commission ("CFTC") terminated Algointeractive, Inc. for fraud, misappropriation and misrepresentation. The U.S. District Court for the Southern District of New York ordered a default judgment against Algointeractive, Kevin P. Whylie, and Matthew James Zecchini and ordered them to pay $1 million in civil penalties and $240,550 in restitution to pool participants. The charges brought by the CFTC included fraudulent solicitation and misappropriation. Of the $300,000 that was

raised for Algointeractive, only $55,000 was actually invested on behalf of the pool participants, but never in futures contracts.

This particular fraud was propagated by two college dropouts who, in their due diligence questionnaires to investors, lied about their backgrounds, education, experience, track record and AUM. The assets raised were never placed in a segregated pooled account but rather misappropriated into multiple accounts for the firm and, in most cases, were spent on personal expenses including transportation, meals and entertainment. To perpetuate their 2 ½ year fraud, they created false account statements for the participants and expense charts. Furthermore, the firm did not register as a Commodity Pool Operator ("CPO") or an Associated Person ("AP") with the National Futures Association ("NFA").

The lesson learned from this case is that due diligence matters, whether you are reviewing or writing materials for your firm or reviewing due diligence materials of another firm. Independently verify backgrounds and experience of principals, review regulators' websites for public information about the firm in question, perform Google searches, and review account statements in detail. Investors should also be wary of small firms that do not use independent compliance consultants or experts. Having one person act as CEO, President, and Chairman of the Board should also raise a red flag. Balancing all those roles, as Zecchini was, makes it almost impossible to place the client's interests first, even for those with the best intentions. In this case, the fraud was not sophisticated; it was based on lies on top of lies that should have been easily identified with a little verification. You always have the option to play the Terminator and say "Hasta la vista, baby." *Contributed by Heather Augustine, Senior Compliance Consultant*

Worth Reading:

Costumes, Candy and Compliance: Check out Hester M. Peirce's speech to the National Society of Compliance Professionals. In addition to demonstrating she has a sense of humor, Ms. Peirce discussed her views on when CCOs should be held liable for failures of a compliance program.

SEC Asks Investors What They Think about the Client Relationship Summary Form: You can read the 122-page report from the RAND Corporation, or check out this helpful summary from Melanie Waddell.

Fund Shareholders Have to Receive Reports. They Don't Have to Pay So Much for Them: With the SEC's new Rule 30e-3 on the horizon (see Optional Internet Availability of Investment Company Shareholder Reports discussed above), the ICI surveyed mutual fund disclosure distribution costs and concluded that the heavy influence and high prices of a single vendor could jeopardize the potential savings associated with the Rule. The article plainly explains the convoluted pricing currently used by intermediaries and summarizes the ICI's proposal to right the system going forward.

How Institutional Investors Are Changing the Cryptocurrency Market: There is a shift underway - institutional investors have steered clear of the cryptocurrency markets, but traditional financial institutions are now seeking diversification with crypto assets. As a result, this article asserts that new crypto-investment products are under development, large volume crypto purchases have the potential to act as an anchor preventing market imbalance, and security for crypto-trading will likely improve.

U.K. Tackles Cryptoasset Regulation, Releasing Task Force Report That May Guide Other Countries: Faegre Baker Daniels concisely summarizes the newly published Final Report by the U.K. Cryptoassets

Task Force. The Task Force report provides a good analysis of the key concepts of cryptoassets, distributed ledger technology, risks, and potential benefits, and how those fit within the current regulatory framework.

SEC issues Investor Bulletin Explaining Variable Annuities: This SEC bulletin is aimed at main-street investors, covering the basics of variable annuities, their potential risks, optional features, and related fees and expenses. They also issued one on Variable Life Insurance that provides a general overview of that product and associated risks, benefits, and costs.

Filing Deadlines and To Do List for December 2018

INVESTMENT MANAGERS AND HEDGE/PRIVATE FUND MANAGERS

- Annual Renewal Program for IARD System: The IARD Renewal Program facilitates the annual renewal of investment adviser (IA) firms and their IA representatives' (IARs) registrations with jurisdictions/states. Preliminary renewal statements for the IARD system will be available **November 12, 2018**, and will be accessible only through the E-Bill System. Renewal statements reflect the registration renewal fees and annual system processing fees for all IARs and state-registered IA firms. Deadline for the receipt of preliminary statement payment is **December 17, 2018**. Questions? Check out the FAQs.

BROKER-DEALERS

- FINRA 2019 Renewal Program Preparations: Consult the FINRA website to access important dates and information regarding the 2019 Renewal Program. Be sure to update your calendars and ensure your Renewal Account is sufficiently funded. **Payment in full is due Monday, December 17, 2018.**
- Statement Regarding Independent Public Accountant: Due no later than December 10th of each year, unless your engagement is of a continuing nature, providing for successive engagements. **Due date of December 10, 2018.**
- Rule 17a-5 Monthly and Fifth FOCUS Part II/IIA Filings: For the period ending November 30, 2018. For firms required to submit monthly FOCUS filings and those firms whose fiscal year-end is a date other than a calendar quarter. **Due date is December 26, 2018.**
- Annual Audit Reports for Fiscal Year-End October 31, 2018: FINRA requires that member firms submit their annual audit reports in electronic form. Firms must also file the report at the regional office of the SEC in which the firm has its principal place of business and the SEC's principal office in Washington, DC. Firms registered in Arizona, Hawaii, Louisiana, or New Hampshire may have additional filing requirements. **Due date is December 26, 2018.**
- Supplemental Inventory Schedule ("SIS"): For the month ending November 30, 2018. The SIS must be filed by a firm that is required to file FOCUS Report Part II, FOCUS Report Part IIA or FOGS Report Part I, with inventory positions as of the end of the FOCUS or FOGS reporting period, unless the firm has (1) a minimum dollar net capital or liquid capital requirement of less than $100,000; or (2) inventory positions consisting only of money market mutual funds. A firm with inventory positions consisting only of money market mutual funds must affirmatively indicate through the eFOCUS system that no SIS filing is required for the reporting period. **Due date is December 26, 2018.**

- SIPC-3 Certification of Exclusion from Membership: For firms with a Fiscal Year-End of November 30, 2018 ***AND*** claiming an exclusion from SIPC Membership under Section 78ccc(a)(2)(A) of the Securities Investor Protection Act of 1970. This annual filing is due within 30 days of the beginning of each fiscal year. **Due date is December 26, 2018.**
- SIPC-6 Assessment: For firms with a Fiscal Year-End of May 31, 2018. SIPC members are required to file for the first half of the fiscal year a SIPC-6 General Assessment Payment Form together with the assessment owed within 30 days after the period covered. **Due date is December 26, 2018.**
- SIPC-7 Assessment: For firms with a Fiscal Year-End of October 31, 2018. SIPC members are required to file the SIPC-7 General Assessment Reconciliation Form together with the assessment owed (less any assessment paid with the SIPC-6) within 60 days after the Fiscal Year-End.
