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SEC's Top Eleven Hits: Investment Adviser Regulatory Review 2018

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The SEC's regulatory actions in 2018 involved few surprises but still managed to challenge investment advisers. In reviewing the SEC's activity over the past 12 months, I have identified the top regulatory hot buttons to help firms focus their efforts to update their compliance programs for 2019.

The SEC's Office of Compliance Inspection and Examinations ("OCIE") issued [five risk alerts](#) in 2018. The most significant guidance deals with investment advisers' best execution obligations, including disclosure failures related to receipt of 12b-1 fees and revenue-sharing arrangements. Coming in a close second is OCIE's list of compliance issues involving investment advisers' fees.

The Enforcement Division's activity remained consistent with prior years. According to its FY 2018 [Annual Report](#), the division brought more enforcement actions in 2018 (821 versus 754), received more in disgorgement and penalties (\$3.945 billion versus \$3.789 billion), but returned fewer dollars to investors (\$794 million versus \$1.073 million). Aside from the statistics, the report highlighted the SEC's formation of the Retail Strategy Task Force and the Share Class Disclosure Initiative, "a program designed to quickly and efficiently bring relief to investors who may have been harmed by failures to disclose conflicts of interest related to marketing fees and expenses associated with the selection of mutual fund share classes." Similar to 2017, the Commission continues to throw serious resources toward protecting retail investors. Expect this trend to continue in 2019.

Similar to 2017, regulatory activity was minimal. The SEC amended two rules under the Advisers Act, [Rules 203\(l\)-1 and 203\(m\)-1](#). Both changes were related to the venture capital adviser exemption from SEC registration as an investment adviser. The SEC amended [Rule 203\(l\)-1](#) by expanding the definition of "venture capital funds" to include small business investment companies ("SBICs"). Additionally, [Rule 203\(m\)-1](#) now excludes SBICs from the definition of "assets under management" for purposes of calculating private fund assets towards the registration threshold of \$150 million.

As promised in OCIE's exam priorities for 2018, SEC examiners focused on disclosure of fees, financial incentives associated with certain products, conflicts of interest, and payments to affiliates. The SEC also made good on its promise to focus on selection of mutual fund share classes.

The top takeaways for investment advisers are:

1. Be ready for the SEC's scrutiny of conflicts of interest. Although the DOL's fiduciary rule is dead, the SEC has become increasingly aggressive against advisers for failing to disclose, or to adequately disclose, conflicts of interest. This includes the receipt of 12b-1 fees, revenue sharing, and kickbacks from other

advisers and service providers. Look through the firm's financials to understand all sources of revenue and make sure the Form ADV disclosure clearly identifies the conflicts inherent in receiving compensation from outside parties.

2. Review and updates policies and procedures regarding advisory fees and expenses, making sure you address issues raised in the [Risk Alert: Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers](#). Compliance officers should test the fee billing process for accuracy and consistency with the advisory contract and Form ADV disclosures.

3. Review OCIE's [Risk Alert: Most Frequent Best Execution Issues Cited in Adviser Exams](#) and confirm your policies, procedures, and practices address the deficiencies cited.

4. Review the [Risk Alert: Investment Adviser Compliance Issues Related to the Cash Solicitation Rule](#) and make sure your firm has a process in place to comply with the requirements of [Rule 206\(4\)-3](#). Compliance officers should perform due diligence on solicitors as well as conduct periodic testing on payments and disclosures provided to clients.

5. Survey firm personnel to determine how electronic messaging is being used for business communications and confirm whether your firm is retaining the required records. Check out OCIE's [Risk Alert: Observations from Investment Adviser Examinations Relating to Electronic Messaging](#), which identifies practices that can help advisers meet their record-keeping obligations under [Advisers Act Rule 204-2](#), the Books and Records Rule.

6. Be prepared for SEC examiners' questions about custody. The SEC's scrutiny of standard custody arrangements that retail investment advisers have with major custodians continues to be an exam focus. It is a good time to review the SEC's [Guidance Update on Inadvertent Custody](#) and the [Investment Advisers Association \(IAA\) No-Action Letter](#).

7. Watch your back. In 2018, there have been at least three cases targeting Chief Compliance Officers ("CCOs"), and at least one other case brought by FINRA punishing a CEO for failing to provide adequate support to a CCO. The SEC will hold individuals accountable for wrongdoing, including those at the top of the corporate hierarchy.¹ As outlined in a [speech](#) from November 2015, former director of the SEC's Division of Enforcement, Andrew Ceresney, the SEC will bring cases against CCOs where they have:

- directly engaged in misconduct unrelated to the compliance function,
- attempted to obstruct or mislead the SEC staff, or
- exhibited a wholesale failure to carry out their responsibilities as CCOs.

8. Adopt policies and procedures to protect senior and vulnerable investors. More than 20 states have adopted laws addressing financial exploitation of seniors and vulnerable clients. Some require investment advisers to report suspected or actual financial exploitation of seniors and vulnerable clients to state adult protective services agencies. FINRA has already [adopted rule changes](#) aimed at protecting senior investors, and the SEC has included protection of senior investors in its exam priorities since 2017.

¹ See page 2, [Division of Enforcement Annual Report 2018](#); and page 11, [Division of Enforcement Annual Report 2017](#).

9. Shore up your cybersecurity policies and procedures. With the constant media reports of cyber-attacks and security breaches, it is no wonder that OCIE's examination priorities for 2019 include cybersecurity protection. OCIE will be focusing on the cybersecurity practices of investment advisers with multiple branch offices, including those that have recently merged with other investment advisers. OCIE will also be looking at access rights and controls, data loss prevention, vendor management, training, and incident response.

Additional Takeaways for Mutual Fund and ETF Advisers and their Sub-Advisers

10. Mutual fund and ETF Advisers, and their sub-advisers, should review the [Risk Alert: Risk-Based Examination Initiatives Focused on Registered Investment Companies](#) and get ready to be examined. OCIE is interested in index funds that track custom-built indexes; smaller, low trading volume ETFs; mutual funds underperforming relative to peer groups; and funds with 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. Review the Risk Alert for the specific focus areas for the funds and advisers.

11. Advisers to mutual funds and ETFs should be working on their Liquidity Risk Management Programs to comply with Investment Company Act [Rule 22e-4](#). The SEC has revised the compliance date for classification, highly liquid investment minimum, and board approval. The SEC has also amended related reporting requirements of Part D on Form N-LIQUID and liquidity disclosures on Form N-PORT under the Investment Company Act of 1940. The revised compliance date is now June 1, 2019 for larger entities (extended from December 1, 2018), and December 1, 2019 for smaller entities (extended from June 1, 2019).

Takeaways for Private Fund Advisers: Changes from CIMA

Beneficial Ownership Register Compliance: Private equity and hedge funds in the Cayman Islands should confirm with their administrators whether they are subject to the Cayman Islands Monetary Authority ("CIMA") new beneficial ownership register rule. The Cayman Islands government passed two laws outlining this new beneficial ownership regime: [The Beneficial Ownership \(Companies\) \(Amendment\) Regulations, 2018](#), and [The Beneficial Ownership \(Limited Liability Companies\) \(Amendment\) Regulations, 2018](#) (the "Amending Laws"). Companies and limited liability companies incorporated or registered in the Cayman Islands are required to maintain a beneficial ownership register at their Cayman Islands-registered offices (or appointed service provider), unless an exemption applies.

CIMA AML Regulations. Cayman Island fund managers should confirm that their policies are in compliance with the Cayman Islands Monetary Authority's ("CIMA's") anti-money laundering regulations. CIMA made a number of key changes in 2018 to expand the reach of its AML regulations to unregulated entities, including private equity, venture capital and real estate funds, insurance entities, and finance vehicles like collateralized loan obligations ("CLOs").

[Recommended resources:](#)

- [Retail, Remedies, Resources and Results: Observations From the SEC Enforcement Division 2018 Annual Report](#)
- [Investment Adviser “To Do” list for 2019](#)

Private Fund and Venture Capital Adviser Exemption

- [The Venture Capital Adviser Exemption Explained](#), by Alexander J. Davie, and [SEC’s Small Entity Compliance Guide](#)

Conflicts of Interest and Best Execution

- [Conflicts of Interest Facing Investment Advisers](#), presentation by Morgan Lewis from 2003.
- [Why the SEC is Obsessed with Mutual Fund Share Class Selection and Disclosure \(and why you should be too\)](#)
- [The Real Nightmare Before Christmas: SEC Gets Tough on Firms that Did Not Self-Report during SCSD Initiative](#)
- [BD/IA pays \\$2.2 million to Compensate Investors for Recommending More Expensive Mutual Fund Share Classes](#)
- [SEC Nails Three Advisors for Fiduciary Failures when Selecting Mutual Fund Share Classes](#)
- [SEC Slams Firm For Failing to Disclose Payments From Outside Managers](#)
- [SEC fines RIA \\$8 million for Failure to Disclose Kickbacks](#)

Cash Solicitation Rule

- [12 Things You Need to Know about Adviser Referral Arrangements and the Cash Solicitation Rule](#)
- [The CPA’s Guide to Investment Advisory Business Models](#)

Electronic Communications

- [Electronic Communications in SEC Examinations and Investigations](#)
- [SEC Sweep on Electronic Communications Document List](#)

Custody Rule

- [Custody Rule Refresher: Review of Most Recent SEC Guidance](#)

CCO and Executive Liability

- [Case regarding Thaddeus J. North, CCO, appeal from FINRA Disciplinary Action](#)
- [Southwind Associates of NJ Inc. \(D/B/A Villafranco Wealth Management\), William Scott Villafranco, and Anthony Laperuta](#)
- [Financial Industry Regulatory Authority Letter Of Acceptance, Waiver And Consent re: Wayne Ivan Miller](#)
- [Cautionary tale: SEC goes after CCO for Aiding and Abetting Fraud Scheme](#)

Protecting Senior and Vulnerable Investors

- SEC's white paper: [Elder Financial Exploitation: Why it is a concern, what regulators are doing about it, and looking ahead.](#)
- [SIFMA's Senior Investor Protection Toolkit](#)
- Bressler Amery Ross's [Senior and Vulnerable Investors Laws 50-State Survey.](#)

Cybersecurity

- [In the Matter of Voya Financial Advisors, Inc.](#)
- [North American Securities Administrators Association Cybersecurity Checklist for Investment Advisers](#)
- [FINRA Small Firm Cybersecurity Checklist](#)
- [FINRA Report on Cybersecurity Practices](#)
- [OCIE Risk Alert: Observations from Cybersecurity Examinations](#)

Liquidity Program Rule Compliance

- [SEC Amends Liquidity Rule Reporting and Disclosure Requirements](#)
- [SEC Requires Mutual Funds to Adopt Liquidity Risk Management Programs](#)
- [Investment Company Liquidity Risk Management Programs Frequently Asked Questions](#)
- [Investment Company Liquidity Risk Management Program Rules – Small Entity Compliance Guide](#)

CIMA Regulations

- [Cayman Islands Requires Companies to Maintain Beneficial Ownership Register; Is Your Fund In or Out \(of Scope\)?](#)
- [Cayman Islands Fund Managers Face New Anti-Money Laundering Requirements](#)
- [Cayman Islands - The Anti-Money Laundering Regulations 2017](#)

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