March Madness for RIAs - Form ADV Annual Update; FINRA Hops on Share Class Bandwagon; More Big Fines for AML Failures and Dual-Hatted CCO takes a Fall: Regulatory Update for March 2019

For Investment Advisers: SEC Actions

Reminder: The deadline for filing the Form ADV update for investment advisers with a fiscal year end of December 31 is March 31, 2019, which is a Sunday. IARD will be open on Sunday, March 31 from 10am-6pm Eastern Time. Therefore the deadline for filing an annual updating amendment will NOT be extended to Monday, April 1, 2019. And check out our latest blog post for tips on updating the Form ADV. Contributed by Cari A. Hopfensperger, Senior Compliance Consultant

Overwhelmed by the Annual Review? We’ve made it easy. Check out our guide to writing the best annual compliance program review ever! Contributed by Jaqueline M. Hummel, Partner and Managing Director

For Broker-Dealers: FINRA Actions

FINRA’s 529 Plan Share Class Initiative (“Initiative”): FINRA issued Regulatory Notice 19-04 to encourage FINRA members to assess their supervisory programs related to share class recommendations of 529 Plans, identify and correct potential deficiencies, and promptly reimburse customers that may have been harmed as a result of any supervisory deficiencies. The carrot being offered to self-reporting firms is that FINRA’s Department of Enforcement “will recommend that FINRA accept favorable settlement terms for firms that self-report these potential violations and provide FINRA with a detailed remediation plan.” This means FINRA’s Enforcement Division will limit sanctions against firms that self-report to restitution but no fines.

To be eligible for relief provided by the Initiative, firms must: (1) voluntarily self-report to FINRA any potential violations regarding the supervision and suitability of share class recommendations to customers of 529 Savings Plans; and (2) confirm eligibility by submitting certain required information for the disclosure period, January 1, 2013 through June 30, 2018.
New FAQ: FINRA issued Frequently Asked Questions Regarding the 529 Plan Share Class Initiative, extending the deadline for the due dates in Regulatory Notice 19-04.

New Due Dates:

- **Tuesday, April 30, 2019** - Firms that want to self-report must submit written notification to FINRA via email to 529initiative@finra.org by April 30 or via mail to “529 Plan Initiative, FINRA, Department of Enforcement, Brookfield Place, 20 Liberty Street, New York, New York 10281.”
- **Extension Requests** - Firms can request an extension to submit the required information via email to 529initiative@finra.org.
- **Friday, May 31, 2019** - Firms that have not received an extension must confirm eligibility by submitting to FINRA and provide the information outlined on page 4 of Regulatory Notice 19-04. Firms that cannot meet this deadline may request an extension from FINRA.

To make the self-reporting decision, conduct a preliminary assessment of your supervisory procedures (refer to MSRB Rules G-17, G-19, and G-27). Regulatory Notice 19-04 conveniently includes some guidance the type of supervision expected by FINRA and the MSRB concerning share class recommendations of 529 Plans. These sources include the 2017 Report on FINRA Examination Findings; FINRA’s 2016 Regulatory and Examination Priorities Letter; and MSRB Notice 2006-07. FINRA also made a video discussing the Initiative. We have gone through these documents and assembled a checklist of factors to consider when assessing deficiencies in your firm’s supervisory system.

**Disclosure Events and Form BD Updates**

Based on the results of the formal assessment, firms may need to file a 4530(b) Disclosure Event through FINRA’s firm gateway. Also, firms that enter into a settlement agreement with FINRA may need to update Item 11.E(2) of Form BD.

**Should You Report?**

Given the numerous potential deficiencies identified by FINRA and the MSRB in various communications, it is highly unlikely that any firm has a perfect supervisory program concerning share-class recommendations of 529 plans. FINRA has made it clear that it intends to focus on firms’ supervision of share-class recommendations during the next examination cycle. If FINRA identifies supervisory failures at firms that did not self-report, these firms should expect fines and more punitive sanctions than those described in the Initiative. Fines will be levied in addition to restitution owed to customers, as calculated by FINRA. The time and financial burden on a firm to respond to a FINRA-initiated investigation will be far greater than the resources required to conduct a self-assessment and pay restitution to customers that may have been harmed. Please note that 4530 Disclosure Events are not public disclosures. Only Form BD disclosures are made available to the public. It is expected that many firms will take advantage of the Initiative. Smaller firms with limited resources whose 529 transaction data was not aggregated into sophisticated surveillance systems are the most likely candidates for self-reporting. Form BD disclosures will most likely be common among the small firm peer group. **Contributed by Rochelle A. Truzzi, Senior Compliance Consultant**

Don’t Forget to Deliver the Options Disclosure Document! Broker-dealers are responsible for delivering a copy of the “Characteristics & Risks of Standardized Options,” a/k/a the options disclosure document (“ODD”), which contains general disclosures on the risks of trading options. Rule 9b-1 and FINRA Rule 2360 (b)(11) require broker-dealers to deliver the ODD and any supplements to options customers.
before approving an options account and when any amendments are made. Introducing broker-dealers can rely on their carrying firms to deliver the disclosure unless otherwise agreed.

The ODD Supplement was amended in October of 2018 and required distribution to all existing options customers no later than when a customer receives confirmation of an options transaction. Distribution may be conducted by way of a mass mailing, individually at the time of confirmation delivery, electronically or via hyperlink to customers who have consented to electronic delivery through the use of a hyperlink.

**FINRA Reminder Regarding U.S. Treasury Security Auction Awards: DON’T DO IT:** Firms should NOT report auction transactions in U.S. Treasury securities to TRACE as the Treasury Department already maintains these auction awards and the auction data is readily accessible to regulators. This includes both house awards and indirect bidder awards. Refer to Section 3.5 of FINRA’s TRACE FAQ. **Contributed by Rochelle A. Truzzi, Senior Compliance Consultant**

**Lessons Learned from Recent SEC and FINRA Cases:**

**FINRA Fines Morgan Stanley $10 Million for AML Program and Supervisory Failures:** Can’t anyone get this right? FINRA has imposed a significant fine on yet another large broker-dealer for anti-money laundering compliance failures. The latest victim is Morgan Stanley, fined $10 million. As noted in its press release, FINRA found that Morgan Stanley’s AML program failed to meet the requirements of the Bank Secrecy Act because of three shortcomings:

- Its AML surveillance system was not receiving critical data from several systems.
- The firm failed to devote sufficient resources to review alerts generated by the surveillance system resulting in the alerts being closed without sufficient investigation.
- The firm’s AML Department did not reasonably monitor customers’ deposits and trades in penny stock for potentially suspicious activity.

Apparently FINRA went easy on Morgan Stanley in light of its “extraordinary corrective measures” including:

- An increase in AML staffing;
- Improvements to its automated transaction monitoring processes and systems; and
- Revisions to policies and procedures.

FINRA continues to find issues with firms’ AML programs. The issues include firms not allocating enough resources to AML monitoring and issues with data integrity of AML surveillance systems. As a result, FINRA continues to make reviewing Member AML Programs an examination priority. **Contributed by Doug MacKinnon, Senior Compliance Consultant.**

**Dual-Hatted CCO Gets Caught in the Crossfire:** When Chief Compliance Officer receives sanctions, pay attention. Especially in a case like this, where Jose Luis Leon served as Chief Compliance Officer for both BAC Florida Bank and BAC Florida Investment Corp. (“BAC”), its affiliated broker-dealer. The Letter of Acceptance, Waiver and Consent (“AWC”) in this matter does not provide much color; it seems that Mr. Leon was thrown into the deep end of the pool without a life preserver. According to the AWC, Mr. Leon was put in charge of compliance for the broker-dealer’s activities without sufficient qualifications,
experience, or training. Predictably, Mr. Leon’s inadequacies were exploited by BAC’s former chief executive and head trader, Alejandro Falla. It all started when BAC agreed to charge no more than 15 basis points to buy and sell bonds for the clients of an investment adviser. Mr. Falla worked out a scheme to circumvent the 15-basis point limit by executing fixed income transactions on the open market and then using a third-party firm that agreed to buy or sell the securities from BAC at inferior prices, making it look like BAC was honoring the limit. BAC received just under $100,000 in fees above the 15-basis point limit through 61 transactions.

Under the AWC, BAC agreed to a regulatory fine of $100,000 and paid RIA’s customers more than $117,000 in restitution. Mr. Falla, who had been barred indefinitely in a separate FINRA disciplinary action, was terminated by BAC. Jose Luis Leon, BAC’s Chief Compliance Officer who had been with the firm for 29 years, ended up as collateral damage. FINRA found that he failed to adequately supervise Mr. Falla’s activities. Mr. Leon agreed to a $10,000 fine and a six-month suspension from working with a FINRA member firm in any capacity.  

**Contributed by Jaqueline M. Hummel, Partner and Managing Director**

**SEC Brings Charges in Edgar Hacking Case:** As noted by SEC Chairman Jay Clayton: “No system can be entirely safe from a cyber intrusion.” Including the SEC. On January 15, 2019, the Commission filed charges in the U.S. District Court of New Jersey against 11 individuals and two companies, involving defendants from Ukraine, the Russian Federation, the U.S., and Korea. Two hackers, Artem Radchenko and Oleksandr Ieremko, are alleged to have taken annual, quarterly, and current reports of publicly-traded companies before the reports were disseminated to the public. Ieremko hacked into the EDGAR system to get access to test filings, including earnings statements, and shared the information with traders. In total, the traders traded before at least 157 earnings releases from May to October 2016 and generated at least $4.1 million in illegal profits.

Ieremko had been charged back in 2015 for a similar scheme that targeted business wire services, including Business Wire, Marketwired and PR Newswire. The two hackers remain at large.  

**Contributed by Jaqueline M. Hummel, Partner and Managing Director**

**Worth Reading**

**Robare Case Oral Arguments – The Case that Started the War on “May”:** Law firm Eversheds Sutherland provides an update on the SEC’s litigation against the Robare Group, Ltd., an investment adviser for allegedly inadequate disclosure of shareholder service fees and 12b-1 fees. Initially, the firm was successful before an SEC Administrative Law Judge but lost on appeal to the full Commission. The case is now on appeal before the DC Circuit Court of Appeals. During the oral argument, the judges focused on (1) whether the use of the word “may” was adequate in light of the potential conflict of interest and the arrangement with the custodian, (2) the appropriate standard of care, and (3) whether the firm acted willfully. Let’s hope that common sense prevails!

**Why I fell in love with compliance:** Wonderful compilation by GAN Integrity of compliance officers discussing their love for the job. Just in case you are feeling all alone out there.

**FINRA Warns Broker-Dealers about Phishing Scam Targeting Compliance Personnel:** Not even compliance personnel are immune from hackers -- FINRA sent out this notice for firms to be on the
lookout for an email from a credit union attempting to notify the firm about a potential money-laundering incident. DON’T OPEN THE ATTACHMENT! It probably contains malware or a virus.

**Launching Alternative Funds in Europe: Easier than You Think:** Great white paper jointly published by BNY Mellon and Sadis & Goldberg provides an overview of non-US fund structures for firms exploring European distribution options.

**When Best Execution Isn’t Best: Mutual Fund Share Class Selection:** Great analysis of Best Execution by Morgan Lewis as applied to Share Class Selection.

**It is 2019 . . . Do You Know Where Your Data Is?:** Michael Volkov offers practical cybersecurity guidance to firms in response to companies’ increasing use of third-party service providers and cloud-based storage solutions.

**How credit funds can operationally transform their valuation process:** The first article in what EY states will be a series focused on the “operational nuances of valuation for credit funds” and its recommended best practices.

**Brexit Preparations for Private Equity Firms:** With time running out for a negotiated Brexit Withdrawal Agreement, Dechert describes certain steps that private equity firms can take to help prepare for a no-deal Brexit.

**Filing Deadlines and To Do List for March 2019**

**INVESTMENT MANAGERS AND HEDGE/PRIVATE FUND MANAGERS**

- **Form ADV Annual Updating Amendment:** Existing registered advisers must update and file an amended Form ADV within 90 days of their fiscal year end (Forms 1A and 2A). The filing fee must be deposited into the adviser’s IARD account before the filing can be submitted. The due date for 2019 is **March 31, 2019**. Check out the [Form ADV quick reference guide here](#).

- **IARD Fees:** SEC-registered advisers and exempt reporting advisers are required to pay IARD fees before the submission of the Form ADV annual amendment (by **March 31, 2019**).

- **State Filings:** A registered investment adviser and an exempt reporting adviser may be required to make a state notice filing in any state in which an adviser has a specified number of clients, called “Notice Filings.” Notice filings may be made on Form ADV by checking the relevant box in Part 1A and depositing the appropriate state fees into the adviser’s IARD account. Exempt reporting advisers may also be required to register as an investment adviser in some states. Notice filing and investment adviser registration requirements differ from state to state. Each adviser should check the requirements for any relevant state in which it operates or has clients. The due date is within 90 days of the adviser’s fiscal year end, on **March 31, 2019**.

- **Exempt Reporting Advisers Form ADV Filing:** Exempt Reporting Advisers (i.e., exempt private funds advisers and venture capital advisers) need to update Form ADV Part 1A within 90 days of the adviser’s fiscal year end, on **March 31, 2019**.
LARGE HEDGE FUND ADVISERS

- **Form PF**: for Large Hedge Fund Advisers must be filed within 60 days of each quarter end on the IARD system. Due **March 1, 2019**.

- **Initial Form PF**: For Hedge Fund Advisers that have reached $1.5 billion regulatory assets under management (“RAUM”) attributable to hedge funds as of December 31, 2018 must make initial filing (the initial quarterly Form PF filing within 60 days of quarter end if an adviser’s hedge fund RAUM exceeds $1.5 billion as of the previous quarter end). Due **March 1, 2019**.

REGISTERED COMMODITY TRADING ADVISORS/COMMODITY POOL OPERATORS

- **Reaffirm YOUR CPO and CTA Exemptions**: Firms that claim exemptions from Commodity Pool Operator (“CPO”) registration under CFTC Rule 4.5 or CFTC Regulation 13(a)(3) (the “de minimis exemption”), or Rules 4.13(a)(1), 4.13(a)(2), 4.13(a)(5), and firms that claimed an exemption from Commodity Trading Adviser (“CTA”) registration pursuant to CFTC Rule 4.14(a)(8) must re-affirm those exemptions annually within 60 days of the calendar year end – by **March 1, 2019**. As noted by the NFA in New & Notes 1-17-24, “[f]ailure to affirm an active exemption from CPO or CTA registration will result in the exemption being withdrawn on **March 4, 2019**. NFA **Notice I-18-25** contains guidance FAQs and **Notice I-19-02** related to this annual affirmation process.

- **CFTC CPO-PQR Form (All Schedules)**: Large Commodity Pool Operators are required to file Form CPO-PQR annually with the NFA by **March 1, 2019**.

- **CPO Members must distribute an Annual Report**, certified by an independent public accountant, to pool participants within 90 days of the pool’s fiscal year-end. CPOs are also required to file this report electronically with NFA using **EasyFile**. The filing must be made by **March 30, 2019**.

- **CFTC Form CPO-PQR Schedule A** must be filed by small CPOs (i.e., CPOs with less than $150 million in aggregated gross pool AUM as of the close of business on any business day during a calendar year), by **April 1, 2019**.

- **CFTC Form CPO-PQR Schedules A and B** must be filed by mid-sized CPOs (at least $150 million to $1.5 billion in aggregated gross pool AUM as of the close of business on any business day during a calendar year) by **April 1, 2019**.

- **Annual Reports for 4.7 Exempt CPOs** Exempt CPOs must electronically file audited annual reports, including statements of financial condition, statements of operations and appropriate footnotes, for their pools with the NFA and distribute them to their investors by **April 1, 2019**.

BROKER-DEALERS

- **Annual Audit Reports for the Fiscal Year-End December 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 **March 1, 2019**.

- **Supplemental Inventory Schedule (“SIS”)**: For the month ending January 31, 2019. 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 March 1, 2019.

- **SIPC-7 Assessment**: For firms with a Fiscal Year-End of December 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. Due March 1, 2019.

- **SIPC-6 Assessment**: For firms with a Fiscal Year-End of July 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 March 2, 2019.

- **SIPC-3 Certification of Exclusion from Membership**: For firms with a Fiscal Year-End of January 31, 2019, 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 March 2, 2019.

- **Rule 17a-5 Monthly and Fifth FOCUS Part II/IIA Filings**: For the period ending February 28, 2019. For firms required to submit monthly FOCUS filings and those firms whose fiscal year-end is a date other than a calendar quarter. Due March 25, 2019.

- **Supplemental Inventory Schedule ("SIS")**: For the month ending February 28, 2019. 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 March 28, 2019.

- **SIPC-6 Assessment**: For firms with a Fiscal Year-End of August 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 March 30, 2019.

- **SIPC-3 Certification** of Exclusion from Membership: For firms with a Fiscal Year-End of February 28, 2019, 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 March 30, 2019.

- **Annual Audit Reports for the Fiscal Year-End January 31, 2019**: 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 April 1, 2019.
Keeping current with regulatory changes while also doing your day job is difficult; partnering with Hardin Compliance can bring you peace of mind with our comprehensive compliance services. Call us today at 1.724.935.6770, or visit our website at www.hardincompliance.com for more information.

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