REGULATORY UPDATE

July 1, 2019

Provided by Hardin Compliance Consulting LLC

SEC Adopts Broker-Dealer Best Interest Standard, Approves Form CRS and Explains Advisers' Fiduciary Duty; GIPS 2020 Finalized; Epic Ethics Fail by Large Auditing Firm; Regulatory Update for July 2019

For Broker-Dealers: SEC Actions

➢ Time to Roll-Up Your Sleeves and Dive into Regulation Best Interest: There are many great resources out there that summarize the newly adopted Securities Exchange Act Rule 15l-1 ("Regulation BI"). Here are a few of my favorites:


Where do we begin? First, determine whether Regulation BI applies to your firm. Regulation BI applies to any broker-dealer that recommends securities transactions or investment strategies involving securities transactions to retail customers. For purposes of Regulation BI, the SEC defines Retail Customer as, “a natural person, or the legal representative (non-professional) of such natural person who: (1) receives personalized investment advice about securities from a broker or dealer or investment adviser; and (2) uses such advice primarily for personal, family, or household purposes”. This definition includes Accredited Investors and high-net-worth individuals! The SEC did not define the term recommendation but will continue to rely on existing broker-dealer guidance and case law.

To prepare for Regulation BI, broker-dealers should review their products and services, and document the following:

1. Identify all securities products, services and strategies offered by your firm;
2. For each product, service, and strategy listed:
   a. Identify all customer-types to whom the products, services, and strategies are made available;
   b. Identify the associated risks, rewards, and costs for each product, service and strategy;
3. Identify all compensation programs in which the Firm and each of its registered representatives participate.

4. For each product, service, and strategy offered to retail customers and for each compensation program in which the Firm participates, identify and document conflicts of interest that create an incentive for a registered representative to place the interest of the broker-dealer, or themselves, ahead of the interest of the retail customer.

5. For each conflict of interest, determine what disclosures are necessary. Existing disclosures may still work, but some conflicts may require a new or amended disclosure document.

NOTE: Form CRS will NOT satisfy all of your Disclosure Obligations under Regulation BI.

We also recommend It is also recommended that, if possible, senior members of Compliance, Risk Management, Legal, and Sales participate on a committee to implement Regulation BI. Over the next several months, we will be dissecting each component of Regulation BI and presenting you with various considerations as you move through the process above. MORE TO COME... Contributed by Rochelle A. Truzzi, Senior Compliance Consultant.

For Investment Advisers and Broker-Dealers: SEC Actions

- **Form CRS Approved.** As part of the regulatory package that includes Regulation BI, the SEC adopted a final version of the Form CRS Relationship Summary (“Form CRS”), a new disclosure document, which applies to retail investors and will become Part 3 of the Form ADV. The SEC took to heart many of the comments on the original Form CRS proposal, dropping much of the required language and adopting a more user-friendly question and answer format. The result is a two-page document with five required topics:
  - Introduction (including a link to Investor.gov/CRS, a page on the SEC’s Office of Investor Education website that will offer educational information about investment professionals)
  - Relationship and Services
  - Fees, Costs, Conflicts and Standard of Conduct
  - Disciplinary History
  - Additional Information

Firms can use graphics such as charts, hyperlinks and electronic formats. The SEC allows the use of embedded hyperlinks in electronic versions to cross-reference more detailed information on fees, services and conflicts. Firms are also required to disclose how their financial professionals are compensated, along with the conflicts the payments create. Firms must disclose whether the firm and any of its financial professionals have reportable disciplinary history and tell investors where they can find more information about these events instead of including descriptions in the form. The form also requires firms to include “Conversation Starters” throughout the document instead of the proposed “Key Questions to Ask” at the end of the document, as recommended in the initial proposal.
The SEC emphasized the use of “plain English” in Form CRS:

“In a change from the proposal, the instructions will not permit use of legal jargon or technical terms without explaining them in plain English, even if the firm believes that reasonable retail investors will understand those terms.”

Registered firms, or investment advisers with a pending registration application with the SEC before June 20, 2020, have from May 1, 2020, to June 30, 2020, to file the initial Form CRS. After June 30, 2020, any newly registered broker-dealer will need to file a Form CRS by the date its registration becomes effective. Similarly, investment advisers seeking registration after that date will be required to include the Form CRS as part of their application. Stay tuned for more on Form CRS from Hardin Compliance! Contributed by Jaqueline M. Hummel, Partner and Managing Director.

- **SEC Issues Standard of Conduct for Investment Advisers.** The SEC explains what fiduciary duty means for investment advisers. The SEC breaks down an adviser’s fiduciary obligations into two basic duties, a duty of care and a duty of loyalty. The duty of care means an adviser must provide advice in the client’s best interest, seek best execution where the adviser has the responsibility to select broker-dealers to execute trades and monitor the client’s portfolio over the course of the relationship. The duty of loyalty hinges on the adviser making full and fair disclosures of conflicts of interest to its clients so they can make an informed decision about whether to hire the adviser. Check out our blog post for advice on how to comply. Jaqueline M. Hummel, Partner and Managing Director.

- **When is a Broker-Dealer Not a Broker-Dealer; SEC defines the Scope of the “Soely Incidental” Exclusion.** Broker-dealers can rely on an exemption from registration as investment advisers for providing advisory services that are “solely incidental” to their brokerage business under Section 202(a)(11)(C) of the Advisers Act, as long as they do not receive any special compensation for this advice. In light of the passage of Regulation BI, the Commission decided to weigh in on the meaning of the “solely incidental” exclusion from the definition of investment adviser in this new interpretation “Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser.” The Commission discusses two situations where broker-dealers can cross the line: where they exercise investment discretion, and when they provide ongoing monitoring of client accounts. A broker-dealer that has unlimited discretion to effect securities transactions in a customer’s account has crossed the “solely incidental” line. The SEC considers the exercise of limited discretion as acceptable in situations where a broker-dealer engages in trading activity based on specific parameters established by the customer.

Similarly, the SEC views a broker-dealer that agrees to provide continuous account monitoring to clients as crossing the solely incidental line. A broker that occasionally reviews a client’s account to provide buy, sell or hold recommendations would not.

Broker-dealers that want to avoid registration as investment advisers should review their written supervisory procedures to ensure that investment discretion and account monitoring are limited
and are reasonably related to the firm’s primary business of effecting securities transactions. 

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

**For Investment Advisers**

- **GIPS 2020 adopted June 30.** The CFA Institute issued its much-anticipated update to the Global Investment Performance Standards for Firms on June 30, 2019. Public comment on the 2020 GIPS Standards Exposure Draft and 2020 GIPS Standards for Verifiers Exposure Draft closed on December 31, 2018. The 2020 GIPS Standards are effective January 1, 2020. The CFA Institute will be hosting a webinar on the key concepts of the 2020 edition applicable to investment managers on August 7, 2019, at 11 a.m. EST and again on August 7, 2019, at 8 p.m. EST.

The 2020 GIPS Standards are divided into three separate documents, one for asset owners, one for investment management firms, and one for verifiers. According to the adopting release, the 2020 GIPS Standards for Firms include nine sections and a glossary. Sections 1 through 7 are the same as in the 2020 Exposure Draft. Section 8 includes the GIPS Advertising Guidelines applicable to asset managers. The GIPS Standards for Asset Owners include the same content as sections 8 through 12 of the 2020 Exposure Draft (renumbered 21 through 25). Section 26 includes the GIPS Advertising Guidelines applicable to asset owners.

The 2020 GIPS Standards include changes intended to improve the accessibility and appeal of GIPS to alternative and pooled fund managers: (1) new report formats for traditional GIPS-compliant presentations, pooled fund and asset owners reports, (2) options for limited distribution and broadly distributed funds to present pooled fund report or composite reports in certain situations, and (3) options for alternative managers to satisfy the external valuation requirement associated with private market investments. Additionally, GIPS compliant firms would gain flexibility through new options to report Internal Rate of Return rather than Time Weighted Return (TWR) in certain circumstances and a return to the acceptable use of carve-outs.

Looking for more information in the meantime? The CFA Institute has grouped its materials related to GIPS 2020 on a dedicated webpage and summarized the top 10 FAQs raised by firms, service providers and others in the industry during the open comment period. Watch for additional information from Hardin once finalized, and see our October 2018 issue of the Compliance Informer for additional exposure draft details. *Contributed by Cari A. Hopfensperger, Senior Compliance Consultant.*

- **Pennsylvania Communicates Custody Requirements for RIAs with Standing Letters of Authorization Arrangements Established by Clients and Qualified Custodians.** Following inquiries from industry, the Pennsylvania Department of Banking and Securities recently issued a Bureau Position memorializing its current requirements for custody for investment advisers with standing letter of authorization arrangements (“SLOA”) established by a client and qualified custodian.

Pennsylvania’s position piggybacks on the SEC’s guidance on SLOAs outlined in the Commission’s February 2017 no-action letter to the Investment Adviser Association (IAA). It’s no surprise that Pennsylvania believes arrangements where an investment adviser is authorized to withdraw client
funds or securities held with a qualified custodian constitutes custody and triggers disclosure of custody on Item 9 of Form ADV Part 1A. Fortunately, just as the SEC states in its no-action letter to the IAA, so long as an investment adviser meets certain conditions with those arrangements, it can escape the more cumbersome obligations for custody.

The conditions identified by the SEC and now by Pennsylvania are designed to eliminate an investment adviser’s ability to exercise discretion in disbursing client funds. Pennsylvania adopts the same seven requirements identified by the SEC in the IAA no-action letter:

1. a client must provide a custodian with written instructions including account numbers or name of the third party for disbursements;
2. a client must control the timing for third-party disbursements;
3. a custodian must verify the client’s instructions;
4. a client can end or alter the disbursement instructions;
5. an investment adviser cannot alter the disbursement instructions;
6. a custodian maintaining client assets is an unrelated party to the investment adviser; and
7. the custodian involved in the SLOA provides initial and ongoing notice to the client regarding the instructions.

Pennsylvania-registered investment advisers meeting these seven conditions will not be required to maintain a net worth of $35,000, file an audited balance sheet, complete an internal control report or be subject to an annual surprise examination of clients’ funds or securities by an independent certified public accountant. Pennsylvania gives affected investment advisers six months to comply with its Position and to amend their Form ADVs. Contributed by Carolyn W. Mendelson, Esq., Senior Compliance Consultant.

Lessons Learned from Recent SEC and FINRA Cases

Wait, What??  SEC Fines Hedge Fund $5 million for Weak Valuation Process that Undervalued Securities. The SEC brought another investment adviser to task for failure to value assets properly in its case against Deer Park Road Management Company, L.P. (“Deer Park”) and Scott E Burg. Surprisingly, Deer Park got caught for undervaluating fund assets. Deer Park is a registered investment adviser that manages private funds, including the STS Partners Fund LP (“STS”). Scott Burg was Deer Park’s chief investment officer and a portfolio manager for STS. STS’s portfolio consisted of mortgage bonds that originated before the 2008 financial crisis and were not guaranteed by a government-sponsored agency.

In the administrative order, the SEC found several issues with the firm’s valuation process. First, the policy that the firm’s valuation policy was deficient since it failed to address how to conform the firm’s valuations with GAAP. The SEC found that the policy was “not reasonably designed for its business practices, given its use of valuation models and pricing vendors, and the potential conflict of interest arising from traders’ ability to determine the fair value assessment of a portion of the positions they manage.”

Not only was the policy poorly designed, but it was also not being followed by the firm’s traders. Another nail in the firm’s coffin was the fact that the committee responsible for overseeing the valuation process had no experience in valuing thinly-traded bonds. The traders sometimes ignored
bond trading prices, provided inaccurate information to pricing services, and relied on their own assumptions regarding the expected yield to mark the bonds. The traders undervalued some bonds, using justifications like “undervalued settlement bond. We can sell for profit when needed” and “undervalued. Mark up gradually.” Scott Burg, as chief investment officer and portfolio manager of the fund, was responsible for reviewing the traders’ pricing. He apparently rubber-stamped the traders’ activity, even though they were not following firm policy or giving appropriate weight to market prices.

The SEC came down hard on Deer Park for an inadequate valuation policy, its failure to follow the policy, and its inadequate supervision. There was no harm to investors -- presumably, STS’ advisory fees were lower because the assets were being undervalued. The takeaway from this case is valuation of client assets is “critically important.” A firm’s compliance policies and procedures should not be gathering dust on the shelf but should be used to avoid regulatory issues. Adequate supervision is also critical; managers that do not keep their eye on the ball will suffer.  Contributed by Jaqueline M. Hummel, Partner and Managing Director.

SEC Lashes out at Accounting Firm for Ethical Lapses. The SEC doesn’t limit its mantra on the “Tone at the Top” solely to registered investment advisers. In a stunning case against KPMG, the SEC fined the public accounting firm $50 million and instituted a cease and desist order for its having violated PCOAB (Public Company Oversight Accounting Board) Rule 3500T under Section 4C(a)(3) of the Exchange Act and Rule 102 (e) (1) (ii) of the Commission Rule of Practice:

- **Under Section 4C (a) (3), The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others; (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations issued thereunder.**

- **Under Rule 102 (e) (1) (iii), The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found to be lacking in character or integrity or to have engaged in unethical or improper professional conduct.**

The PCOAB, a nonprofit corporation, was created by Congress under the Sarbanes-Oxley Act of 2002 to subject public accounting firms to external and independent oversight. The five-member board is appointed by the SEC, who also has oversight responsibilities.

From 2015 through 2017, KPMG embarked on a plan to hire PCOAB personnel to KPMG to improve its PCOAB audit deficiencies. In fact, KPMG hired the Associate Director, Brian Sweet, who had conducted previous audits of KPMG. Sweet, on his way out of the PCOAB, took confidential information which he, in turn, shared with his new supervisors and partners at KPMG. The KPMG partners used this information to alert its engagement partners working on audits that were targets of the PCOAB and allowed them to tailor their focus to help mitigate PCOAB concerns. Sweet also helped his former colleague from the PCOAB, Cynthia Holder, to get a job at KPMG. To prove her worth to KPMG partners, she too passed along confidential information to Sweet while still employed at the PCOAB. And finally, a third PCAOB employee, Jeffery Wada, who became disenchanted with the PCOAB after not being promoted, contacted Holder and provided her additional confidential information on KPMG audits. At
the time, KPMG was under serious scrutiny by the PCOAB, and Wada provided information that prompted KPMG to alter unlocked audit work papers. Interestingly, it was during one of the engagement manager tip-offs by Sweet that one of the engagement managers reported the incident to the KPMG internal ethics hotline. This act of courage kicked off a KPMG internal investigation, which in turn was reported to the PCOAB.

The story doesn’t end here. There were additional ethics failures regarding the required internal professional training conducted at KPMG. As a result of a settlement with the SEC in August 2017, KPMG audit staff were required to take 12 hours of continuing professional education training, in addition to the required 120 hours of professional education training required in a three-year time period. At KPMG, the training is conducted online. It turns out that auditors who completed and passed their online training were sharing their answers with engagement partners and others in the firm to ensure passage of the training modules. Once again, there was an internal investigation and, to make matters worse, some of the engagement partners tried to conceal their involvement by destroying text messages and lying on written questionnaires of their receipt and transmission of the training answers. Finally, some audit professionals were able to manipulate the training hyperlink URL’s to lower the score required to pass their training.

In the SEC cease and desist order, the SEC recognized the cooperation that KPMG provided in the investigation. In addition to the $50 million fine, the SEC also required KPMG to conduct a review of its policies and procedures and provide a special committee review of the training failures and employment actions to the KPMG independent Board of Directors. KPMG was required to hire an independent consultant to review the special committee reviews and reports. Criminal charges were also filed against the partners at the firm who were misappropriating the PCOAB confidential information as well as Sweet, Holder and Wada. Contributed by Heather A. Augustine, Senior Compliance Consultant.

**Worth Reading**


[12 Things You Need to Know about Adviser Referral Arrangements and the Cash Solicitation Rule](#). This article by Hardin Compliance Partner and Managing Director, Jaqueline Hummel, and reprinted in the May 2019 NSCP Currents, contains great practical guidance.

[After SEC cases, Commonwealth Makes ‘Terrible’ Disclosures](#). Tobias Salinger from Financial Planning addresses the fall-out impacts on firm disclosures in the wake of the Share Class Selection Disclosure Initiative.

[ Custody Rule Traps for the Unwary](#). Winston & Strawn LLP provides this helpful refresher of the current state of the custody rule and highlights open questions under consideration following the SEC’s request for comment last month.

**SEC Compliance Outreach.** Check out these newly archived webcasts!

- The May 21st San Francisco 2019 [Compliance Outreach Program for Municipal Advisors](#).
• The New York Regional Office recorded the second installment in its series of Investment Adviser Compliance Netcasts. This episode covers 2019 examination priorities, including (1) fees and expenses for retail clients; (2) conflicts of interest; (3) senior investors and retirement savers; (4) portfolio management and trading; (5) never-before examined advisers; (6) mutual funds and ETFs; and (7) cybersecurity. The Netcast also provides a timely discussion of two hot topics: digital asset investments and the Share Class Selection Disclosure Initiative.

**NASAA Members to Offer Resources to Help Investment Professionals Work with Clients Affected by the Opioid Epidemic.** In recognition of World Elder Abuse Awareness Day (WEAAD) on June 15, 2019, the North American Securities Administrators Association (NASAA) announced new resources available to investment professionals to raise awareness of the impact the opioid crisis may have on investment firms and their clients. It highlights recent research by the Virginia Tech Center for Gerontology and the Elder Justice Coalition which identified “a connection between opioid abuse and elder abuse, including financial exploitation.” NASAA’s new resources include a guide and checklist to be used by broker-dealers to assist investment professionals in identifying and navigating these complex situations.

**Statement on Final Rules Governing Investment Advice.** SEC Commissioner Robert J. Jackson, Jr. outlines his dissenting opinion on Reg BI and the related rulemaking package, as presented at the SEC’s June 5th open meeting.

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

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

• **Form 13H:** Following an initial filing of Form 13H, all large traders must make an amended filing to correct inaccurate information promptly (within ten days) following the quarter-end in which the information became stale. Recommended due date: **July 10, 2019.** (Note: Neither the SEC nor its staff has provided guidance on the definition of “promptly” for Form 13H.)

• **Form PF for Large Liquidity Fund Advisers:** Large liquidity fund advisers must file Form PF with the SEC on the IARD system within 15 days of each fiscal quarter end. Due date is **July 15, 2019.**

**HEDGE/PRIVATE FUND ADVISORS**

• Blue Sky Filings (Form D): Advisers to private funds should review fund blue sky filings and determine whether any amended or new filings are necessary. Generally, most states require a notice filing (“blue sky filing”) within 15 days of the first sale of interests in a fund, but state laws vary. Did you know that Hardin Compliance Consulting offers a convenient and economical blue sky filing service to help firms manage this complicated monthly task? [Learn more here](#) and give us a call to discuss your needs further. Due **July 15, 2019.**

• Distribute Audited Financial Statements for Private Funds for Funds of Funds: Private fund investment advisers generally should have their funds audited by an independent, PCAOB-registered accountant and deliver the audited financial statements to the funds’ investors within
120 days of the end of the funds’ fiscal year. This deadline for private fund of funds is within 180 days of the funds’ fiscal year end. That’s **June 29, 2019** for funds with December 31 year-end.

**BROKER-DEALERS**

- **FINRA Accounting Support Fee:** Quarterly invoice to support the GASB budget. Based on municipal securities the firm reported to the MSRB. De Minimis firms (that owe less than $25) will not receive an invoice. Invoices are sent to the firm via WebCRD’s E-Bill. **Log in and check your E-Bill account for firm-specific details.**

- **Annual Audit Reports for Fiscal Year-End April 30, 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 July 1, 2019.**

- **Customer Complaint Quarterly Statistical Summary:** For complaints received during the 2nd Quarter, 2019. FINRA Rule 4530 requires Firms to submit statistical and summary information regarding complaints received during the quarter by the 15th day of the month following the calendar quarter. **Due date July 15, 2019.**

- **Rule 17a-5 Quarterly FOCUS Part II/IIA Filings:** For Quarter ending June 30, 2019. FINRA requires that member firms file a FOCUS, (Financial and Operational Combined Uniform Single) Report Part II or IIA on a quarterly basis. Clearing firms and firms that carry customer accounts file Part II and introducing firms file Part IIA. **Due date July 24, 2019.**

- **Quarterly Form Custody:** SEC requires that member firms file Form Custody pursuant to Securities Exchange Act Rule 17a-5(a)(5) for the quarter ending June 30, 2019. **Due date July 24, 2019.**

- **Supplemental Statement of Income (“SSOI”):** For the quarter ending June 30, 2019. FINRA requires firms to submit additional, detailed information regarding the categories of revenues and expenses reported on the Statement of Income (Loss) page of the FOCUS Report Part II/IIA. **Due date July 29, 2019.**

- **Supplemental Inventory Schedule (“SIS”):** For the month ending June 30, 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 date July 29, 2019.**

- **Annual Audit Reports for Fiscal Year-End May 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 July 30, 2019.**

- **SIPC-3 Certification** of Exclusion from Membership: For firms with a Fiscal Year-End of June 30, 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 date July 30, 2019.**

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

- **SIPC-7 Assessment**: For firms with a Fiscal Year-End of May 31, 2019. 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 date July 30, 2019.**

- **Form OBS**: For the Quarter ending June 30, 2019. Unless subject to the de minimis exception, all clearing, self-clearing, and carrying firms and those firms that have a minimum dollar net capital requirement equal to or greater than $100,000 and at least $10 million in reportable derivatives and other off-balance sheet items must submit Form OBS as of the last day of a reporting period within 22 business days of the end of each calendar quarter via eFOCUS. Firms that claim the de minimis exemption must affirmatively indicate through the eFOCUS system that no filing is required for the reporting period. **Due date July 31, 2019.**

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**Partner with Hardin Compliance**

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