COMPLIANCE INFORMER

REGULATORY UPDATE

September 1, 2020

Provided by Hardin Compliance Consulting LLC

COVID-19 Compliance Risks Continue, SEC Surveying Initial Form CRS Filings, Exempt CPOs: Your Attention is Needed, and Guidance for BDs on Customer Due Diligence: Regulatory Update for September 2020

For Investment Advisers and Broker-Dealers

- **Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers**. Although it may seem like a note from Captain Obvious, SEC's Office of Compliance Inspections and Examinations (OCIE) sent out a Risk Alert on Select COVID-19 Compliance Risks and Considerations to remind broker-dealers and investment advisers of key challenges related to the ongoing COVID-19 pandemic. OCIE has continued its outreach to registrants to monitor the impacts, challenges and responses associated with COVID-19, and this risk alert summarizes its findings. While we continue to experience "in real life" how necessity ***is*** the mother of invention, OCIE reminds firms to ensure that innovation makes its way into documented policies and procedures.

  Protection of investors' assets. Consider practices regarding handling of investor checks, transfer requests and disbursements. For disbursements in particular, consider whether any adjustments to your procedures to verify the client's identity and accuracy of the instructions would be appropriate to better address your firm's risk in this area.

  Supervision of personnel. Given the prolonged use of work-from-home ("WFH") arrangements by many, OCIE encourages adapting supervisory policies and procedures to this new environment. For example:

  - Many supervisors are having less interaction with employees while working remotely and developing new ways to stay in touch.
  - If a firm invests in securities with higher risk for fraud as a result of the pandemic or its on-site due diligence reviews of investments (or third-party managers) have stopped, consider documenting any new methods developed to monitor trading and/or investment decision-making.
  - If a firm's trading includes using alternative communication channels, find ways to monitor these channels and ensure firm procedures are updated in-step.

Fees, expenses and financial transactions. OCIE highlighted again the elevated risk of misconduct resulting from "increased financial pressures on Firms and their personnel to compensate for lost revenue". Remain alert for misconduct similar to that mentioned in prior risk alerts regarding conflicts of interest, including borrowing from clients or investors, billing errors and valuation.

Investment fraud. OCIE reminds firms of the increased risk of fraudulent offerings, and encourages extra scrutiny when considering new investments for clients.

Business continuity. Firms still heavily reliant on WFH arrangements should continue to monitor the impacts on their business continuity plans ("BCPs") and update their BCP accordingly. For example, consider updating your BCP to address new resources (human or technological) that are deployed to ensure that physical facilities, servers, systems and remote data remain secure.

Protection of investor and other sensitive information. With the increased use of personal devices, videoconferencing and other electronic communication, there remains an elevated risk of the potential loss of clients' personally identifiable information ("PII"). For example, firms should consider their information security practices surrounding:

- *Identity protection*: Remind clients to contact the firm by phone with any concerns about suspicious communications and train internal personnel to assist clients with these concerns.
- *Technology*: Revisit your encryption technologies to ensure they also address the use of personally-owned devices and stay current on new cyber-related issues (especially those associated with third parties). See the SEC's recent risk alert on ransomware attacks for more information.

While many of these observations are not new, the regulators are watching. Hardin recommends that firms continue to think critically about their business operations during these prolonged challenges and document their responses to these issues - whether operational, technical, commercial or otherwise. This will help demonstrate to the SEC that the firm has been thoughtful and flexible in its response to the WFH challenges and should help track updates. The U.S. hurricane season is again upon us, the COVID-19 pandemic continues, along with wildfires and many other challenges - firms that address adversity in an organized and methodical manner should be better poised to "weather the storm", both literally and figuratively. *Contributed by Cari A. Hopfensperger, Senior Compliance Consultant.*

For Investment Advisers

- **Statement by the Staff Standards of Conduct Implementation Committee Regarding New Form CRS Disclosures.** The Standards of Conduct Implementation Committee is reviewing a cross section of Forms' CRS and providing feedback to firms where improvements can be made. The Commission will conduct a roundtable this fall to share their thoughts on the results of this initial review. Date and time of the roundtable will be released soon. Questions regarding your firm's Form CRS can directed to IABDQuestions@sec.gov or visit the SEC's FAQ on FORM CRS. Check out Hardin's FORM CRS and REG BI resources. *Contributed by Heather A. Augustine, Senior Compliance Consultant.*

For Private Funds

- **CFTC Amends Rule 4.13 Extending Statutory Disqualifications to Exempt CPOs**. In June, the CFTC amended a widely-used exemption from registration as a commodity pool operator (CPO) (Regulation 4.13). Private fund advisers relying on this exemption are permitted to operate as exempt CPOs when trading a *de minimis* amount of commodity interest products, subject to certain conditions. The amendment closes a regulatory gap resulting from differing treatment of registered and exempt CPOs concerning statutory disqualifications listed in section 8a(2) of the Commodity Exchange Act (CEA). Typically, the CFTC denies registration to firms or firm principals that have any such disqualifications; however, exempt CPOs under Rule 4.13 have not been subject to the same treatment – until now. The amendment will require exempt CPOs under Rule 4.13 to represent that neither they nor their principals have any such disqualifications.

  Additionally, amended Rule 4.13 requires firms to implement procedures to identify its "principals" as defined in the rule (but generally "those individuals and entities within the CPO who have either management authority and responsibilities, or significant power derived from stock ownership or capital contributions"). Firms must also conduct appropriate background checks on individual principals prior to their next filing of a 4.13 exemption notice (whether initial or annual). For entity principals, we recommend establishing procedures to review the disciplinary background of the entity. This amendment takes effect for new filers on September 8, 2020, and existing exempt CPOs are expected to comply by the time of their annual affirmations, which is due March 1, 2021. *Contributed by Mark L. Silvester, Compliance Associate.*

For Broker Dealers

- **Beware of Imposter FINRA Website!** FINRA warns members of an imposter FINRA website. The fake domain name is being used to infiltrate member firms with phishing and malware attacks. **The fake includes an extra "n" in the domain name.** Please be cautious when browsing FINRA-related topics. *Contributed by Rochelle A. Truzzi, Managing Director*.

- **Does Your Firm Claim an Exemption from the SEC's Customer Protection Rule (15c3-3)?** If so, recent guidance issued independently by the SEC and FINRA may impact your firm's FINRA Membership Agreement, future FOCUS filings, and Annual Exemption Reports. The rule requires segregation of client assets from the firm's proprietary business activities. Exemptions are available for firms that do not carry customer accounts or otherwise receive or hold customers' funds or securities.

  - SEC's FAQs Concerning the July 30, 2013 Amendments to the Broker-Dealer Financial Reporting Rules 12, 12.1, 12.2):

- The SEC modified Q&A #8, defining the term, ***Non-Covered Firm,*** as "A broker-dealer that does not meet any of the exemption conditions of paragraph (k) of Rule 15c3-3 (i.e., paragraph (k)(1), (k)(2)(i), or (k)(2)(ii)), but also (1) does not *directly or indirectly receive, hold, or otherwise owe funds or securities for or to customers, other than money or other consideration received and promptly transmitted in compliance with paragraph (a) or (b)(2) of Exchange Act Rule 15c2-1; (2) does not carry accounts of or for customers; and, (3) does not carry PAB accounts (as defined in Rule 15c3-3).*" (Emphasis added) See Q&A #8.

- A ***Non-Covered Firm*** that does not meet any of the exemption conditions of paragraph (k) of Rule 15c3-3 should not indicate on the FOCUS Report that it is claiming an exemption from Rule 15c3-3. Items 4550, 4560, 4570, and 4580 of the FOCUS Report should be left blank. See Q&A 8.1.

- ***Non-Covered Firms*** may file an Exemption Report (and corresponding accountant's report) instead of filing a Compliance Report (and corresponding accountant's report). See Q&A #8.

- The Exemption Report should include a description of all the firm's business activities and a statement that during the reporting period the firm did not engage in the specific activities included in the definition of ***Non-Covered Firm,*** and highlighted above.

- Non-carrying broker-dealers may conduct business in multiple ways (e.g., introduce customers to the carrying firm on a fully disclosed basis; direct-way business with fund companies and annuity providers), availing themselves to multiple exemptions from Rule 15c3-3. In such cases, the non-carrying broker-dealer should indicate on the FOCUS Report and identify in the Exemption Report each and every exemption provision relied upon during the reporting period. The Exemption Report should also identify any applicable exceptions for each exemption claimed. See Q&A #12, 12.1.

- A broker-dealer that conducts any activity subject to Rule 15c3-3 is not permitted to indicate on the FOCUS Report that it is claiming an exemption from the rule. See Q&A #12.2.

o SEC's FAQs Concerning Amendments to Certain Broker-Dealer Financial Responsibility Rules (Q&A #18):

- ***Non-Covered Firms*** are not required to calculate or deposit amounts into a customer or PAB reserve account. See Q&A 18.

o FINRA's FAQs About Exemption Reporting Under SEA Rule 15c3-3(k) for Purposes of FOCUS Reporting and Updating of Membership Agreements:

- If your firm meets the definition of ***Non-Covered Firm*** and you believe the exemptions noted in the FINRA Membership Agreement do not accurately reflect the firm's current business activities, contact your assigned FINRA Risk Monitoring Analyst. See Q&A #1.

- Any request to correct the membership agreement must be in writing and submitted through FINRA's Firm Gateway. There is no fee to update the membership agreement if the firm is only updating the exemption status. See Q&A #2.

- When filing the FOCUS Report***, Non-Covered Firms*** should enter a memo to Item 4560 that states: "The firm has no possession or control obligations under SEA Rule 15c3-3(b) or reserve deposit obligations under SEA Rule 15c3-3(e) because its business is limited to [list activities]." See Q&A #3.

Contributed by Rochelle A. Truzzi, Managing Director.

- **FinCEN Publishes Additional FAQs Addressing Customer Due Diligence.** On August 3rd, FinCEN released guidance in response to three frequently asked questions regarding obtaining customer information, establishing a customer's risk profile, and monitoring customer relationships. The Release is a three-page easy read. The overall message is that a Financial Institution must develop policies and procedures to assess a customer's risk profile, and, based on that profile, collect enough information to understand the nature and purpose of the customer relationship. The higher the customer's risk profile, the more information would be required. Similarly, the firm must have policies and procedures to determine when to update customer information, based on the customer's risk profile. The requirement to update customer information is risk-based and firms should consider its ongoing monitoring of changes in customer information (e.g., beneficial owners, transaction types, frequency, amounts). Finally, firms should reassess the customer's risk profile as critical information changes.

  FinCEN's CDD webpage provides additional information regarding the Customer Due Diligence Requirements for Financial Institutions. *Contributed by Rochelle A. Truzzi, Managing Director.*

- **SEC Provides Reg BI Guidance to Brokers when Using the Terms "Adviser/Advisor."** On August 4th, the SEC added four scenarios to its FAQs on Regulation Best Interest to address questions regarding the use of the terms "Adviser" and "Advisor" in names or titles. The SEC states that the presumed violation of the Disclosure Obligation under Reg BI would apply not only to the improper use of the terms in the legal entity name, but also the improper use of the terms in the firm's doing-business-as, and "marketing" names.

  The Staff clarified that a ***dually-registered*** broker-dealer may use firm-prepared marketing materials that generally refer to financial professionals using the terms Advisers/Advisors, provided the firm and associated person make full and fair disclosure of the capacity in which they are acting with respect to individual recommendations when using the marketing material. Conversely, ***standalone broker-dealers*** that use firm-prepared marketing materials that generally refer to its financial professionals as Advisers/Advisors are presumed to violate the Disclosure Obligation. The updated FAQs also address the distribution of ***issuer-prepared*** marketing materials that utilize the terms Adviser/Advisor and the use of the terms when offering services on behalf of a bank. If you have questions about how the Disclosure Obligation applies to your firm's use of the terms Adviser/Advisor, please contact us to discuss your firm's unique situation. *Contributed by Rochelle A. Truzzi, Managing Director*.

- **Broker-Dealers: Prepare for LIBOR Phase-Out**. In the August edition of Hardin's ***Compliance Informer***, Senior Consultant Cari Hopfensperger reported on the SEC's examination initiative focusing on the transition away from the use of LIBOR as a global benchmark interest rate. Days later, FINRA released Notice 20-26, where it shared survey results of a representative sample of

firms with significant exposure to LIBOR-linked financial products to demonstrate how firms are preparing.

FINRA expects firms to evaluate their exposure to LIBOR-linked financial products, take steps to transition away from LIBOR, and determine the impact of the LIBOR phase-out on customers. A strong transition plan will address and document:

- Implementation of governance framework;
- Financial risk analysis including: the evaluation of exposure to LIBOR-linked securities/contracts that mature after 12/31/2021 and the firms use of LIBOR with market, credit or liquidity risk models;
- Assessment of operational risks associated with business processes, systems, and vendors' use of LIBOR, and any mitigating controls;
- Identification of alternative references rates;
- Training of firm and registered representatives;
- Communications with customers; and
- Supervisory procedures regarding recommendations of LIBOR-inked financial products.

Contributed by Rochelle A. Truzzi, Managing Director.

Lessons Learned

- **Another Private Equity Firm Nailed for Overhead Expense Allocation Issues.** Rialto Capital Management, a private equity firm to real estate private funds and related co-investment vehicles, employed an expense reimbursement practice by which it performed certain services for the funds that are usually performed by external service providers (described here as "Third-Party Tasks"). The fund's operating documents then permitted Rialto to reimburse itself for performing those tasks, following approval by each fund's Advisory Committee.

  Rialto was found to have misallocated a disproportionate share of Third-Party Task expenses to the Funds over the review period, where more should have been paid by the co-investment vehicles. Additionally, when seeking approval from the Advisory Committees, Rialto failed to provide sufficient disclosure of increases to the rates of overhead expense over time and evidence to support a statement that the services were "at or below" market rates, as required by the fund operating documents. Finally, the SEC found the adviser's policies and procedures to ensure proper calculation, allocation and disclosure of these costs and expenses.

  SEC scrutiny of the practices used by funds to calculate, allocate and disclose fund expenses continues to escalate. This is especially true for firms with co-investment vehicles and that reimburse themselves for internally provided services to their own funds. Firms with these elevated risks should take extreme care to ensure that disclosures are thorough and appropriate, that procedures to calculate and allocate those expenses are robust, that proper governance and controls are in place, and that they are tested properly to confirm compliance. *Contributed by Cari A. Hopfensperger, Senior Compliance Consultant.*

- **Advisers Punished for Not Telling the Whole Truth**. The SEC expects "the truth, the whole truth, and nothing but the truth" from investment advisers. WBI Investments, Inc. ("WBI") and Millington Securities, Inc. ("Millington") both SEC-registered investment advisers found this out the hard way. WBI and Millington provide advisory services to a series of ETFs and mutual funds (the "Funds"), and WBI made the investment decisions for these shared clients, while Millington acted as an introducing broker for WBI since it was also registered as a broker-dealer. Millington routed trades for the Funds to a group of broker-dealers for execution, the "Executing Brokers." Millington did not charge WBI or the Funds commissions for its brokerage services but still profited from the trading activity, and that's where the trouble starts. The Executing Brokers paid Millington a flat fee per share for executing trades for WBI's clients, a practice known as "payment for order flow". WBI and Millington told their clients, including the Funds, not only that they received payments for order flow, but that these payments did not affect the prices at which the clients' orders were executed. Millington received approximately $7.6 million in order flow payments over the course of the arrangement.

  But wait, there's more. As part of Millington's deal with the Executing Brokers, Millington agreed that the brokers could execute trades for WBI clients on a "net pricing" basis. Here's how it worked: after receiving orders from Millington, the Executing Brokers would buy the securities in the market and sell them to Millington at a mark-up, known as the "net price." The Executing Brokers kept the difference between the market price and the net price as compensation for effecting the trade, and WBI's clients paid the net price. Over time, Millington and the Executing Brokers agreed to specific net pricing designed to compensate the Executing Brokers for the order flow payments and provide them with some profit for executing the trades.

  So ultimately WBI's clients, including the Funds, were paying higher than market prices for their trades. This was a problem, according to the SEC, because WBI and Millington told their clients, including the Funds' Board of Trustees, that the payment for order flow did not have a negative impact on the price of securities traded for WBI's clients. Millington and WBI had to pay penalties of $250,000 and $750,000, respectively, for making "materially misleading statements" in violation of Section 206 of the Advisers Act (the anti-fraud provision).

  What is interesting about this case is that there was no discussion of whether the Funds would have been better off paying commissions instead of engaging in this payment for order flow/net pricing arrangement. Instead, the Commission focused on the lack of disclosure about how the order flow payments were connected to net pricing. Advisers should be careful to "tell the whole truth" when disclosing arrangements that result in significant revenue to affiliated entities. Although the SEC does not come out and say it, the $7.6 million payment received by Millington may have influenced its decision to bring this case. *Contributed by Jaqueline M. Hummel, Partner and Managing Director.*

- **The Hidden Risks of Trade Allocation Practices**. As compliance professionals, we strive to ensure our policies and procedures, disclosures and agreements adhere to the fiduciary standard imposed by the SEC under Investment Advisers Act of 1940. However, there are times when it is not obvious that clients are not being treated fairly when allocating securities to multiple client accounts. In the case of Birinyi Associates, the SEC laid bare the inequality of the firm's allocation policy as applied to its "Day Trade" and "Buy and Hold" Clients. "Buy and Hold" clients formed the majority of the firm's

client-base, while a smaller number were “Day Trade” accounts where clients directed Birinyi to sell at the end of each day.

Like many firms, Birinyi used a master account at a third-party broker to execute block trades and then allocate those trades to their client accounts according to its pre-trade decisions. Birinyi would monitor block orders and if a purchase was profitable that day the firm would sometimes sell off the purchased security that same day and then allocate the trades to its Day Trade Clients, contrary to its pre-trade determinations. The SEC stated that “through this allocation process, the Day Trade Clients were subject to risk-free profits where the Buy and Hold Clients bore all the risk.” The Buy and Hold clients did not benefit from the first day returns.

Birinyi argued that over the long term, the Buy and Hold Clients “earned significantly higher-than-average annual returns during the Relevant Period than the Day Trade Clients”. However, the SEC disagreed. “The trades that Birinyi Associates allocated to the Day Trade Clients during the Relevant Period earned an average first-day return of 0.26%. By comparison, the trades allocated to Buy and Hold Clients during the Relevant Period had an average first-day return of −0.02%.” The SEC did have mercy on Birinyi and only fined the firm $100,000 and required it to hire a third-party compliance consultant to update its policies and procedures and disclosure documents. Advisers are reminded to have checks and balances in place whenever an allocation deviates from the pre-trade determination. But, the critical take-away is that long-term results are not the only criteria to use when reviewing allocation practices and testing client accounts. The firm must also consider short-term results and risk. *Contributed by Heather A. Augustine, Senior Compliance Consultant.*

Worth Reading

- SEC Share-Class Crackdown Could Spell the End for 12b-1 Fees. Mark Schoeff Jr., from *Investment News*, offers perspective on the recent SEC enforcement action against SCF Investment Advisers for share class selection violations and what it may signal to the investment community.

- SEC Staff Announces Examination Initiative on LIBOR Transition Preparedness. Jones Day summarizes the SEC’s new focus on LIBOR readiness by broker-dealers, investment advisers and investment companies. It also highlights several questions firms should expect from the SEC in upcoming examinations. In addition to this helpful article, the SEC attached a list of 20 possible questions to the risk alert itself. For more on this topic, see “Broker-Dealers: Prepare for LIBOR Phase-Out” by Rochelle Truzzi above and the August issue of Compliance Informer.

- IAA 2020 Compliance Testing Survey Results Released. This annual survey of nearly 400 firms reviews a wide variety of RIA investment management compliance testing practices. Encouragingly, the “vast majority” of firms reported they were not materially impacted by the COVID-19 pandemic. Almost 80% do not plan to make material updates to their BCP as a result of COVID-19; however, almost 70% of firms’ BCPs already addressed pandemic response plans. Unsurprisingly, BCP overtook Cybersecurity’s six-year run as the year’s hot topic. Check out the results for more interesting insights.

- How One Person Can Change the Conscience of an Organization. Step outside of typical compliance topics and consider this inspiring article from the Harvard Business Review. It draws from leadership experience in pharmaceuticals and global healthcare to highlight universal ways

that an employee at any level of an organization can become a catalyst for positive change – lessons that are instrumental for any compliance professional.

- Ten Tips for Navigating Risks and Liability at Portfolio Companies During COVID-19. Proskauer's Coronavirus Response Team notes that the COVID-19 pandemic has contributed to an increase in litigation associated with portfolio companies and offers these tips to help fund sponsors identify and mitigate risks as well as inform directors.
- Shed the Shame: Taking a PPP Loan Is Not What You Think. Kirsten Plonner offers this *ThinkAdvisor* editorial on PPP Loans as the industry continues to process the implications of accepting them.

Filing Deadlines and To-Do List for September 2020

HEDGE/PRIVATE FUND MANAGERS

- 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 **September 15, 2020**.

BROKER-DEALERS

- Rule 17a-5 Monthly and Fifth FOCUS Part II/IIA Filings: For the period ending August 31, 2020. For firms required to submit monthly FOCUS filings and those firms whose fiscal year-end is a date other than a calendar quarter. **Due September 24, 2020.**
- SIPC-7 Assessment: For firms with a Fiscal Year-End of July 31. 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 September 29, 2020.**
- Annual Audit Reports for the Fiscal Year-End July 31, 2020: 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 September 29, 2020.**
- Supplemental Inventory Schedule ("SIS"): For the month ending August 31. 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 September 29, 2020**.
- SIPC-6 Assessment: For firms with a Fiscal Year-End of February 29. 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 September 30, 2020.**

MUTUAL FUND ADVISERS

- Form N-MFP: Form N-MFP (Monthly Schedule of Portfolio Holdings of Money Market Funds) reports information about the fund's holdings as of the last business day of the prior calendar month and must be filed no later than the fifth business day of each calendar month. Due date is **September 7, 2020.**

Partner with Hardin Compliance

Have a compliance question or want an independent review of your compliance program? Hardin Compliance can help! Call us today at 1.724.935.6770, or visit our website at www.hardincompliance.com for more information.

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