



## REGULATORY UPDATE

February 1, 2021

*Provided by Hardin Compliance Consulting LLC*

ADV Season is Here; Hardin Releases 2021 Compliance Resources for Brokers and RIAs; Don't Forget Your CPO Annual Affirmations; SEC Creates 5-Year "Sandbox" for BD Custody of Digital Assets: Regulatory Update for February 2021

### General SEC Updates

- [Custody of Digital Asset Securities by Special Purpose Broker-Dealers](#). Just in time for Christmas, the SEC issued a [Statement](#) conveying its position that, for five years, a broker-dealer operating under specified circumstances will not be subject to enforcement. To take advantage of this non-enforcement position, broker-dealers must first acknowledge physical possession or control of customers' fully-paid and excess margin digital asset securities for the purpose of Securities Exchange Act Rule 15c3-3(b)(1). The Commission is also requiring a broker-dealer to:
1. Have exclusive access to and the ability to transfer the digital asset securities;
  2. Limit its business to digital asset securities;
  3. Establish procedures to assess whether the digital asset is a registered security or subject to an exemption from registration;
  4. Develop procedures to assess the digital asset security's distributed ledger technology and associated network;
  5. Develop policies and procedures to refrain from taking custody of any digital asset securities if the firm is aware of any material security or operational issues or weaknesses;
  6. Develop procedures to protect against the theft, loss, or unauthorized and accidental use of the private keys necessary to access and transfer the digital asset securities;
  7. Develop procedures to identify the steps it will take in the event of a breach of custody, allow for the broker-dealer to comply with a court-ordered freeze or seizure, and allow for the transfer of the digital asset securities to another appropriate custodian; and
  8. Provide written disclosure to prospective customers regarding the risks associated with transacting in digital asset securities.

The Commission is also requesting comment on the evolving standards and best practices related to custody of digital asset securities. The five-year period was designed to provide the industry an

opportunity to develop sound practices to demonstrate possession or control over digital asset securities and also allow the Commission to gain experience overseeing custody of digital assets.  
*Contributed by Rochelle A. Truzzi, Managing Director.*

## For Investment Advisers

- [Annual Amendments to Form ADV and CRS Due March 31, 2021](#). Registered investment advisers are required to update their Form ADV within 90 days of their fiscal year-end, and that's March 31, 2021, this year. First time using the system? FINRA prepared these useful guides with instructions on filing [Form ADV Part 1 and 2](#) and [Form CRS](#).

Remember to pay the annual updating fee before the deadline since the Investment Adviser Registration Depository (IARD) system will not accept the filing if the funds are not already in the firm's account. Not sure how much to pay? Check out IARD's fee schedule [here](#). Payment options include electronic payments using E-Bill, wire transactions, ACH, or check, and instructions are available [here](#).

Need some advice on enhancing your conflict disclosures, creating a better update process, and answering the trickier questions? Check out our blog posts: [Coming Clean on Conflicts of Interest: Tips for Updating Your Form ADV for 2020](#), [How I Learned to Stop Worrying and Learned to Love Form ADV](#) and [Feeling your Pain: Advice on Answering Form ADV's Trickier Questions](#).

The SEC is looking at other conflicts in recent SEC exams:

1. [Revenue sharing from cash management vehicles](#). If an investment adviser with an affiliated broker-dealer receives revenue sharing payments from a cash sweep vehicle, this conflict must be disclosed. For advisers with affiliated broker-dealers that recommend a specific cash sweep vehicle for clients, make sure there is a process for periodically reviewing whether the sweep is the best available alternative. If the firm receives revenue sharing payments, how is that conflict addressed? For example, does the firm evaluate available cash sweep vehicles to ensure that clients receive market rates on their cash balances?
2. [Proprietary products](#). When applicable, firms should disclose that they have a conflict concerning proprietary products. For example, a client's investment in proprietary products can result in the firm and its Investment Adviser Representatives (IARs) receiving more compensation than for other comparable investment products.
3. [Consistency among disclosure documents](#). Review Forms ADV Part 1A, Part 2A, Part 2B, and CRS to ensure that disclosures are consistent across these forms and with marketing materials.
4. [Conflicts related to other businesses](#). For firms whose IARs are also licensed insurance agents, the SEC is looking at disclosures related to insurance products. For example, the SEC wants to know whether firms have disclosed that their fiduciary duty does not extend to the sale of annuities.
5. [Conflicts created by using a specific custodian](#). For example, many advisers receive computer software and related systems support from custodians, such as Fidelity, Schwab, and TD Ameritrade, which allow firms to monitor client accounts maintained at those custodians without cost. These services are not paid for using client commissions (e.g., "soft dollars") but nonetheless benefit advisory firms. The SEC expects to see disclosure of these benefits,

including a discussion that the receipt of these benefits creates a conflict of interest since the firm may favor custodians that offer these types of software, systems support, or services.

If you need help drafting your Form ADV or want an expert to review your current disclosures, call us today at 1.724.935.6770, or shoot us an email at [contact@hardincompliance.com](mailto:contact@hardincompliance.com) to set up a time for one of our consultants to discuss your needs and how we can help. *Contributed by Jaqueline M. Hummel, Partner and Managing Director.*

## For Broker-Dealers

- **Brokers Named as Beneficiary or Holding a Position of Trust on Behalf of Customers.** As a reminder, FINRA Rule 3241 goes into effect on February 15<sup>th</sup>. In the December 2020 edition of [Compliance Informer](#), Hardin outlined the responsibilities of firms and registered representatives under this new rule. If you have not done so already, we encourage you to consider the training and data collection necessary to ensure compliance with Rule 3241 as well as your supervisory obligations under FINRA Rule 3110. Institutional firms should also develop procedures to screen current and new-hire employees in order to identify relationships that may trigger compliance with Rule 3241. Hardin has the tools to assist you in developing, implementing, supervising, and testing firm procedures, designed to comply with these rules. *Contributed by Rochelle A. Truzzi, Managing Director.*

## For Private & Mutual Funds

- **Reminder: Background Check Rules Now Apply to Funds Reaffirming Rule 4.13 Exemption.** In 2020, the Commodities Future Trading Commission (CFTC) adopted a rule change impacting those entities relying on the Rule 4.13(a)(3) exemption (the *di minimis* exemption) from commodity pool operator (CPO) registration. The rule became effective last September and beginning March 1, 2021, filers must now represent on the annual affirmation that neither the person making the filing nor any of its [principals](#) are subject to any statutory disqualification included in [Section 8a\(2\) of the Commodity Exchange Act](#), as amended (the CEA) (each a Covered Statutory Disqualification). If you haven't already, now is the time to finish obtaining background checks for your principals in order to ensure a smooth affirmation process. See Hardin's September 2020 [Compliance Informer](#) for details. *Contributed by Cari A. Hopfensperger, Managing Director.*

## Lessons Learned

- **Robinhood Failed to Disclose True Cost of Commission-Free Trades to Customers.** The bill for "commission-free" trading is coming due for broker-dealers. [Robinhood Financial, LLC](#) ("Robinhood") had to pay the price when the SEC fined the firm \$65 million for misleading customers about revenue sources and failing to satisfy its duty to seek best execution. Established in 2013, Robinhood was one of the first retail broker-dealers to offer commission-free trading to its customers. The big issue in this case was "payment for order flow." Here's how it works: Instead of sending customer orders directly to national exchanges, "Robinhood, like other retail broker-dealers, routed its orders to other broker-dealers (often referred to as "principal trading firms" or "electronic market makers") to either execute those orders or route them to other market centers," according to the SEC's order. The market makers paid Robinhood for the right to execute customer trades. SEC rules permit brokers to receive payment for their order flow, as long as the payments do

not interfere with their efforts to obtain best execution. Broker-dealers must disclose payments for order flow arrangements on quarterly reports filed under Rule 606 of Regulation NMS.

The SEC noted that many retail broker-dealers can get better prices (“price improvement”) than those that are publicly available, so the practice can benefit retail investors. There is, however, a trade-off, as Robinhood learned during its negotiations with principal trading firms. Charging more for order flow means less money is available for price improvement. Nonetheless, Robinhood charged principal trading firms four times the going rate for order flow, which ultimately ate into the price improvement investors might have realized on their trades. The SEC found that Robinhood customers lost \$34 million due to poor execution compared to competing broker-dealers, even after netting out the approximately \$5 per order commissions charged by those brokers at the time.

To add insult to injury, Robinhood was not benchmarking its order execution quality to its competitors until October, 2018. At that point, the data showed that Robinhood’s execution quality lagged behind other retail brokerages by a wide margin. At the same time, the firm’s FAQs on its website claimed that its execution quality matched or beat that of its competitors. Even worse, Robinhood appeared to deliberately hide the fact that it received a significant portion of its revenue from payment for order flow.

The takeaways from this case are that the SEC will continue to look at payments for order flow and how they impact best execution. Broker-dealers and investment advisers should review Rule 606 reports and ask questions about how the routing arrangements might be impacting the execution quality of trades. *Contributed by Jaqueline M. Hummel, Partner and Managing Director.*

## Worth Reading, Watching and Hearing

- [Top 10 Tips for Updating your Investment Adviser Compliance Program for 2021](#). Check out Jaqueline Hummel’s practical tips for advisers as you prioritize goals for the new year.
- Download Hardin’s 2021 [Investment Adviser](#) and [Broker-Dealer](#) To-Do Checklists to help shore up your 2021 compliance calendars.
- Want to learn more about Form 13F filing obligations? If you missed Hardin Managing Director, Denise Alfieri’s recent article on the topic, [find it here](#).
- [OFAC Issues Guidance Regarding Ban on Transacting in Securities of “Communist Chinese Military Companies”](#). Confused by the Executive Order (and the subsequent Executive Order to amend the original Executive Order)? Thompson Hine offers this summary to explain what is expected of advisers and funds. Additionally, here are links to the [amended executive order](#) and latest [FAQs](#).
- [Financial Services Webinar Series: Industry Hot Topics](#). Interested in blocking off some time on your calendars to catch up on industry perspectives? Check out this timely webinar series sponsored by Ulmer & Berne.
- [Don’t Forget Your Bitcoins](#). We enjoyed Matt Levine’s take on a NYT story about Bitcoin and potential pitfalls of investing in cryptocurrency. We hope you do too!
- Curious about the ongoing industry dialogue regarding CCO liability? Curious about the ongoing industry dialogue regarding CCO liability? Check out [SEC Settlement Proves That When CCOs Spot A](#)

[Problem, Silence Is Not Golden](#), by Alan Wolper at Ulmer & Berne, [Managing CCO Risk Without A Liability Standard From SEC](#), by Michael Asaro, Barry Greenberg and Nathaniel Botwinick from Akin Gump, and the NSCP, Calfee Co-Sponsored [Securities Compliance Podcast: Compliance in Context, Episode 10: Thoughts on CCO Liability from Commissioner Peirce](#). All offer great insight into this developing topic.

- [Congress Amends Exchange Act, Expanding SEC Enforcement Power](#). Tucked deep in the recent National Defense Authorization Act are amendments to Section 21(d) of the Securities Exchange Act of 1934 (the Exchange Act) that push the number of years for the SEC to pursue disgorgement in fraud cases out to ten years – that’s double the five-year period previously available. Read this analysis of the January 1<sup>st</sup> amendments by Wilmer Hale for details.
- [Robo Advisors and Custody Rules of the Road](#). Thompson Hine maintains this useful blog focused on a variety of RIA topics specifically targeted to robo advisors. This installment on the custody rule is one great example.

## Filing Deadlines and To-Do List for February 2021

### **INVESTMENT ADVISERS**

- [Form 13F](#). Form 13F (institutional manager) quarterly filing for Q4 2019 is due within 45 days after the end of the calendar quarter, on **February 16, 2021**.
- [Form 13H](#). Form 13H (large trader) annual filing is due for advisers that already have a Form 13H filing obligation by **February 16, 2021**. (This filing is not required if the quarterly amendment was filed for the fourth quarter.)
- [Schedule 13D and Schedule 13G](#). Annual amendments are due for advisers that have changes to disclosure information on previously filed 13D or 13G forms, on **February 16, 2021**.

### **HEDGE/PRIVATE FUND ADVISERS**

- [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 **February 15, 2021**.
- [Form PF for Large Hedge Fund Advisers](#). Large Fund Advisers must file Form PF with the SEC on the IARD system within 60 days of each fiscal quarter-end. For funds with a December 31 fiscal quarter end, Form PF is due **March 1, 2021**.
- [Initial Form PF](#). Hedge Fund Advisers that have reached \$1.5 billion regulatory assets under management (“RAUM”) attributable to hedge funds as of December 31, 2019, 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, 2021**.

- [NFA Annual Affirmation](#). for Entities Operating Under an Exemption from CPO or CTA Registration: Annual amendments are due for advisers that have changes to disclosure information on **March 1, 2021**. **NFA Notice I-19-29 also contains guidance FAQs related to this annual affirmation process.**

## ***BROKER-DEALERS***

- [Supplemental Inventory Schedule \(“SIS”\)](#): For the month ending December 31, 2020. 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 February 1, 2021.**
- [Supplemental Statement of Income \(“SSOI”\)](#): For the quarter ending December 31, 2020. 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 February 1, 2021.**
- [Form OBS](#): For the Quarter ending December 31, 2020. 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 February 3, 2021.**
- [Rule 17a-5 Monthly and Fifth FOCUS Part II/IIA Filings](#): For the period ending January 31, 2021. For firms required to submit monthly FOCUS filings and those firms whose fiscal year-end is a date other than a calendar quarter. **Due February 24, 2021.**
- [Annual Reports for the Fiscal Year-End December 31, 2020](#): FINRA requires that member firms submit their annual 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, 2021.**
- [Supplemental Inventory Schedule \(“SIS”\)](#): For the month ending January 31, 2021. 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, 2021.**
- [SIPC-6 Assessment](#): For firms with a Fiscal Year-End of July 31. 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 1, 2021.**

- **SIPC-7 Assessment:** For firms with a Fiscal Year-End of December 31st. 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, 2021**
- **SIPC-3 Certification of Exclusion from Membership:** For firms with a Fiscal Year-End of January 31 **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 1, 2021.**

### **MUTUAL FUNDS**

- **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 **February 5, 2021.**

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### **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](http://www.hardincompliance.com) for more information.

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*Hardin Compliance Consulting provides links to other publicly-available legal and compliance websites for your convenience. These links have been selected because we believe they provide valuable information and guidance. The information in this e-newsletter is for general guidance only. It does not constitute the provision of legal advice, tax advice, accounting services, or professional consulting of any kind.*