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DINSMORE COMPLIANCE SERVICES

INVESTMENT ADVISERS NEWSLETTER

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Top Story

Form CRS

Risk Alert:
Examinations Focusing on Compliance with Form CRS

After filing Form CRS ahead of the June 30 2020 deadline, many investment advisers breathed a sigh of relief. However, advisers must remain vigilant as the June 30 deadline was the beginning of a new set of compliance efforts which firms must meet on a going-forward basis. In an effort to keep firms on track, we have summarized these ongoing obligations.

1) Initial Delivery.

Advisory firms must make an initial delivery of Form CRS to all current retail investor clients within 30 days of the regulatory filing deadline. Additionally, firms must deliver the relationship summary to any new retail investor client before or at the time they enter into an investment advisory contract with the retail investor client. This delivery requirement also extends to oral agreements. Firms may satisfy this by integrating Form CRS into their onboarding process by adding it to the collection of other account-opening documents. However, it is important—if Form CRS is delivered like this in paper format—for it to be the first document in the package. If delivering it electronically, firms must ensure it is presented prominently in the electronic medium, such as a direct link or in the body of an email or message. Firms must also post their Form CRS prominently on their public website in an easily accessible format.

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2) Updating Requirements.

Firms must update and refile their Form CRS with the SEC within 30 days of it becoming materially inaccurate and must notify current retail investor clients within 60 days after the updates are required to be made. Delivery of the amended Form CRS should include an attached exhibit that highlights the most recent changes.

3) Subsequent Delivery.

Firms must also deliver a relationship summary to an existing retail investor client before or at the time the firm:

A. Opens a new account that is different from the retail investor client's existing account(s);
B. Recommends that a retail investor client roll over assets from a retirement account into a new or existing account or investment; and
C. Recommends or provides a new brokerage or investment advisory service or investment that does not necessarily involve the opening of a new account and would not be held in an existing account, such as the first-time purchase of a direct sold mutual fund, insurance product or variable annuity.

There is an exception to these delivery requirements. If a firm delivers a relationship summary to a retail investor client, and within 30 days delivery is triggered again, the firm does not need to make a second delivery. However, firms must deliver a relationship summary within 30 days upon request, regardless of prior delivery.

4) Recordkeeping Requirements.

Generally speaking, firms should make a practice of integrating the relationship summary into their compliance program, including policies and procedures, supervisory controls, testing, tracking, training, and recordkeeping. According to amended Rule 204-2(a)(14)(i) of the Investment Advisers Act of 1940, firms must make and keep a record of the dates that each Form CRS, and each amendment or revision was given to any retail investor client or prospective retail investor client who subsequently becomes a client. These records must be maintained for a minimum of five years.

https://www.sec.gov/files/Risk%20Alert%20-%20Form%20CRS%20Exams.pdf

OCIE Risk Alert: Observations from Examinations of Investment Advisers Managing Private Funds

On June 23, 2020, the Office of Compliance Inspections and Examinations (OCIE) issued a Risk Alert focused on assisting private fund advisers in reviewing and enhancing their compliance programs, as well as providing information to investors regarding potential private fund adviser deficiencies. In the Risk Alert, OCIE addresses three general areas of concern: (i) conflicts of interest, (ii) fees and expenses, and (iii) policies and procedures relating to material non-public information (MNPI). OCIE found over 36 percent of registered advisers managed private funds, and through its examinations, it has found the following commonalities.

Conflicts of Interest

Advisers are prohibited under Section 206 of the Advisers Act of defrauding or otherwise misleading clients as well as making full and fair disclosure of all conflicts of interest such that a client can provide informed consent to any conflicts. More specifically, Rule 206 (4)-8 of the Advisers Act prohibits advisers to pooled investment vehicles from making untrue statements, omitting to state a material fact, or otherwise engaging in a deceptive manner to an investor in a pooled investment vehicle. OCIE, during its examinations, noted the following conflicts of interest that were often inadequately disclosed under Rule 206(4)-8: the allocations of investments; multiple clients investing in the same portfolio; financial relationships between investors or clients and the advisor; preferential liquidity rights; private fund adviser interests in recommended investments; co-investment vehicles and other co-investors; service providers; fund restructurings; and cross-transactions.

Fees and Expenses

Over the course of its examinations, OCIE observed the following areas where fee and expense issues appeared deficient: improper or inaccurate allocation of fees and expenses; inadequate disclosure regarding the role and compensation of individuals, who are not adviser employees, providing services to the private fund or portfolio companies; valuation of client assets in accordance with the adviser's valuation process; and issues regarding the receipt of fees from portfolio companies such as monitoring fees, board fees, or deal fees.

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MNPI / Code of Ethics

Section 204A of the Advisers Act requires advisers to establish, maintain and enforce written policies designed to prevent the misuse of MNPI. Advisers are also required under Advisers Act Rule 204A-1, otherwise known as the Code of Ethics Rule, to adopt and maintain a code of ethics which sets forth standards of conduct for the firm as well as addresses conflicts arising from personal trading by firm personnel. Recent OCIE examinations have revealed several areas where deficiencies appeared under Section 204A due to firms not addressing risks posed by their personnel interacting with: insiders of publicly traded companies; outside consultants arranged by "expert network" firms; (iii) "value added investors" (e.g. corporate executives). Additionally, OCIE noted the following additional recurring issues related to Rule 204A-1: firms not enforcing trading restrictions related to the firm's restricted list; failing to enforce requirements in their code of ethics relating to receipt of gifts and entertainment from third parties; and failing to require access persons to submit transactions and holdings reports in a timely manner.

https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf

OCIE Risk Alert: LIBOR Transition Preparedness

OCIE issued an examination initiative on June 18, 2020, regarding firms' readiness to transition away from the London Interbank Offered Rate (LIBOR). LIBOR, widely used in the United States and elsewhere as a benchmark rate for various commercial and financial contracts, including corporate and municipal bonds, floating-rate mortgages, asset-backed securities, consumer loans, and other derivatives, is being discontinued sometime after 2021. Such disruption could have a significant impact on the financial markets and their participants, including SEC-registered investment advisers and municipal advisers.

In light of this, OCIE has identified registrant preparedness for the transition away from LIBOR to alternative reference rates as an exam priority for FY 2020. During examinations, OCIE will be looking to see if and how the registrant has evaluated the potential impact of the LIBOR transition on the firm's business activities, operations, services, customers, clients and/or investors. For more details on how firms should be preparing, please see the Risk Alert.

https://www.sec.gov/files/Risk%20Alert%20-%20OCIE%20LIBOR%20Initiative_1.pdf

SEC Enforcement Action against Morgan Stanley Smith Barney for Providing Misleading Information to Retail Clients

On May 12, 2020, the SEC announced Morgan Stanley Smith Barney (MSSB) agreed to a $5 million penalty to settle charges that the firm provided misleading information to clients in its retail wrap fee programs regarding trade execution services and transaction costs. According to the SEC's order, from October 2012 to June 2017 some of MSSB's marketing and client communications indicated to wrap fee clients they were not likely to incur additional trade execution costs. However, the SEC alleges that during this period, some MSSB managers would often direct wrap fee clients' trades to third-party broker-dealers, resulting in additional transactions costs which were not visible to the clients. Therefore, clients were unable to determine the value of the services received in exchange for the wrap fee.

The SEC found MSSB failed to adopt and implement trading policies reasonably designed to prevent wrap managers from "trading away," which often resulted in clients paying MSSB twice for the order execution. Recently, other firms, such as Raymond James & Associates and Stifel Nicolaus & Co., have paid penalties regarding wrap fee program failures.

https://www.sec.gov/litigation/admin/2020/34-88856.pdf

SEC Charges California Trader for Manipulative Trading Scheme Involving COVID-19 Claims

On June 9, 2020, the SEC charged a penny stock trader in California with conducting a pump-and-dump scheme using the stock of a biotech company. According to the complaint, the trader attempted to drive up the stock price of Arrayit Corporation by encouraging investors online to purchase shares while making various false assertions regarding an approved COVID-19 test. The trader failed to disclose his own large position in Arrayit, as well as his plans to sell the shares while others were buying. Additionally, he attempted to give the impression of high demand for the stock by placing and subsequently canceling large orders—a tactic known as "spoofing." This is likely not the only instance of financial service professionals taking advantage of the chaos created by COVID-19 and investment advisors should be on the lookout for people approaching their clients with similar investment opportunities.

SEC Orders Three Self-Reporting Advisory Firms to Reimburse Investors over Improper Share Class Selection Disclosure

On April 17, 2020, the SEC announced it has settled charges against three firms that self-reported as part of the Division of Enforcement's Share Class Selection Disclosure Initiative. The SEC's orders found Merrill Lynch, Pierce, Fenner & Smith Inc. (MLPFS) and Eagle Strategies LLC violated Section 206(2) of the Advisers Act, which prohibits investment advisers from engaging "in any transaction, practice or course of business which operates as a fraud of deceit upon any client." The SEC also charged Cozad Asset Management Inc., finding Cozad violated 206(2) and 206(4) by failing to fully disclose the conflicts arising from it and its associated persons' selection of more expensive mutual fund share classes when other, lower-cost share classes for the same fund were available. The firms were censured and ordered to cease and desist from future violations. MLPFS and Eagle Strategies were ordered to pay disgorgement and prejudgment interest of over $425,000, while Cozad was ordered to pay $400,000 plus a $10,000 civil penalty. See the press release for details as well as links to the SEC orders.

https://www.sec.gov/news/press-release/2020-90

A Vital Resource from Dinsmore Legal Counsel

COVID-19 Business Strategies Hub

In an ongoing effort to help business leaders sort through information regarding the COVID-19 pandemic, we have created a user-friendly hub with updates, insights, and best practices.

VISIT AT DINSMORE.COM/COVID-19/

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Questions? Contact the DCS Team

Dinsmore Compliance Services (DCS), an affiliate of Dinsmore & Shohl LLP, offers compliance solutions for investment managers and municipal advisers. DCS will help you develop and maintain high-quality compliance programs customized to your particular business demands and operational realities. We offer these services, all as an affiliate of a coast-to-coast, full-service law firm.

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