JACKO LAW GROUP, PC

Legal Risk Management Tip
March 2017

WHAT RIAS SHOULD FOCUS ON IN 2017: REGULATORY HOT TOPICS

New regulatory developments seem to occur with ever-increasing frequency. The past twelve months in particular have seen a bevy of new rules, regulations and guidance that will have significant impacts on the daily practices of advisers. With so much new information being promulgated by regulatory bodies, it could be quite easy to miss ones that could have a substantial impact on your business.

The purpose of this article is to review some of the more recent and prevalent regulatory updates affecting registered investment advisers ("RIAs"). While not applicable to all firms, the following will highlight those updates likely to have a broad reach in the industry. RIAs are expected to know and comply with new rules and regulations as they occur, so it is important to stay abreast of when and how these rules could affect your business.

A. Recent Regulatory Developments

1. Privacy Notice Delivery Requirements

Recently, the Fixing America's Surface Transportation Act was signed into law. Part of this bill amended consumer privacy provisions of the Gramm-Leach-Bliley Act (which is implemented by the Securities and Exchange Commission ("SEC") as part of Regulation S-P). This amendment eliminates the annual privacy notice requirement for financial institutions.

Prior to the amendment, advisers were required to provide initial and annual privacy notices to clients that describe the adviser's privacy policy and practices regarding disclosure of client non-public personal information ("NPI") and whether clients can "opt-out" of certain disclosures of such information. Following the amendment to the rules, SEC registered advisers are no longer required to provide annual privacy notices to clients provided that:

- The adviser does not disclose NPI in any manner that permits a client to "opt-out" of such disclosure;[1] and
- The adviser has not changed its policies and procedures with respect to the disclosure of NPI that were disclosed to clients in the firm's most recent privacy notice.

It should be noted that despite this amendment, it is still important for firms to carefully review their business practices annually to determine if their privacy notices and policies require updating. Further, depending upon the state in which the advisory firm operates, there could be additional state requirements that mandate an annual delivery of the firm's privacy notice.

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[1] *See* https://www.sec.gov/rules/final/34-42974.htm for additional information concerning when advisers must provide clients with an "opt-out" option prior to sharing NPI.

2. Robo-Advisors

As more and more firms provide automated investment advisory services, or "robo-advice,"[2] to all or a portion of their client base, the SEC has provided a Guidance Update[3] with respect to robo-advisers and practices commonly associated therewith.

As part of the Guidance Update, the SEC noted that while robo-advisers are subject to the same rules and regulations as other registered advisers, their unique business model raises additional considerations. Three specific areas were noted in the Guidance:

- The substance and presentation of disclosures to clients about the adviser and services offered;[4]
- The obligation to obtain client information and provide suitable advice; and
- The adoption and implementation of effective compliance programs.

For those advisers who either directly provide robo-advisory services or utilize third-party robo-advisers to manage all or a portion of their client's assets, the Guidance Update should be reviewed thoroughly to ensure current practices align with the expectations of regulators in this emerging area.

B. Recent Rules and Revisions to Existing Rules

1. Succession Planning

On June 28, 2016, the SEC proposed new Rule 206(4)-4 under the Investment Advisers Act of 1940, as amended (the "Advisers Act") requiring advisers to implement both written business continuity plans ("BCP") and transition plans. As stated by the SEC in its press release, "the proposed rule is designed to ensure that investment advisers have plans in place to address operational and other risks related to a significant disruption in the adviser's operations in order to minimize client and investor harm."[5]

While most advisory firms have already put into place a BCP to cover external interruptions to their businesses (such as fires, extreme weather and/or natural disasters), this rule would force firms to have written transition plans in place to cover internal disruptions to businesses such as the death, disability, retirement or other loss of key personnel. How the transition plan is structured will depend upon the nature of the firm itself. The SEC acknowledges that there will be significant differences between transition plans developed by firms due to the size and operational aspects of the business. While the rule states that RIAs must address certain key

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[2] Robo-advice and robo-advisors is described by the SEC in its Guidance Update as "registered investment advisers that provide discretionary asset management services to their clients through online algorithmic-based programs."

[3] IM Guidance Update, February 2017, No. 2017-02; please *see* https://www.sec.gov/rules/final/34-42974.htm for further information.

[4] Per the SEC, an explanation of the business model must be provided that should include, among other things, (i) a statement that an algorithm is used to manage individual client accounts, (ii) a description of the algorithmic functions used to manage client accounts, (iii) assumptions and limitations of the algorithm used, (iv) associated risks, and (v) any direct or indirect fees associated with the services.

[5] *See* https://www.sec.gov/news/pressrelease/2016-133.html.

components in their transition plans,[6] each adviser should tailor its plan based on the complexity of its business operations, the specific risks faced and any other unique aspects of its operations.

Firms who either do not have a transition plan in place, or have not reduced the plan to a written medium, should do so immediately. This can often be a difficult and time-consuming process that touches several different legal areas including corporate, tax and estate planning matters. It is recommended that you have your transition plan reviewed by professionals familiar with these and other issues that may arise.

2. Department of Labor Rule – And Possible Implementation Delay

As most RIAs are very aware, the Department of Labor's ("DOL's") Conflict of Interest Rule was adopted in April of 2016. Originally scheduled to have an implementation date of April 10, 2017 (the "Effective Date"), the rule is now in a state of flux.

In February of 2017, at the behest of a Presidential Directive, the DOL submitted a proposal to the Office of Management and Budget ("OMB") that would delay the implementation date of the new rule for up to six (6) months. Later that month, the OMB concluded its review of the proposed delay, but did not approve it. Rather, it was sent back to the DOL with a change request for the DOL to show that the new rule is not "economically significant" as the DOL had stated in its proposed delay.[7] As such, the DOL must now perform an economic analysis before resubmitting to the OMB (OMB approval is required before the rule delay can be made public). It is unclear whether or not this can be accomplished prior to the Effective Date, and as such, whether firms must continue to prepare to comply with the new rule.

In an attempt to help address the issue, the DOL issued Field Assistance Bulleting No. 2017-01,[8] which discussed the DOL's temporary enforcement policy. In the Bulletin, the DOL recognized the confusion surrounding the implementation date of the new rule, and adopted the following temporary enforcement policy:

- In the event a final rule is issued *after* the Effective Date implementing a delay in the Effective Date of the new rule, the DOL will not initiate an enforcement action because an adviser or financial institution did not satisfy conditions of the new rule during the "gap" period; or
- In the event the DOL decides not to issue a delay of the new rule, the DOL will not initiate an enforcement action because an adviser or financial institution, as of the original Effective Date, failed to satisfy conditions of the rule provided that the adviser or financial institution satisfies the applicable conditions of the rule, including sending out

[6] Under the proposed rule, an RIA's transition plan must include: (i) policies and procedures related to the safeguarding, transfer and/or distribution of client assets during transitions; (ii) an inventory of key documents, such as organizational documents, contracts, policies and procedures, including the location of such documents; (iii) details regarding the RIA's management structure, risk management processes and financial and regulatory reporting requirements; (iv) material financial resources available to the RIA; (v) policies and procedures relating to the prompt production of client specific information in order to transition client accounts; and (vi) an assessment of the applicable legal and contractual issues related to a transition.

[7] *See* http://www.investmentnews.com/article/20170228/FREE/170229922/delay-of-dol-fiduciary-rule-faces-new-challenges.

[8] *See* https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2017-01.

required disclosures or other documents to retirement investors, within a reasonable period after the publication of a decision not to delay the Effective Date.

Firms should review their current practices in light of the new rule to determine its potential impact on their business. Whether the new rule is delayed, amended or ultimately overturned remains to be seen; and as such, the circumstances inherent to each firm will dictate the immediate efforts firms should undertake to comply with the new rule in its current form.

3. Changes to Required Form ADV Disclosure

In a press release dated August 25, 2016,[9] the SEC announced their issuance of a final rule, which, among other things, amends the Advisers Act as it relates to Form ADV (Uniform Application for Investment Adviser Registration) disclosures required by SEC registered advisory firms.[10] The implementation date of this new rule is currently set for October 1, 2017, and will affect disclosures made by firms in both Form ADV as well as other marketing materials.

The portion of the new rule that is likely to cause the most complications for advisers involves the additional information now required for separately managed accounts ("SMAs") (*i.e.*, advisory accounts other than those that are pooled investment vehicles). Per the new rule, Form ADV Part 1 will now ask advisers whether they have regulatory assets under management ("RAUM") that are attributed to SMAs, and if so, advisers must provide additional information as part of Schedule D to Form ADV. This information must include the types of assets[11] comprising the SMA accounts and the percentage of RAUM attributable to each such asset class.[12]

The new rule will also require additional disclosures to Form ADV pertaining to the firm's use of social media, firm identifiers (such as CIK numbers and office locations), outside activities of the firm's Chief Compliance Officers, non-US clients of the firm and other information that is pertinent to operations of the firm.

In addition to the disclosures noted above, the new rule will amend the Advisers Act requiring advisers to maintain additional records related to the calculation and distribution of performance information[13] in marketing materials. This is not limited to Form ADV, but applies to any marketing materials distributed by firms that include performance data.

Firms should start reviewing their practices in light of the new rule. Additionally, as there is a potentially large amount of additional data that will be required for inclusion in Form ADV that previously was not required, gathering and verifying this information should start well before the effective date.

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[9] *See* https://www.sec.gov/news/pressrelease/2016-168.html.

[10] While the amendments made to Form ADV and other Adviser Act rules currently only affect SEC registered investment advisers, the SEC noted that "state securities authorities intend to consider similar changes that affect advisers registered with the states."

[11] Per the rule, Form ADV will list twelve (12) asset categories from which to choose.

[12] Depending upon the type assets selected and amount invested, additional disclosures will be required.

[13] *See* https://www.sec.gov/news/pressrelease/2016-168.html.

C. Conclusion

As mentioned above, this article is intended to highlight those areas that will impact most RIAs and is not designed as an all-inclusive list of new regulatory developments. The topics discussed herein are some of the more prevalent and universal changes, but several others have been brought forth in recent months that may impact advisory businesses and their compliance programs. It is important to remember that not all advisory firms are the same, and as such, new rules will affect firms differently. Each firm should review new rules with respect to their internal operations and assess the impact a new rule may have on the firm. Utilizing the services of experienced legal counsel can help ensure that all relevant factors are considered.

For more information on these and other considerations, please contact us at (619) 298-2880 or at info@jackolg.com.

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