JACKO LAW GROUP, PC

Legal Risk Management Tip
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Common Compliance Violations Seen in 2018

For those of us who have been in the regulatory compliance space for some time, we have seen compliance failures evolve as the financial industry continues to change. But two of the subject areas that continue to appear time and time again involve performance advertising and compliance program failures. Moreover, we have seen a series of enforcement cases emerge involving the calculation of advisory fees and inappropriate assessment of expenses. In this month's Legal Risk Management Tip, we will be examining these three areas and focusing on "lessons learned" as a result of recent enforcement actions.

A. Performance Advertising

Performance Advertising has been a constant focus during SEC examinations. The world heavily relies on technology to support, brand, and market their company and services. Investment advisers primarily use websites, social media and marketing emails as their advertising arsenal to disseminate information, news, alerts and company information. Rule 206(4)-1 under the Advisers Act (the "Advertising Rule") governs adviser advertising, including performance advertising. The Advertising Rule includes four specific prohibitions[1] and general prohibitions on false, misleading, and incomplete advertisements.

On September 14, 2017, the SEC's Office of Compliance Inspections and Examinations ("OCIE") published a Risk Alert, "*The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers*,"[2] which was generated as a result of a recent exam initiative that focused on advisers who marketed accolades relating to their firms and professionals (the "Touting Initiative"). This Risk Alert focused on the most common regulatory examination deficiencies noted by the SEC regarding investment advisory firms' non-compliance with Advertising Rule.

Highlights of some of the most common deficiency areas noted in the Risk Alert include the following:

[1] Specifically, in addition to the general prohibition, the Advertising Rule prohibits (i) the use of testimonials; (ii) reference to any past, specific recommendations made by the adviser that were profitable, unless the advertisement sets out a list of all recommendations made by the adviser within the preceding period of not less than one year; (iii) any representation that any formula or other device can be used to make investment decisions without disclosing prominently the limitations and difficulties with respect to its use; and (iv) any representation that any report, analysis, or other service will be provided without charge unless the report, analysis, or other service will be provided without any obligation whatsoever.

[2] Available at https://www.sec.gov/ocie/Article/risk-alert-advertising.pdf.

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Misleading Performance Results

- The deduction of advisory fees must be reflected in all marketing materials.
- Adequate disclosures on the inherent limitations of comparisons of strategies to benchmarks must be presented.
- All hypothetical and back-tested performance results must contain disclosures which provide all relevant material information regarding the performance results, including a thorough explanation of how the returns were derived.

Misleading One-on-One Presentations

- All one-on-one presentations showing gross of fee only performance must include all materially relevant disclosures outlined in applicable SEC guidance, including the fact that the deduction of advisory fees will reduce the client's returns.

Misleading Claim of Compliance with Voluntary Performance Standards

- Firms claiming compliance to voluntary performance standards (*e.g.*, Global Investment Performance Standards or "GIPS®") must ensure they are complying with all required standards.

Cherry-Picked Profitable Stock Selections and Recommendations

- Marketing and advertising that present only a partial list of securities cannot cherry pick only profitable holdings and must adhere to SEC No-Action Letters and regulatory guidance.[3]

Compliance Policies and Procedures

- Firms must have written policies and procedures reasonably designed to prevent deficient advertising practices. These should include, among other things, a process for compliance review and approval of advertising and marketing materials prior to their dissemination.

Misleading Use of Third Party Rankings or Awards

- Firms must disclose all facts related to third party rankings, ratings, or awards used in marketing and advertising, including selection criteria, who created the ranking or award, and whether the firm paid a fee to participate. Also, firms cannot publish only favorable rankings, ratings or awards.

Misleading Use of Professional Designations

- If a professional designation, title, or certification has lapsed, it can no longer be referenced in marketing or advertising materials.
- When using a professional designation, the minimum qualifications required to attain such designation must be included.

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[3] *See*, for example, The TCW Group, SEC Staff No-Action Letter (Nov. 7, 2008) *available at* https://www.sec.gov/divisions/investment/noaction/2008/tcwgroup110708.htm; Franklin Management, Inc., SEC Staff No-Action Letter (Dec. 10, 1998) *available at* https://www.sec.gov/divisions/investment/noaction/franklinmanagement121098.pdf; and Investment Counsel Ass'n of America, Inc., SEC Staff No-Action Letter (Mar. 1, 2004) *available at* https://www.sec.gov/divisions/investment/noaction/ica030104.htm.

Testimonials

- Using testimonials (*i.e.*, statements attesting to or endorsing the firm's services) in marketing or advertising materials, including websites, social media, article reprints, and/or presentations is prohibited under the Advertising Rule.

The Risk Alert provides strong guidance on what investment advisers should consider prior to disseminating marketing materials and highlights a number of enforcement cases which help to formulate "lessons learned" for other registrants to consider.[4]

B. Compliance Program Failures

Policies and Procedures Are Not Customized

One of the most frequent findings of the SEC is failure of registrants to adopt written policies and procedures reasonably designed to prevent violations of federal securities laws. Under Rule 206(4)-7 of the Investment Advisers Act of 1940, all SEC-registered investment advisers are required to adopt policies and procedures customized to their firm and service offerings. Too often, firms may "borrow" another firm's policies or purchase an "off the shelf" manual to attempt to satisfy the regulatory requirement. However, this short cut does just the opposite. By not taking the time to customize policies and procedures, investment advisers are not satisfying their fiduciary duties to protect investors by taking steps to prevent rule violations from occurring.[5]

Annual Reviews Are Not Conducted

Another area frequently cited as a deficiency is failure for SEC-registered investment advisers to perform an annual review of their compliance program (an "Annual Review"). The purpose of an Annual Review is to test how effective a firm's policies, procedures and internal controls are to prevent, detect, respond and correct violations of the Advisers Act. Thus, Annual Reviews are integral to any compliance program and are subject of review during an SEC examination.

In its adopting release, the SEC provided guidance on what should be considered as part of a firm's Annual Review. Namely, registrants should consider: (1) any compliance matters that arose during the previous year, (2) any changes in the adviser's or its affiliates' business activities, and (3) any changes in the Advisers Act or applicable regulations that may require a

[4] *See*, for example, *In the Matter of Arlington Capital Management, Inc. and Joseph F. LoPresti* (IA Rel. No. 4885 (Apr. 16, 2018)), the SEC found that from 2012 to 2015, the investment adviser used misleading advertisements in written communications, weekly radio broadcasts and webcasts related to the performance of its model portfolios. Also consider the recent case *In the Matter of Creative Planning, Inc. and Peter A. Mallouk* (IA Rel. No. 5035 (Sep. 18, 2018)) whereby the SEC found that, among other things, the firm distributed hundreds of radio advertisements that contained prohibited client testimonials and failed to adopt and implement written policies and procedures to prevent such violations.

[5] *See*, for example, *In the Matter of Lyxor Asset Management, Inc.* (IA Rel. No. 4932 (Jun. 4, 2018)), wherein the adviser failed to implement policies and procedures reasonably designed to detect and prevent conflicts of interest.

revision to the compliance program.[6] In addition, registrants should implement various forms of testing to assess its policies and procedures.

There are three forms of compliance testing for firms to use: transactional tests (which occurs at the point of the transaction, such as a review of client guidelines and restrictions prior to conducting a trade); periodic tests (which occurs at certain intervals to verify compliance requirements, such as quarterly best execution reviews); and forensic testing (which are designed to evaluate trends or patterns, such as dispersion amongst client accounts that are managed in the same style or manner).

Absent these tests, it is difficult for the registrant to detect whether a firm's policies and procedures require adjustment to detect, prevent and correct industry rule violations. Furthermore, if gaps are detected, it is important for advisers to timely address and correct such problems.[7]

Competency of the Chief Compliance Officer ("CCO")

Section 203 of the Advisers Act requires that firms create and sustain an adequate compliance program, and in alignment with Rule 206(4)-7 of the Advisers Act. The rule also stipulates the necessity to elect a CCO accountable for administering the firm's compliance program. This designated party must be (1) competent and knowledgeable about the Advisers Act, (2) authorize to develop appropriate policies and procedures, and (3) have seniority to enforce and compel the adherence to the compliance program. The CCO also must be able to report violations to boards and senior management alerting them to compliance challenges.[8]

To strengthen the role compliance plays at a firm is to invest in the professional development of the compliance personnel, as new challenges and regulations develop over time. Conferences, webinars, training programs and professional designations can be powerful tools to mentor and invest into a firm's compliance team.

[6] *Speech by SEC Staff: Remarks Before the Fund of Funds Forum – SEC Expectations for Regulatory Compliance*, Gene A. Gohlke (Nov. 14, 2005) (pub. avail. at https://www.sec.gov/news/speech/spch111405gag.htm).
[7] *See*, for example, *In the Matter of RT Jones Capital Equities Management, Inc.* (IA Rel. No. 4204 (Sep. 22, 2015)) whereby the SEC found, among other things, the firm failed to conduct periodic risk assessments, implement a firewall, encrypt personally identifiable information stored on its server or maintain a response plan for cybersecurity incidents, thus violating Regulation S-P. These gaps could have been detected with periodic testing as part of an Annual Review.
[8] *See*, for example, *In the Matter of Blackrock Advisors, LLC and Bartholomew A. Battista* (IA Rel. No.4065 (Apr. 20, 2015).

C. Advisory Fees

In April 2018, the SEC's OCIE issued a Risk Alert related to the most frequent advisory fee and expense and compliance issues found during its examinations of investment advisers.[9] Specifically, the Alert cited that registrants are lacking proper disclosure and improperly assessing advisory fees in accordance with disclosures provided to clients. The end result is the over-charging of fees to clients that conflict with terms of that client's advisory service agreement or disclosures made within the adviser's Form ADV.[10]

Included in the list of the most common deficiencies is:

- Fee-billing based on incorrect valuations;
- Billing fees in advance or with improper frequency;
- applying incorrect fee rate;
- Omitting rebates and applying discounts incorrectly;
- Disclosure issues; and
- Adviser expense misallocations.

While this list is not exhaustive, recent enforcement actions cite these types of deficiencies.[11]

Risk Management Tips

As new regulations develop and the SEC's issues new Risk Alerts and "Examination Priorities," review them carefully and consider what the firm's risk efforts should focus on. This month's Risk Management Tip centers around three areas that have long been part of compliance programs; yet, enforcement actions citing these areas continue.

By routinely revisiting and testing policies, procedures and internal controls, gaps within a compliance program can be detected and addressed.

Consider, for example, some practical steps to take related to ensure firm practices align with disclosures to clients related to advisory fees and expense:

- **Review Current Disclosures.** Consider whether such disclosures are consistent with actual practices.

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[9] The Risk Alert is available in its entirety at https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf.

[10] See *Risk Alert: Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers*, Office of Compliance Inspections and Examinations (Apr. 12, 2018) (pub. avail. at https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf).

[11] *See*, for example, *In the Matter of Barclays Capital Inc.* (IA Rel. No. 4705 (May 10, 2017)) and *In the Matter of Morgan Stanley Smith Barney, LLC* (IA Rel. No. 4607 (Jan. 13, 2017)).

- **Review Relationships with Third-Parties.** Be sure to test the methodologies used and how they are providing essential data for valuations and calculation of advisory fees.
- **Review Contracts.** Review client agreements and fee schedules pertaining to advisory services to assure that fees are being billed at rates and times detailed with in those agreements.
- **Test Billing Practices.** Evaluate their billing practices and test billing process controls.
- **Utilize Technology.** Implementing automated technology will help create efficiencies and can reduce the chance for error.

For more information on this and other risk mitigation approaches, please contact Jacko Law Group, PC at (619) 298-2880 or at info@jackolg.com.

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