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FOR THE SECURITIES INDUSTRY

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Wolters Kluwer
Financial Services

When you have to be right

PRACTICAL COMPLIANCE & RISK MANAGEMENT
FOR THE SECURITIES INDUSTRY
VOLUME 8, NO. 2 MARCH–APRIL 2015

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PRACTICAL COMPLIANCE & RISK MANAGEMENT
FOR THE SECURITIES INDUSTRY

Editorial Advisory Board

A Note From The Managing Editor

David D. Thetford

This time last year, I thought we were having a really tough winter. There's no comparison really, between this year and last. Last winter was aggravatingly long and cold. This winter has been brutally cold at times and the snow just won't stop coming. The snow is not all that terrible here in the Midwest, but at our home offices in the Boston area, there are literally walls of snow. Boston Logan Airport recorded over 90 inches of snow from January 23 to February 16! I know the world of securities compliance sometimes feels like that: like we're being buried in a blizzard of regulation. Like snow, it does tend to come and go in waves. Okay, maybe the articles in this issue are not a blizzard, but each one is an example of a whole separate issue that compliance professionals must contend with…maybe a small snow storm. By the time you read this, winter 2014-2015 will be over or almost over, but I suspect the snow storms of regulation will keep coming!

Customers' Diminished Capacity – The subject of seniors and the fact that their mental acuity may diminish over time has been a concern and a priority of the regulators for many years. Financial services firms have a tough time caring for customers in general; when we add the dimension of a senior customer with diminishing, or even potentially diminishing, capacity, firms must feel like they are dancing on a razor's edge. Sandy Adams of the Center for Financial Planning has given us an outstanding discussion of many of the issues and problems that face financial services firms in their care for their customers as well as some excellent practical advice on how to handle many of those problems and issues. If your firm deals with senior customers, this is a must-read!

Investment Advisers Act Compliance Developments for 2015 – The regulators were pretty busy in 2014 in their efforts to oversee the financial services industry. They made numerous changes over the year that will affect investment advisers in 2015 and going forward. Jesse Kanach of Perkins Coie LLP has provided us, for the fourth year in a row, an excellent discussion of what's new and what's hot for investment advisers in the coming year, and what firms should be considering and doing to address the changes.

Editorial Advisors Corner – Patricia C. Foster – This is the first in a series intended to highlight this publication's editorial advisors … the brains behind the operation. I have managed to surround myself with some of the very best minds in the country to guide this publication. I get to talk with them regularly, but, until now, except for an occasional article, you have only been able to see the fruits of their thoughts. This section is intended to give you a better idea of who they are by bringing you their professional work. In this first venture, Patricia Foster, of her own law firm in upstate New York, has given us her Q1 2015 newsletter to her own clients who are primarily investment advisers and investment companies.

Challenges to Dual Registration – The SEC pays close attention to the activities of dually registered firms and broker-dealer and investment advisory businesses that share common financial professionals. Their activities are woven throughout OCIE's annual examination priorities letter, so firms would do well to consider that aspect of their businesses. Bob Tuch of Oyster Consulting LLC has given us an excellent discussion of some of these issues and concerns as well as some ways to reconcile the two different business models.

Regulation of Municipal Advisors – The Dodd-Frank Act mandated that the SEC begin to more robustly regulate municipal advisors. In just the last year or two, much of that regulation has begun to come to fruition, as the MSRB has worked its way through the rulemaking process and the SEC has approved numerous new MSRB rules that specifically affect muni advisors. Tom Potter of Burr & Foreman LLP and Chris Charles of Wulff Hansen & Co have given us an excellent discussion of the development of this body of regulation which is getting more and more complex with each new rulemaking.

Forms Templates and Tools – Two new forms are included here, an Authorization to Release Information and Waiver of Confidentiality, and a Personal Financial Record System & Letter of Last Instruction. Both documents are provided by Sandy Adams of the Center for Financial Planning, and accompany her article above on diminished capacity. Please feel free to use or adapt them as you see fit. As always, these are not regularly reviewed for currency, so you should tailor them to your firm's business and review carefully to ensure it is up to date.

That's the line-up for this issue. I hope you find it informative and useful. Please contact me anytime at (847) 267-2095 or by email at David.Thetford@wolterskluwer.com, or at our group on Linked In to give me your suggestions on how to make this better or suggestions on a specific subject you would like us to cover.

PRACTICAL COMPLIANCE & RISK MANAGEMENT
FOR THE SECURITIES INDUSTRY

Mission Statement and Guiding Principles

Mission Statement

The mission of Practical Compliance and Risk Management for the Securities Industry is to provide practical, useful information and guidance concerning regulatory compliance and promoting the professional development of compliance and risk professionals in the financial services industry, and their counsel.

Guiding Principles

The following principles should guide the publication schedule for this journal, and is intended to aid in selection of subject matter for coverage and in selection of writers.

1. Should cover subjects promoting professional development in Compliance and Risk Management.
2. Should be practical and written in plain English.
3. Should be useful to compliance and risk professionals in the financial services industry, and their counsel.

Client Diminished Capacity from the Compliance Perspective

By Sandra D. Adams, CFP®

Sandra D. Adams, CFP®, is a Partner and Financial Planner at the Center for Financial Planning, Inc., in Southfield, Michigan. She is the Center's point-person for Elder Care related issues. Sandy received her bachelor's degree and more recently a Master's Certificate in Gerontology from Eastern Michigan University. Her accreditations include CFP®, Series 7 and 63 Securities Licenses and Registered Health and Life Insurance agent.

Sandy is currently the Financial Planning Association of Michigan (FPA®) board chair; she also serves on the Legal and Financial Advisory Committee and Board of Visitors at WSU Institute of Gerontology. She is frequently asked to speak on Elder Care planning for the public and for professional groups.

The growth of the older adult population in America is presenting great challenges to the financial services industry. According to recent data from the U.S. Census Bureau and the Alzheimer's Association, by the year 2030 there will be 72.1 million people in the U.S. over the age of 65, and 7.7 million of them will have Alzheimer's disease. Alzheimer's and related dementias, as well as cognitive decline related to normal aging pose serious risks to financial advisors in the form of diminished capacity.

Older adults disproportionally have wealth. Baby boomers over age 50, alone, represent 32 percent of the U.S. population and control 77 percent of the nation's net worth.[1] At the same time, a startling 22 percent of adults over age 71 have some neurocognitive disorder.[2] The majority of these disorders are minor, but according to the Alzheimer's Association, Alzheimer's disease will strike about 8 million Americans age 65 and older by 2030 (a rise of 60 percent from 2010)[3] These statistics are indicative of the likely exposure of financial advisors to this population, and the likelihood that those advisors will encounter clients with diminished capacity. Financial professionals will need to be able to recognize and respond appropriately when clients exhibit signs of diminished capacity, or they will face significant compliance and regulatory consequences.

Financial Capacity

Financial capacity can be thought of as the capacity to manage money and financial assets in ways that meet a person's need and which are consistent with his/her values and self-interest. Financial capacity is one of the first abilities to decline as cognitive impairment progresses. A big distinction exists between what financial capacity is and how it can be understood and used by financial advisors. Daniel Marson, professor of neurology at the University of Alabama at Birmingham, and his colleagues[4] have outlined nine domains of financial capacity:

1. Basic monetary skills
2. Financial conceptual knowledge
3. Cash transactions
4. Checkbook management
5. Bank statement management
6. Financial judgment
7. Bill payment
8. Estate planning/wills
9. Investment decision making

Professor Marson's research has focused on how neurocognitive disorders affect the realm of financial capacity. For financial advisors and compliance officers, it is critical to understand how financial capacity impacts financial judgment and how clients make decisions about how to invest and handle financial assets. According to his research, Marson found that fifty percent of older adults with mild Alzheimer's disease were fully incapable of making financial judgments as measured by the Financial Capacity Inventory (FCI). Created by Marson, the FCI uses a neutral, non-person-centered investment problem to measure financial judgment. Marson's results clearly indicate that having neurocognitive problems such as early Alzheimer's disease poses an increased risk that the older adult will have diminshed capacity, and that they may not be able to make his or her own sound financial decisions.

According to recent data from the U.S. Census Bureau and the Alzheimer's Association, by the year 2030 there will be 72.1 million people in the U.S. over the age of 65, and 7.7 million of them will have Alzheimer's disease.

Capacity is not an all-or-nothing concept and it can fluctuate over time. Mental abilities can vary during the course of a day and are largely dependent on stressors, energy level and a multitude of other factors. In the legal context, the definition of diminished capacity depends largely on the type or decision or transaction being considered.[5] In the context of financial services, the legal definition of capacity focuses on the capacity to initiate transactions, understanding of personal financial needs and goals, and understanding of investment concepts, products and consequences.[6] Decisional abilities have long been recognized as the key factors in determining whether an individual's decision (choice) is an authentic and capable one. It combines key contextual and intellectual factors influencing decision-making. Intellectual factors refer to functional abilities needed for financial decision-making capacity and include the client's ability to express a choice, communicate the rationale for the choice, demonstrate an understanding of the choice, demonstrate an appreciation of the relevant factors involved in that choice, along with the consistency of the choice with past cherished values. Simply put, are the client's decisions and actions representative of his/her underlying goals and values and consistent with past decisions? How financial advisors assess and address these issues is at the forefront of concern for the industry's compliance officers – and it is significantly more than just a suitability issue.

Awareness, Regulation and Compliance Issues

The financial media, as well as the health and social services industry, consistently address the issues and risks to financial advisors related to older adults and diminished capacity. The *Journal of the American Society on Aging* had two recent issues devoted to financial capacity and elder justice. *Investment News* consistently addresses these issues, recently devoting a major portion of its publication to the topic of Alzheimer's disease and the responsibilities of and risks to financial advisors. The *Journal of Financial Planning*, professional journal for Certified Financial Planners™ regularly addresses these issues as well, including in its April 2014 cover article "How to Protect and Help Clients with Diminished Capacity, " which I co-authored with Peter A. Lichtenberg, Ph.D., ABPP, director of the Wayne State University Institute of Gerontology.

The media are not the only ones giving attention to older adults and diminished capacity. Government agencies, industry regulators, and advocacy groups are also actively addressing the issues.

In 2009, the U.S. Congress passed the Elder Justice Act, which stated that older adults have the right to be free from abuse, neglect, and exploitation. The act was written in response to the dramatic increase in financial exploitation of older adults -- a trend that has continued to escalate. States are ramping up efforts not only to protect older adults from financial exploitation, but also to better prosecute those who exploit older adults. According to Acierno et al. (2010),[7] "In the U.S. an estimated 5 percent of elderly people have fallen victim to financial exploitation, second only to theft and scam cases." Another study (Beach et al. 2010)[8] estimated that 10 percent of all older adults have experienced financial exploitation since turning 60 years of age. Lichtenberg et al. (2013)[9] reported results of a nationally based study which demonstrated that psychological vulnerability made older adults nearly three times more likely to be the victim of a scam. The research study involved 20 experts from across the country, including three financial planners, who created a new interview-based screening tool regarding financial decisions and judgments for financial advisors, and a more comprehensive tool for health and mental health professionals.

Regulatory agencies have made protection of vulnerable older adults a top priority.[10] As early as 2006, collaborative efforts began to protect seniors by providing educational programs, conducting focused compliance exams of advisors and firms doing business with senior investors, and actively prosecuting investment scams. In 2008, the SEC, FINRA and the North American Securities Administrators Association (NASAA) collaborated on a report called *"Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Serving Senior Investors,"* which summarized practices shared by financial advisors, firms and industry groups and outlined key practices relevant to diminished capacity. FINRA has developed a training module for the purpose of educating registered representatives about how to identify and address senior investors with potential diminished capacity. In 2011, AARP's Public Policy Institute published "Protecting Older Investors: The Challenge of Diminished Capacity," that serves as a guide for advisors working with older adults. The SEC holds annual "Senior Summits" for the purpose of bringing awareness and education to advisors regarding issues related to older clients. In 2014, NASAA developed a Committee on Senior Issues and Diminished Capacity to address the wide range of challenges confronting senior investors, financial advisors, regulators and compliance officers.

Industry regulators and federal, national and state regulators have been active in recent years, promoting legislation focused on elder fraud and abuse, and adopting regulation of senior designations and credentials, free lunch seminars to sell financial products, and suitability.[11] According to NASAA enforcement statistics[12], 34 percent of enforcement actions taken by state securities regulators since 2008 have involved senior victims.

Broker-dealers have been more actively developing compliance and practice management resources and continuing education focused on issues related to older adults and diminished capacity and have increased their compliance oversight. In many cases, there are designated compliance officers for senior-related issues regarding communication, suitability, privacy and other areas of greatest risk to advisors. Compliance officers focus mainly on legal and liability issues, including:

- financial capacity,
- transactions that could harm the client,
- lawsuits by heirs of the client related to financial transactions,
- determining fiduciary authority under powers of attorney, and
- financial fraud and abuse by family, friends, and others.

Financial advisors who uncover financial exploitation should consider whether they can, should, or must report the situation to the appropriate state authorities.

Practice Management Implications for Advisors and Compliance Officers

For many financial advisors, the 65-and-older population makes up a significant portion of their client base. According to the AARP Public Policy Publication, which surveyed 360 financial advisors and 166 compliance officers with various firm structures, most financial advisors report that diminished capacity is a problem for them or for their firms. It will be increasingly important for advisors and their compliance officers to be prepared to handle issues involving financial capacity. Advisors need to be aware of the potential financial vulnerability of this client segment and prepared to take action to protect and serve them.

Following are ideas on how some of the most important issues might be addressed and what practice management tools might be used to best serve these clients.

Recognizing Diminished Capacity

Due to the ongoing and long-term relationships that many financial advisors have with their clients, they are often the first to notice signs of diminished capacity. Because financial advisors are not health care professionals, most do not learn cognitive screening or other direct assessments of cognitive abilities. Instead, financial advisors can use "behavioral triggers" or red flags —patterns of behavior exhibited by an older client that raise suspicion of memory loss or problem-solving declines. Common triggers can be found during direct communication with clients by the advisor and/or the staff. These include:

- Missed office appointments and/or showing up without an appointment
- Confusion about instructions
- Frequent calls to the office
- Repetitive speech and/or questions
- Missed bill payments
- Difficulty following directions
- Trouble with handling paperwork
- Difficulty recalling past decisions or actions
- Unusual or first-time wire transfers (especially to other countries)
- Appearance of insufficient care despite having available financial resources
- Difficulty with abstract thinking
- Drastic uncharacteristic mood swings

When a financial advisor is concerned about the decision-making abilities of the older client, relationships can be developed with health care providers who can more thoroughly assess capacity including: (1) whether there is a diagnosable neurocognitive disorder; (2) how completely the older adult displays decisional abilities; (3) whether there appears to be any undue influence; and (4) how the results integrate with specific legal standards that apply to the financial decision (for example, will versus investment versus real estate contract). This may include a discussion with the client and/or client's family about seeking medical attention via a full geriatric assessment or more specific neurological assessment to uncover the cause of the perceived decline in capacity.

Training for Staff. It is imperative that advisors working with the older adult population train their staffs to recognize potential changes in financial capacity and give them clear guidance on what to do if issues are identified. At least annually, I provide training in an all-staff setting to review signs of cognitive impairment and diminished capacity, to review our firm's communication and documentation processes for at-risk clients, and to emphasize the compliance-related rules and regulations. For all staff, there is a clear expectation that if there is a question about the financial capacity of a client, the financial advisor is to be alerted. If the advisor is not available, the branch manager and then our broker-dealer's compliance department are the next to be contacted for guidance on how to proceed.

Build a Network. Financial advisors often have a broad base of knowledge with which to assist clients with their financial lives. As clients age, issues can extend beyond just financial into areas such as housing, care assistance, legal issues, and government and other benefits. Advisors don't need to know how to address all of these issues. They just need to know who to call to find out. It is important for planners to build networks of professionals in their geographic area who can be part of the team that serves these older adults. Such professionals can include elder law attorneys, geriatric care managers, home care providers, and medical professionals who can assess financial capacity. The financial advisor is in a unique position to quarterback this team of professionals to best serve their clients' best interests. It is important to note that the advisor and the compliance department should fully vet any referrals for the services recommended in order to avoid potential referral risk liability.

Resources. Advisors should arm themselves with resources addressing common issues for older adults, and have them on file to give to clients and families when and if needed. Specific to diminished capacity, the Alzheimer's Association (www.alz.org) is a tremendous source and can provide free written materials addressing any of the concerns that advisors, clients or families have regarding cognitive decline. In addition, they provide education, caregiver and patient support, provide social work services and counseling and referrals to specialized physicians and care services. AARP[13] and state senior service agencies can be great resources.

On-Staff Specialist. Firms that work with a large number of older adults and are large enough in size to support it, they might consider having a specialist on staff. Ideally, this would be a registered advisor who could dedicate a portion of his or her time and resources to focusing on issues related to older adults. This person would stay in tune with current issues and resources (including compliance guidelines and regulations), develop networks of professionals, develop processes for the firm to address issues, educate staff and clients on relevant issues, and, most importantly, be available to participate and consult with all firm advisors and their clients when issues like diminished capacity arise. Note that FINRA has taken a strong stance on the use of what might be considered "senior-specific designations," so it is important that advisors work with their compliance departments when developing titles for on-staff specialists. There is risk in implying, by way of a title, that the advisor has expertise, certification, training or specialty in advising senior investors, if the certification or title is not backed by a credentialed educational program.[14]

Compliance Officer/Compliance Department is a Team Member. Advisors should view compliance officers and compliance departments as part of the team, not as an adversary. Indeed, compliance personnel will be central to helping the advisor create, adopt and implement appropriate compliance policies and procedures aimed at handling diminished capacity issues. Advisors cannot possibly keep on top of every new rule and regulation, and should not feel pressured to make decisions related to diminished capacity that are outside of their knowledge base. Having clear procedures in place in advance will help alleviate that concern. At many firms, any question about how to handle a situation related to diminished capacity should be directed to the appropriate legal or compliance officer for guidance, who in turn may find it necessary to consult with outside professionals. In this way, advisors are proactively seeking guidance from the appropriate sources, rather than making a judgment call and putting themselves at risk for future regulatory action.

Education and Awareness for Clients. Advisors have many tools available to enhance client education and awareness about diminished capacity and related issues. For example, our firm regularly blogs about topics related to financial planning issues for older adults. These are often some of our most-read posts. In addition, at least annually we hold client education sessions related to aging. Downsizing, diminished capacity, and resources have been previous topics. By proactively providing information to clients and openly discussing the issues and potential risks, we open the door to more comfortable and candid conversations (and better future planning) in individual client meetings.

Address the Elephant in the Room. For many advisor/client relationships, the elephant can be that physical and/or cognitive change that no one wants to talk about, but everyone is aware of. The financial advisor can more easily address the subject of incapacity than family members can. My firm uses a "Future Care Questionnaire" to start this conversation with our clients (See a sample of our questionnaire in the Forms Templates and Tools section of this issue). The advisor can approach the topic within the realm of finances and maintaining control over how they live, and within the context of making sure the legal and financial resources are in place so as not to burden others when they are not able to handle their own affairs. (an excellent resource for clients/families that have trouble discussing these issues is "Parent Care Conversations" by Daniel Taylor). The risks of not addressing the issues can be detrimental to the client and to the advisor, putting the advisor at risk (in the case of diminished capacity) of not knowing if the client is capable of making decisions and not putting pieces in place to make sure that sound financial and investment decisions can be made in the client's best interest going forward. The legal and liability ramifications for not addressing this in advance can be significant.

Client Relationships. Building trusting, personal relationships with clients is a best practice, no matter the age of the client. However, this becomes even more important when it comes to serving older adults with possible diminished capacity. Frequent contact is imperative and not only builds rapport and trust, but also allows for a deeper understanding of the client, giving the advisor the ability to recognize changes in client behaviors and abilities. Establishing a relationship in which the financial advisor becomes the client's partner and sounding board for all financial-related issues can be invaluable when it comes to preventing financial fraud and abuse and addressing potential capacity issues promptly.

Family Relationships. In addition to building relationships with clients, building relationships with clients' families is important. Financial advisors should make a practice of encouraging older adult clients to include trusted family members or friends in their planning. The advisor should be aware that, since much of the elder financial abuse and exploitation that takes place is committed by family members, friends and caregivers, they must pay particular attention to the information disclosed and to the questions and comments made during these meetings; any questionable intentions should be addressed with the client and/or discussed with the compliance office and reported to the proper authorities. The invitation to include these additional participants may start with a simple, informal meeting during which the family members meet the advisor's team without an in-depth discussion of client assets or overall plan. Subsequent meetings can incorporate family members into annual planning meetings or can involve holding a family meeting to cover current and future planning; any private and/or confidential information to be discussed should be approved by the client in advance to avoid violation of privacy issues. A family meeting to discuss future/elder care planning would involve discussions around the challenges, alternatives, resources, and experiences the older adult clients may have as they age. This planning allows the clients to maintain control and to express desires related to their money, legacy, housing, and care. Planning ahead for future care can keep the client in control, even if financial capacity issues develop later.

Baby boomers over age 50 … represent 32 percent of the U.S. population and control 77 percent of the nation's net worth.

Communication Guidelines. Frequent and consistent communication with clients becomes more important as they age. In-person and other verbal communication is not only the best way to build trust, but it is also the best way to keep on top of each client's situation and to make adjustments as needed. It is important that advisors establish a process within their document management systems to ensure that they are in consistent contact with at-risk clients. My firm has a contact frequency system that generates reports of those clients that we have not been in contact with based on our contract frequency preference (quarterly, semiannually, annually, etc.). In addition, it is important to follow up each client meeting with a written letter outlining discussion topics and action items. Written communications should be in larger than normal print (as cognitive decline is often accompanied by visual challenges) and should be in simple, plain language (no industry jargon). The follow-up letter helps ensure the client and advisor are on the same page and serves as a reminder to the client about what was discussed. It is also recommended to follow up phone calls with a short, written summary, especially if the conversation involves numbers or new decisions. Communications should be copied to involved family members, etc., if prior authorization is provided by the client, and consistent with the advisor's privacy policy.

Client Relationship Management System (CRM)/Client Database. Every client contact and communication should be documented and tracked in a client database or client relationship management system. Tracking client contacts allows advisors to notice trends and changes in client behaviors, especially when multiple team members are involved. Activity reports should be reviewed regularly by advisors, team members and supervisors, so issues can be addressed in a timely manner. Tracking also provides a history of activity and documents advice to clients over time and can be invaluable from a compliance perspective if actions or recommendations are later called into question by the client, the client's family, or regulators. The client database also provides the team with a place for relevant alerts and notes related to specific clients – important in cases of diminished capacity.

Document Management System. In addition to documenting conversations, all client written communication and client related documentation should be stored in a secure electronic document management system. From a compliance standpoint, this provides a way to capture and store written correspondence, statements, legal documents, checks, financial plans and investment recommendations for future reference. With no exception, any printed document should be stored in the advisor's document management system and can be referenced on-site at the firm and off-site by the advisor at any time.

Record-Keeping Document. It is important for all clients, but particularly for older clients, to have their financial lives organized and documented. Using a single document, either on paper or in an electronic format, to capture advisor names and contact information, all financial accounts, policies, legal documents, medications, etc., can be helpful when/if a time comes that the client cannot remember or communicate this information to others. Financial advisors should check in with clients regularly to make sure they have the most up-to-date document, and can store a complete copy for the client as a back-up to their original.

For a copy of my firm's document, go to http://www.centerfinplan.com/storage/pdfs/personal_records_20141204_form.pdf.

Estate Planning Documents. Advisors should keep copies of all legal documents on file, including Wills, Trusts, General/Financial Durable Powers of Attorney and Powers of Attorney for Health Care/Patient Advocate Designation. In addition advisors should have processes in place to address updates or changes to these documents and to make sure that the most recent documents are on file at the firm. For older adult clients, advisors should consider the option of having durable powers of attorney written to authorize “immediate” power rather than “springing” power, with the aim of allowing both the client and/or the named agent to act on the client’s behalf without requiring two physicians to certify the client’s inability to make their own decisions, as may be required with a springing power of attorney. An immediate power of attorney, in the case of diminished capacity, can create a much easier action path for the financial advisor. When diminished capacity is suspected, the agent named in the power of attorney can be contacted and involved with fewer concerns from a privacy or compliance standpoint. Of course, estate planning recommendations should be coordinated with the appropriate estate planning attorney and an elder law attorney consulted when necessary and appropriate.

Client Authorization Document. It is now a common practice for financial advisors working with older adults to use an “authorization document.” This document, which is completed and signed by the client, gives the planner permission to contact named professionals, family members, or friends if a change in the client’s physical, psychological, or cognitive abilities are suspected (see a sample of my firm’s authorization form in the Forms Templates and Tools section of this issue). When clients complete and sign this authorization document, it helps avoid privacy issues and provides the planner the opportunity to better serve the client in any circumstance. Presenting the document to clients also provides the opportunity to discuss capacity issues with them before they occur and can assure clients that the planner is prepared to serve them as they age. From a process standpoint, when the client reaches a preset trigger age, the advisor can discuss the authorization document with the client, have it completed and signed, and keep a copy in the firm’s document management system. Some firms have all clients, regardless of age, sign the authorization document. The advantage to requiring and discussing the form at an older age is that it allows the advisor to approach additional planning topics relevant to the client as they age. It is important to note that the authorization document is not a Power of Attorney in that it allows the advisor to contact the authorized person if there is a concern about the clients physical or cognitive health, but it does not allow release of specific and/or confidential financial information and does not allow for the authorized person to take action on the client’s behalf.

Investment Policy Statement. Financial advisors providing investment management services for clients need to be particularly aware of capacity issues that may affect clients’ decision-making abilities. To be prepared, every client should have a signed investment policy statement (IPS) on file. An IPS should detail any important information that is significant to managing the client’s personal investment portfolio, including:

- Target asset allocation
- Risk tolerance
- Timeframe for investment/use of assets
- Goals for the assets
- Liquidity needs
- Account restrictions/preferences
- Any special circumstances that might affect investments.

The IPS should be reviewed and reaffirmed at least annually with the client to update for changes in goals and circumstances. This document and its use in the investment management process can be invaluable for documenting suitability. In addition, if and when the client’s financial capacity comes into question, there is clear documentation of the history of investment guidelines, goals, and any changes made over time.

Discretionary Investment Management. Many advisors have developed their investment process and have received the appropriate compliance approval to invest for their clients on a discretionary basis. For older adult clients and those at risk for diminished capacity, discretionary authorization combined with an investment policy statement can provide for consistent and suitable service to the client, even if cognitive abilities change. Discretion removes the risk to the advisor that he or she may be relying on the client to make investment decisions when the client may not have the financial capacity to do so. Note that the discretionary agreement would remain in affect until and unless revoked by a Power of Attorney or Successor Trustee if the client is deemed unable to make financial decisions on their own behalf (refer to any legal language on the specific document you are using)

Limited Trading Authorization. In the absence of discretionary investment management, it is important to ask clients to complete and sign a trading authorization. A limited trading authorization allows the client to assign someone to make limited decisions on specified investment accounts related to purchases and sales of securities, in the case that the client is unable or unavailable to do so. Note that the limited trading authorization, in most cases, continues to be in existence until revoked in writing by the client; a Power of Attorney or Successor Trustee, once invoked, would be able to revoke the agreement on the client's behalf, if in the client's best interests (again, refer to the legal language of the specific document you are using). In non-discretionary accounts, this form should be part of the account opening required paperwork. Having a signed limited trading authorization can allow the advisor to recommend and have authorized appropriate and timely investment recommendations in the case of suspected diminished capacity, until appropriate actions can be taken.

Ongoing Planning/Updates. Medical questions can be added to initial client and annual reviews with the goal of picking up on ongoing changes to a client's health that may indicate current or future cognitive decline. In addition, questions about Military Veteran status and long-term care insurance can help with planning to address cognitive decline. With older adults, it is even more important to meet regularly and to update financial and investment planning relevant and suitable to the client's current situation and to have a plan which can be adjusted for future developments.

Conclusion

Financial advisors need to be prepared to meet head on the aging population boom and its potential financial capacity issues. Developing the right team as well as putting into place the right planning tools, documents, and compliance-sound processes is essential in serving as fiduciaries for older clients—protecting them while doing what is best to serve their financial services needs.

ENDNOTES

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Investment Advisers Act Compliance Developments in 2015*

By Jesse P. Kanach

Introduction

Asset management at its simplest involves three principal aspects: outreach to prospective investors; operating the investment product; and interacting with the markets in which the investments are made. An asset manager's employees often have roles that fit into one of the above: sales, operations, and portfolio management. The year 2015 is shaping up to have an unusual focus on the center of that string of relationships which trace the path from end-investor to asset class -- that is, the nuts and bolts of "operations." This is because regulators have recognized that soundness and controls help markets and their participants maintain integrity and the public's confidence despite the ebbs and flows of asset allocations and market swings. Not since the introduction of the Sarbanes-Oxley Act has so much scrutiny been visited upon firms' internal controls and processes.

This article focuses on several key operations-oriented compliance developments for investment advisers in 2015:

- *Cybersecurity and other tech-related issues*. Safekeeping assets and maintaining sound information systems is an obvious focal point of regulatory scrutiny this year. The risk is real and the harm can be tremendous.
- *Increased reporting of data*. The U.S. Securities and Exchange Commission and other regulators are intensifying their sifting of the data they gather on numerous forms. In coming months, asset managers can expect regulators to both seek more input (more new forms) and produce more output (studies analyzing the data, and rules implementing regulators' conclusions about the data). Compliance staffers must endeavor to stay ahead of both.
- *Other core operational functions.* Risks and threats to an asset management firm's operational integrity take many forms, and the SEC has placed these on par with more traditional concepts of compliance under the U.S. Investment Advisers Act of 1940.

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Death, Taxes, and … Cyber Insecurity

The internet of finances has placed the pocketbooks and investments of all of us online, accessible with a virtual key that is as simple or as complicated as our username and password. Financial firms, as they have done since before the era of the stagecoach, take further steps to build barriers to outside threats. It is no secret that hackers have targeted money managers and their service providers, and those attacks are sure to continue. Whether measures involve multiple-step verification, encryption, firewalls, monitoring, or other electronic or physical safeguards, investment advisers have their work cut out for them. In light of this ongoing threat, the SEC and other regulators are engaging in various related initiatives. All of this is supplemental to an adviser's fiduciary duty, its data safeguarding obligations under Regulation S-P and other applicable laws, and commercial and reputational concerns arising from potential harm to customers. Some regulatory initiatives follow.

FINRA Cybersecurity Sweep

The Financial Industry Regulatory Authority, which regulates broker-dealers (including those dual-registered as investment advisers), initiated a sweep in January 2014 to enhance its understanding of data threats and industry responses. FINRA has announced that it will publish the results of the sweep in 2015 and that, subsequently, FINRA members will be called on to identify their critical assets and implement appropriate controls to protect them.[1] Even for non-FINRA members, this report may be a useful resource as investment advisers and their vendors address cyber threats.

SEC Cybersecurity Roundtable

In March 2014, the SEC built on its growing focus on cybersecurity by holding a roundtable dedicated to the subject. For a full morning and afternoon, panelists covered ground ranging from the cybersecurity landscape, to disclosure and trading systems, to concerns specific to asset managers. With respect to investment advisers, the SEC Chair's opening remarks highlighted data protection and identity theft vulnerabilities in particular.

OCIE Risk Alert

The following month, the staff of the SEC's Office of Compliance Inspections and Examinations, or OCIE, issued a Risk Alert describing its Cybersecurity Initiative.[2] That Risk Alert includes an appendix that sets out a couple of dozen separate questions that OCIE incorporated into sweep examinations of registered advisers. OCIE later issued another Risk Alert summarizing the results of its examination sweep.[3] OCIE's latest list of examination priorities also highlights cybersecurity, and, for years to come, cybersecurity is sure to remain a topic on that annually-published list.

Legislative Initiatives

Calls for legislation to promote cybersecurity, formalize the reporting of cyber-related incidents, and adopt a federal consumer privacy bill of rights should be expected to result in substantial obligations on a financial business to monitor, keep records, and make internal and external reports in connection with data security processes and incidents. Every financial business has private information about its clients or others, and while protecting that information has long been a priority, an investment advisory firm will need to

Note on OCIE's cybersecurity examination initiative

During OCIE's Cybersecurity Initiative, examiners asked SEC-registered investment advisers and broker-dealers questions that touched on the following topics, among others:

- Procedures for maintaining an inventory of different technologies used by the business
- Findings from the firm's risk assessments to identify both cybersecurity threats and physical threats
- Written plans for recovery from a cybersecurity incident
- The nature of any insurance that covers such incidents
- Guidance and training for personnel
- Restricting data access to need-to-know personnel
- Processes for system maintenance
- Controls against malware
- Data encryption policies, and data destruction policies
- A tally of customer online access risks
- Service provider and vendor risks
- Processes for detecting unauthorized activity
- Identifying the personnel responsible for many of the foregoing items

While most of the documents or topics identified are not required books and records, a prudent firm may wish to consider whether taking measures with respect to some or all of these are worth considering for its business.

stay ahead of any specific, technical requirements imposed by forthcoming law or regulation.

International Developments

Multi-national firms, or those having affiliates or even just clients across the globe, must also consider the recent and forthcoming development of cross-border standards such as under the European Union's Data Privacy Directive, and any standards that may arise from trans-Atlantic or trans-Pacific trade partnerships.

The Future is Now

Investment advisers should consider risks-of-the-unknown embedded within new financial technologies. "Fintech," a word that can have many meanings, refers here to the application of innovative technologies to facilitate public participation in new financial and investment platforms or products. Many advisers will seek to take part in this expansion of direct retail access to the markets.

Fintech breakthroughs promise to go far beyond the past decade's adoption of web sites, feeds, and apps that are now commonly used in retail financial contexts. Examples of forthcoming innovations include:

- the further evolution of digital payment systems,
- the proliferation of "decentralized" companies that purport to have no jurisdictional domicile,
- the expansion of peer-to-peer lending, offering, and trading platforms, and
- the use of bitcoin and other virtual currency as the basis for exchange, investment, or enterprise.

Given that financial regulation abhors a vacuum, most of these developments face challenges – both in determining what rules apply in the first place, and in implementing the new technologies in compliance with those rules. Above all, advisory firms who engage in these areas should be aware that much of the regulatory framework that potentially applies to Fintech concepts is at a nascent stage, and that the only certainty is that regulation will progress in fits and starts.

First of all, depending on the nature of the product, the federal securities or commodities laws may be implicated. Ironically, despite the de-regulatory bent of certain Fintech proponents, under certain scenarios the formal federal registration of a product may present the path of least resistance. Otherwise, consumer protection initiatives of the Consumer Financial Protection Bureau or the Federal Trade Commission could provide *ad hoc* federal oversight, as they do for many categories of retail financial transactions. In the unusual event that a financial instrument completely avoids federal regulation, its purveyor might well then scour the patchwork of laws of the 50 states, the District of Columbia, and other jurisdictions. In this era of a borderless internet, online offerings and transactions can inadvertently run afoul of overseas laws as well. For its part, the SEC has not turned a blind eye to online public offerings conducted from overseas locations, in which non-accredited U.S. investors were not prevented from investing. On top of everything else, tax implications are also in flux.

Note about the potential regulation of Fintech products

As the production of new Fintech tools accelerates, attention must be given to whether they constitute:

- securities (thus potentially implicating the U.S. Securities Act of 1933 and its rules on registration, or exemptions from registration);
- advice on securities (the Advisers Act);
- pooling securities (the U.S. Investment Company Act of 1940);
- trading in securities (the U.S. Securities Exchange Act of 1940, including broker-dealer provisions)
- derivatives or commodity interests (provisions administered by the U.S. Commodity Futures Trading Commission).

The federal definition of a "security" is a complicated one, reflecting over 80 years of regulatory guidance and case law, and may encompass many things that appear wholly unlike traditional stocks and bonds. Other complications may arise out of the securities laws of non-U.S. jurisdictions, as well as other U.S. federal laws and the various state laws.

In sum, a healthy respect for compliance obligations can help an entrepreneur avoid such consequences as reputational harm, fines, bans, and even rescission rights. Asset managers would do well to keep those regulatory risks in mind as they look forward to incorporating these new technologies into their business operations or investment programs.

The same goes for algorithms and other automated trading strategies (and the failure of an adviser to base its marketing on the algorithm's actual trading results or to fulfill the firm's promises to rely solely on the promised algorithm), which the SEC's Enforcement staff have targeted of late. Going forward, the SEC has sought funding to examine "the increasing use of technology in operations that facilitate such activities as high-frequency and algorithmic trading,"[4] so more Enforcement developments or even substantive new regulation can be anticipated.

Traditional Operational Functions

The SEC's focus on the operations of investment advisers and investment companies goes beyond technology. Some topics of particular interest are noted below.

Protecting Traditional Client Assets

Electronic data is just one client asset to be protected. Traditional assets -- money and securities -- remain at the top of the list, and the SEC has been vigorous in enforcing the Advisers Act custody rule. The SEC's Division of Investment Management has also been providing custody rule-related guidance, including in the form of an IM Guidance Update that spells out ways in which a private equity fund manager may handle certain scenarios involving special purpose vehicles or escrow arrangements.[5] A client asset that is somewhat less obviously considered an asset -- a client's right to vote its proxies or have the adviser vote them in the client's best interest -- is likely to move to the forefront as greater scrutiny is applied to the concentration of market share among the major proxy advisory firms that provide many asset managers and institutional investors with recommendations on voting proxies.

The year 2015 is shaping up to have an unusual focus on the center of that string of relationships which trace the path from end-investor to asset class – that is, the nuts and bolts of "operations."

Data, Data, and More Data

The good news is that, by now, most asset managers have their feet under them with respect to the SEC's Form PF, the CFTC's Form CPO-PQR and Form CTA-PR, and the related National Futures Association filings, not to mention greater visibility of filing obligations on cross-border transactions under the U.S. Treasury International Capital (TIC) system and the U.S. Department of Commerce's similarly-focused Bureau of Economic Analysis filings. For many of these forms, the formerly-steady stream of FAQs has slowed to a trickle of online updates, managers have by now submitted a few rounds of filings, and the rules of the road have been absorbed into operational staffs' periodic routines.

Next up? For registered investment companies, expect to see the reform of Form N-SAR, the semi-annual report that uses a combination of outdated technology and a non-user-friendly format. For investment advisers generally, expect ever-more granular reporting, including on separately-managed accounts. SEC Chair Mary Jo White has said:

> While funds and advisers currently report significant information about their portfolios and operations to the Commission, these reporting obligations have not, in my view, adequately kept pace with emerging products and strategies being used in the asset management industry. For example, our rules do not require standardized reporting for many types of derivatives used by funds today. This is a clear gap, particularly given the growth in the volume and complexity of derivatives used by funds. Similarly, we do not today receive the most complete information about securities lending by funds, which is done by approximately a quarter of funds.
>
> The staff is developing recommendations for the Commission to modernize and enhance data reporting for both funds and advisers. Even the reporting of basic census information should be updated so that we are better able to monitor industry developments and potential compliance issues. Beyond that, the reporting and disclosure of fund investments in derivatives, the liquidity and valuation of their holdings, and their securities lending practices should all be significantly enhanced. Collecting more data on separately managed accounts, where the adviser manages assets owned by a particular client, will also better inform examination priorities and the assessment of the risks associated with those accounts, which are a significant portion of the business of many investment advisers.[6]

On that basis, investment advisory firms can expect to face added operational burdens in tracking and reporting data. Furthermore, compliance staffs should be aware of the

SEC Enforcement Division's "use of big data to detect and investigate violations," after sifting big data for "problematic patterns" and "troubling trends.[7] Similarly, the Division of Investment Management's Risk and Examinations Office has been increasing its use of data to engage in risk monitoring, review market trends that may include complex investment structures, compile ongoing financial analysis of the asset management industry, and maintain awareness of the risk-taking activities of investment advisers and funds.

FSOC on the Move

As 2015 progresses, the U.S. Financial Stability Oversight Council, or the FSOC, will continue to analyze the asset management industry's contributions to systemic risks facing the economy. To date, the FSOC's most-publicized mission has been to identify systemically important financial institutions, or SIFIs. Its views on money market funds and its consideration of nonbank financial companies (such as, potentially, major investment advisory firms) as SIFIs has brought the FSOC squarely into the asset management space historically occupied by the SEC. In considering its next steps, the FSOC has requested public comment on a variety of matters relating to the asset management industry.[8] One key topic in its call for comment is labelled "operational functions" and covers a variety of areas, which further suggests means that keeping an eye on operational effectiveness is the order of the day.

That FSOC request for public comment also asked a number of questions about the risks of mismatches between the liquidity of a portfolio's assets and investors' rights to withdraw cash; risks arising from the use of leverage in investing; and the effects on clients and the financial system of the insolvency of asset managers. Compliance officers can anticipate that the SEC will ask similar questions during its interactions with investment managers.

Note on the FSOC's focus on asset management firms' operational functions

The FSOC's discussion of investment adviser operations in its request for public comment on the asset management industry includes the following topics:

- Risks associated with transferring client accounts or assets from one manager to another, including any special risks relating to:
  - transferring derivatives or other asset types
  - any asset class for which no other manager is qualified to substitute
  - foreign markets or service providers
  - the speed with which assets can be transferred in good order
  - having to liquidate assets in connection with such a transfer
- Key functions for which the market share of service providers is particularly concentrated
- Due diligence when selecting a provider or tools for:
  - valuation
  - oportfolio risk management
- Operational risk transmission among affiliates upon the failure of one of them
- The effect of an asset manager's bankruptcy or dissolution on its funds
- Best practices employed by asset managers to assess and mitigate the operational risks associated with service providers
- Contingency plans to deal with failures of service providers

Sub-TA Arrangements in Focus

Transfer agency tends to sit deep within what is considered Operations. The TA function processes investors' holdings as they invest and withdraw money, and fulfills countless other roles including arranging the payments of dividends and distributions, tracking missing shareholders, and dealing with lost share certificates. In the competitive money management industry, many intermediaries have become possessive of their client relationships, and seek to institute omnibus arrangements for reasons as varied as keeping sensitive client information confidential, controlling access to a book of business, and not trusting others to provide the special touch that customers value. Since an intermediary's customers are not bound to remain with the intermediary, responsive full service is often the name of the game.

As in any market, there are diverse means of compensating such a service provider. Some are compensated by their customers. Others are compensated by the mutual funds in which their customers invest, under shareholder servicing agreements or sub-transfer agency (sometimes called "sub-TA") arrangements that are structured in a variety of ways. Part of the rationale for a mutual fund to compensate a sub-TA is that the intermediary acts as a central point that handles mailings and other outreach to the intermediary's customers who invest in the fund, thus saving the fund the trouble of doing so and augmenting the benefits to fund shareholders.

Sub-TA services are often bundled with other operational, administrative and customer-facing services, and may be provided in exchange for an asset-based fee, a fee per account, a combination of the two, or another fee arrangement. In some cases, such services (either expressly or *de facto*) may include facilitating the distribution of fund shares, which is where most of the regulatory scrutiny comes in. For the past 35 years, ever since the SEC adopted Rule 12b-1 under the Investment Company Act, the payment for distribution out of mutual fund assets has been subject to an elaborate regulatory regime that includes disclosures, board of directors determinations, and prohibitions.[9] An overlay of FINRA regulation on the kinds and extent of compensation that a broker-dealer may accept adds further complexity to this topic. In the coming year, based on signals from the SEC staff, some registered fund boards and sponsors can expect to be challenged in their handling of sub-TA arrangements, along with scrutiny of related fees and services, in cases where the arrangements may be deemed to involve direct or indirect payments for the distribution of fund shares. Among ops staffers, a firm's transfer agency, recordkeeping, and other operational systems may need to be adapted as new approaches are implemented.

Operational Integrity in General

Other operational topics of interest to an investment adviser's compliance department include:

- *Operational risk generally*: The SEC Chair has said that, "by 'operational risk,' I generally mean risk from inadequate or failed internal processes and systems."[10]
- *Operational integrity*: The SEC's Investment Management chief has underscored the importance of reviewing operational integrity as a matter of monitoring risk.[11]
- *Whistleblowers*: Advisers should take care that their processes are set to handle whistleblower complaints with the highest priority in order to address any valid issues raised and mitigate risks to the enterprise.
- *Committee functions*: The Enforcement Division has taken issue with actions that it considered improper by investment advisers' internal committees.[12]
- *Valuation controls*: The SEC's budget request for fiscal year 2015 includes a request for additional staff to examine, among other things, the processes and controls for valuation of complex, illiquid assets.[13]
- *Document delivery*: FINRA has brought actions against several violations of the obligations to deliver such documents as trade confirmations, or prospectuses relating to purchases of shares issued by exchange traded funds, or ETFs.
- *Portfolio composition risks*: Although more of a portfolio management or compliance function than the foregoing items, responsibility for identifying portfolio composition risks may implicate operations personnel who help with risk management analysis and the monitoring of compliance with investment restrictions.

Note on existing mutual fund regulations on portfolio composition

SEC Chair White, in her Safeguards Speech, suggests that the SEC may impose specific, substantive investment restrictions on funds. These would be in addition to those that already exist. Although the federal securities laws operate primarily as a disclosure regime, the Investment Company Act has long imposed a number of limitations on the portfolios of registered investment companies or funds regulated as business development companies (or BDCs), including the following:

- *Diversification:* A registered fund or BDC that markets itself as "diversified" must limit its investments in any one issuer; additional diversification requirements arise under Subchapter M of the U.S. Internal Revenue Code
- *Concentration:* A registered fund must adopt a policy to either concentrate its portfolio in an industry or group of industries, or undertake not to so concentrate
- *Borrowing and use of derivatives:* A registered fund is limited in its ability to use leverage, whether directly or by means of derivative instruments, or to otherwise engage in borrowing, and a BDC is subject to similar limitations but to a different degree
- *Investments in other registered investment companies:* Funds, whether regulated or not, are limited in their ability to invest in registered funds
- *Investments in or with affiliates:* A registered fund is generally prohibited from investing in, or transacting with, affiliates of its investment adviser; a BDC, despite having more flexibility, is subject to a similar regime; even the adviser of a separate account may be required by the Advisers Act to obtain prior client consent to any transaction with the account's investment adviser or its affiliate
- *Names rule:* If a registered fund's name identifies a certain asset class or strategy, the fund may be required to invest the bulk of its portfolio in assets suggested by the name
- *Short sales and securities lending:* SEC guidance limits the extent to which a registered fund or BDC may engage in short selling or in lending its securities
- *Illiquid assets:* Given its obligation to pay redemption proceeds promptly, a registered open-end mutual fund must maintain a minimum level of liquidity
- *Eligible portfolio assets:* A BDC is restricted in the kind of assets it may acquire.
- *Disclosed restrictions:* A fund, whether registered or not, may be subject to greater restrictions if provided in its prospectus, other disclosure documents, or charter

Conclusion

While 2015 holds exciting prospects for future innovations, asset managers should expect a regulatory push to get back to basics. While the past decade has been the era of the CCO (chief compliance officer), the next phase is bringing the COO (chief operating officer) to the compliance forefront. Firms' operations and compliance departments should be working hand-in-hand like never before to face the regulatory challenges posed by cybersecurity threats, manage risks relating to technological innovations in the financial sector, and adapt core internal controls as circumstances demand.

ENDNOTES

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[1] Regulatory and Examinations Priorities Letter, FINRA (Jan. 6, 2015).

[2] *OCIE Cybersecurity Initiative*, National Exam Program Risk Alert (Apr. 15, 2014).

[3] *Cybersecurity Examination Sweep Summary*, National Exam Program Risk Alert (Feb. 3, 2015).

[4] *FY 2015 Budget Request by Program*, SEC ("SEC Budget Request"), at 56, available at https://www.sec.gov/about/reports/sec-fy2015-budget-request-by-program.pdf.

[5] IM Guidance Update, *Private Funds and the Application of the Custody Rule to Special Purpose Vehicles and Escrows* (June 2014).

[6] Mary Jo White, Chair, SEC, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry* (Dec. 11, 2014) (speech) ("Safeguards Speech"). Internal footnotes were omitted from the above excerpt.

[7] Andrew Ceresney, Director, SEC Enforcement Division, Remarks to the American Bar Association's Business Law Section Fall Meeting (Nov. 21, 2014).

[8] Notice Seeking Comment on Asset Management Products and Activities, Financial Stability Oversight Council (Dec. 18, 2014).

[9] In 2010, the SEC attempted to clarify and modify the ground covered by today's Rule 12b-1, by proposing amended rules and new guidelines. *See Mutual Fund Distribution Fees; Confirmations*, Investment Company Act Release No. 29367 (July 21, 2010). The 278 page proposing release covered a range of related topics, including proposals as to limits on distribution fees and clearer disclosures to investors about sales charges, and it touched on sub-TA fees. To date, the rule has not been adopted and is no longer central to the SEC's announced regulatory agenda.

[10] Safeguards Speech.

[11] Norm Champ, Director, SEC Division of Investment Management, Remarks to the ALI CLE 2014 Conference on Life Insurance Company Products (Nov. 13, 2014) (speech).

[12] *See, e.g., In the Matter of Vero Capital Management, LLC, et al.,* Investment Advisers Act Rel. No. 3991 (Dec. 29, 2014) (instituting proceedings claiming, among other things, that requisite client consent under Advisers Act Rule 206(3) was not properly obtained when approved by an internal committee of the adviser).

[13] SEC Budget Request, at 58.

PRACTICAL COMPLIANCE & RISK MANAGEMENT

FOR THE SECURITIES INDUSTRY

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Editorial Advisors Corner: Investment Management Quarterly – First Quarter 2015

By Patricia C. Foster

Patricia C. Foster has been a member of this publication's Editorial Advisory Board since 2008. She is the founder of Patricia C. Foster, Esq. PLLC, a firm that provides comprehensive legal services to the investment management industry. She provides advice to investment advisers, investment companies and broker-dealers. Ms. Foster is a recipient of the Certified Securities Compliance Professional (CSCP®) designation, a credential awarded by the National Society of Compliance Professionals, Inc.

We began the year with a heightened awareness of the importance of information security. Following the recent Sony and Anthem incursions, institutions of all types are actively engaged in an effort to protect their data. And, as federal authorities take a deeper dive into the Morgan Stanley breach that occurred late last year, the investment management industry is squarely focused on cybersecurity. In this first newsletter of 2015, we discuss information security as a continuing regulatory focus, recent staffing changes at the Securities and Exchange Commission (Commission), examination priorities for 2015, and other topics of importance to the investment management industry.

Information Security – A Continuing Regulatory Focus

Information security continues to be an important regulatory focus. On February 9, New York State's Financial Services Department announced that it will "integrate regular, targeted assessments of cyber security preparedness at insurance companies as part of the department's examination process," and that it plans to issue "enhanced regulations" that would require institutions to meet "heightened standards for cyber security." On February 3, the Commission's Office of Compliance Examinations and Examinations (OCIE) released the results of its 2014 cybersecurity sweep exam in the form of a *Risk Alert*. Contemporaneously with OCIE's release of the Risk Alert, the Financial Industry Regulatory Authority (FINRA) released a 46-page *Report of Cybersecurity Practices* which identifies effective practices for dealing with cyber threats. We discuss the OCIE Risk Alert in more detail below.

OCIE Risk Alert

The Risk Alert summarizes the results of OCIE's 2014 cybersecurity sweep exam which examined over 100 industry participants (57 registered broker-dealers and 49 registered investment advisers) in an effort to assess their cybersecurity preparedness. Specifically the OCIE staff collected and analyzed information relating to industry practices in three specific areas: (1) identification of risks related to cybersecurity; establishment of cybersecurity governance, including policies, procedures and oversight processes; protection of firm networks and information; (2) Identification of risks associated with remote access to client information and funds transfer requests; and (3) Identification and assessments of risks associated with vendors and other third parties and detection of unauthorized activities.

Among the observations included in the Risk Alert:

- Of the firms examined, 93% of the broker-dealers and 83% of the advisers have adopted written information security policies; 89% of the broker-dealers and 57% of the advisers conduct periodic audits to determine compliance with these policies and procedures.
  - Written business continuity plans often addressed the impact of cyber-attacks, and outlined a plan to recover from a cyber incident.
  - Written policies and procedures generally did not address how firms would determine whether they are responsible for client losses associated with cyber incidents.
  - Many firms are utilizing external standards and other resources to model their information security infrastructure and processes.
- The vast majority of firms examined conduct periodic risk assessments on a firm-wide basis to identify cybersecurity threats, vulnerabilities and potential business consequences; fewer firms applied these requirements to their vendors.
- The vast majority of firms examined conduct firm-wide inventorying, cataloguing, or mapping of their technology resources.

Information security continues to be an important regulatory focus.

- Cybersecurity risk policies relating to vendors and business partners revealed varying findings. Of the firms examined, 72% of the broker-dealers incorporate requirements relating to cybersecurity risk into their contracts with vendors and business partners; in contrast, only 24% of the advisers incorporated such requirements into their contracts.
- Of the firms examined, 98% of the broker-dealers and 91% of the advisers make use of encryption in some form.
- Many firms examined provide their clients with suggestions for protecting their sensitive information.
- Of the firms examined, 68% of the broker-dealers and 30% of the advisers have designated an individual as the firm's Chief Information Security Officer (CSIO).
- Of the firms examined, 58% of the broker-dealers and 21% of the advisers maintain insurance that covers losses and expenses attributable to cybersecurity incidents.

Division of Investment Management

On January 21, the Commission announced that Norm Champ, Director of the Division of Investment Management (IM), would leave the agency. Prior to joining IM as Director in 2012, Champ had served as Deputy Director of the Commission's Office of Compliance Inspections and Examinations (OCIE) and also as an Associate Director in the New York Regional Office. Among Champ's initiatives during his tenure at IM was the creation of the Risk and Examination Office within the division which uses data collected from the investment management industry to monitor risks and inform policy at the Commission. Although Champ's successor has not yet been named, David Grim has been appointed Acting Director of IM.

National Examination Program Priorities

On January 13, 2015, the Commission released its annual list of exam priorities for investment advisers, broker-dealers and transfer agents. The priorities for 2015 center around three distinct themes. Specifically, the Commission will examine matters of importance to retail investors and investors saving for retirement, in an effort to determine whether the information, advice, products and services being offered are consistent with applicable laws, rules and regulations; it will assess issues related to market-wide risks; and it will use its evolving ability to analyze data to identify and examine registrants that may be engaged in illegal activity, such as excessive trading and penny stock pump-and-dump schemes.

1. Protection of Retail Investors and Investors Saving for Retirement

Noting that retail investors are being offered an increasingly complex array of investment options, and that investors are more dependent than ever on their own investments for retirement, the Commission stated that it is planning various examination initiatives to assess risks to retail investors that could arise from these trends. We can expect these examinations to focus on: (1) compensation arrangements, sales practices, suitability, supervision of registered representatives and investment adviser representatives in branch offices; (2) mutual funds that utilize "alternative" investments, and the manner in which these funds are marketed to investors; (3) fixed-income funds that have significant exposure to interest rate increases.

2. Assessment of Market-Wide Risks

The Commission stated that, in connection with its mission to maintain fair, orderly and efficient markets, it will use its examination authority over a wide variety of registrants in an effort to identify structural risks and trends. Specifically, OCIE will collaborate with IM as well as the Division of Trading and Markets (TM) to monitor risks posed by the largest asset managers and broker-dealers in order to develop an awareness of industry-wide developments, and it will continue its annual examinations of clearing agencies that have been designated as systemically important. The Commission intends to assess potential conflicts of interest in connection with equity trading in an effort to determine whether firms are prioritizing trading venues based on payments for order flow in contravention of their best execution obligations. It came as no surprise that the Commission will continue its focus on cybersecurity compliance and controls.

3. Use of Data Analytics to Identify Signals of Illegal Activity

The Commission will use enhanced data analytics developed by OCIE to focus on registrants that appear to be engaged in potentially fraudulent and/or illegal activity. The types of activities that will be targeted include firms that employ individuals with a track record of misconduct, operations of broker-dealers and transfer agents that may indicate pump-and-dump schemes, market manipulation or excessive trading. Yet another focus will be anti-money laundering (AML) programs of broker-dealers.

4. Other Initiatives

Agency resources will also be allocated to numerous other priorities, including:

- *Municipal Advisors*. OCIE will continue to conduct examinations of newly registered municipal advisors in an effort to assess their compliance with rules recently adopted by the Commission and the Municipal Securities Rulemaking Board.
- *Proxy Services*. Resources will be dedicated to examination of select proxy advisory service firms, with a focus on the process of making recommendations for proxy voting, the disclosure of conflicts of interest, and mitigation of those conflicts. Resources will also be dedicated to examination of investment advisers' compliance with their fiduciary duty in voting proxies on behalf of investors.
- *Investment Companies*. OCIE will conduct focused, risk-based examinations of selected registered investment company complexes that have previously not been examined.
- *Private Equity Fund Advisers*. OCIE will continue to conduct examinations of advisers to private equity funds with a specific focus on fees and expenses.

The Commission specifically stated that the list of priorities is not exhaustive, and noted that the staff will also conduct examinations focused on various other risks, issues and policy matters that arise from market developments and new information learned from other sources (e.g. tips, complaints and referrals).

Enforcement Focus on Conflicts of Interest

An administrative proceeding brought on January 13, 2015 against an investment adviser headquartered in Ft. Wayne, IN illustrates the substantial costs of a compliance infrastructure that fails to address conflicts of interest adequately. This cautionary tale also reminds us that regulators will not hesitate to find willful violations of federal securities laws based on negligence. In the Matter of Shelton Financial Group, Inc. and Jeffrey Shelton involved an investment adviser's failure to address the conflicts of interest attendant to its arrangement with a broker-dealer, its failure to disclose those conflicts of interest to its clients, and its failure to adopt and implement policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940 (Advisers Act) and rules.

The Consent Order issued on January 13, 2015 (Order) reflects the Commission's finding that the firm's receipt of compensation in connection with the arrangement, and its failure to adequately disclose the conflicts of interest resulting from the arrangement caused violations of the anti-fraud provisions of the Advisers Act and Rule 206(4)-7 thereunder which requires investment advisers to, among other things, "[a]dopt and implement written policies and procedures, reasonably designed to prevent violation" of the Advisers Act and rules. It also reflects the Commission's finding that the negligent conduct had also caused the firm and its owner to have *willfully* violated (1) the anti-fraud provisions of the Advisers Act (Sections 206(2) and 206(4)); and (2) Section 207 of the Advisers Act which makes it unlawful for a person to "willfully omit to state…material fact[s] in registration applications and reports filed with the Commission." In connection with these findings, the Commission noted that scienter is not required to establish a violation of Section 206(2), noting that a violation under that section may be based on a finding of negligence, citing *SEC v. Steadman*, 967 F.2d 636 D.C. Cir. (1992) and *SEC v. Capital Gains Research Bureau, Inc*. 375 U.S. 180 (1963).

The Shelton case is significant because it illustrates the substantial costs that can result from a compliance infrastructure that does not address adequately the specific conflicts of interest presented by a firm's business model. The tab resulting from the firm's carelessness included disgorgement in the amount of $99,114.19 and pre-judgment interest of $20,952.91, as well as a civil monetary penalty of $70,000.00. But, that was not all. The firm was required to provide its existing advisory clients with a copy of the Order within thirty (30) days of its entry. Among the other costs that are less readily quantifiable:

The Commission stated that, in connection with its mission to maintain fair, orderly and efficient markets, it will use its examination authority over a wide variety of registrants in an effort to identify structural risks and trends.

- The firm has been required to engage, for a period of five years, an independent compliance consultant that is "not unacceptable" to the staff of the Commission, and incur the consultant's compensation and expenses; the specifics of the consultant's responsibilities as well as applicable timeframes for completing of those responsibilities are set forth in the Order.
- The firm has been required to employ, for a period of five years, a Chief Compliance Officer whose sole responsibility is to serve in that position and who may not simultaneously hold any other office or position during the five-year period.
- Shelton may not act as the firm's Chief Compliance Officer for a period of five years.
- Within one year of the entry of the Order, the firm must require its Chief Compliance Officer to complete thirty (30) hours of compliance training relating to the Advisers Act.

A more robust compliance program developed as a result of ongoing risk assessments and adequate attention to Form ADV disclosure obligations might have avoided this costly result.

ICI/IDC Report on Funds' Use of Proxy Advisory Firms

In January, the Investment Company Institute (ICI) and the Independent Directors Council (IDC) issued a *Report on Funds' Use of Proxy Advisory Firms* that provides information and guidance to mutual fund boards (Report). The 20-page Report reminds fund boards that as part of their fiduciary duties to shareholders, they are responsible for the voting of proxies relating portfolio securities of the funds that they serve. It also reminds boards that, although it is customary to delegate proxy voting responsibilities to a fund's investment adviser, the proxy voting activities of the adviser remain subject to the board's continuing oversight. The Report follows the issuance on June 30, 2014 of Staff Legal Bulletin No. 20 on proxy voting, *Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms.* Both the Report and Legal Bulletin No. 20 will be useful to firms as they review their proxy voting policies and procedures.

Insider Trading

Last month Preet Bharara, the United States attorney in Manhattan, mounted a challenge to the decision of a three-judge appellate panel that overturned the convictions of two hedge fund managers for insider trading last year. Considerable fallout has resulted from the December 10, 2014 decision of the Second Circuit Court of Appeals which concluded that the judge who presided over the trial of Todd Newman and Anthony Chiasson set too low a bar for conviction when instructing jurors. Now Bharara, who is credited with 80 convictions for insider trading, has filed a petition asking the three-judge panel to reconsider its decision. The Securities and Exchange Commission (Commission), which is responsible for civil enforcement of the federal securities laws, has filed an amicus brief in support of the government's petition. The amicus brief also takes the position that rehearing is necessary to avoid conflict with the prior precedents of both the Second Circuit and the Supreme Court. Stay tuned.

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ENDNOTE

* Nothing contained in this document is intended to serve as legal advice. Each investment company, investment company board and investment adviser should seek the advice of counsel for issues related to its individual circumstances.


RiskHQ

Compliance Challenges for Dually Registered Firms

By Robert L. Tuch

Introduction

The Securities and Exchange Commission (the "SEC") continues to pay close attention to the activities of dually registered firms and broker-dealer and investment advisory businesses that share common financial professionals.[1] Upon announcing its examination priorities, the SEC's Office of Compliance Inspections and Examinations ("OCIE") has indicated that the SEC staff would review:

- how financial professionals and firms satisfy their suitability requirements when determining whether to recommend brokerage or advisory accounts, the financial incentives for making such recommendations, and whether all conflicts of interest are fully and accurately disclosed;
- dually registered firms' policies and procedures related to such recommendations;
- the significant risks to investors of migration and other conflicts this business model presents;
- the impact to investors of the different supervisory structures and legal standards of conduct that govern the provision of brokerage and investment advisory services; and
- when a variety of fee arrangements is offered for advisory accounts, whether the recommendation of an advisory account is in the best interest of the client at the inception of the arrangement and thereafter, including fees charged, services provided and disclosures made about such relationships.[2]

With this regulatory focus in mind, it would be useful to review the functions performed by broker-dealers and investment advisers and note the differences. It would also be useful to note the differences in applicable laws, rules and regulations and take a look back at some important events that have helped shape the current state of the U.S. financial services industry. Accordingly, this article will (i) describe the different functions and regulatory regimes of broker-dealers and investment advisers, and (ii) address evolutionary changes that have led to the blurring of distinctions between investment advisers and broker-dealers.

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This will provide a good foundation for a discussion of compliance challenges for dually registered firms and for financial professionals and firms that wish to become dually registered. Upon addressing those challenges, this article will identify recommended practices that may be appropriate for consideration by management personnel and compliance professionals.

I. Different Functions and Regulatory Regimes

Section 202(a)(11) of the Investment Advisers Act of 1940 (the "Advisers Act") defines an investment adviser as any person or firm that, for compensation, is engaged in the business of providing advice to others or issuing reports or analyses regarding securities.[3] This may include the provision of personalized investment advice about securities to retail customers. It also may include such things as (i) portfolio design and portfolio management (including asset allocation strategies), (ii) financial planning (including retirement planning), (iii) estate planning and generational wealth transfer and (iv) business succession planning.

The SEC continues to pay close attention to the activities of dually registered firms and broker-dealer and investment advisory businesses that share common financial professionals.

By contrast, broker-dealers operate as sales people whose primary roles are distributing and selling securities and executing securities transactions. Depending on the scope of a broker-dealer's business, it may be involved in (i) the provision of investment advice about securities when recommending securities transactions to retail customers, (ii) underwriting securities offerings, (iii) serving as syndicate members or wholesalers, (iv) matching buyers and sellers of securities, (v) acting as market makers, (vi) selling securities to the public from inventory and/or (vii) clearing and settling trades. With respect to the sale and distribution of securities, broker-dealers may act as agents for issuers, as principal underwriters or as wholesalers, while also providing advice and recommending the purchase of securities to the public. As such, broker-dealers often have competing loyalties; e.g., maximizing sales while also making suitable recommendations to customers.

Given the different functions noted above, investment advisers and broker-dealers have been subject to separate regulatory regimes.

The broker-dealer regulatory regime has been characterized as predominantly a rules-based approach.[4] It governs, among other things, the way in which broker-dealers operate, focusing in large measure on applying rules embodying principles of fairness and transparency to relationships between broker-dealers and customers. Broker-dealers are primarily subject to the Securities Exchange Act of 1934 (the "Exchange Act"), rules adopted under the Exchange Act and rules of self-regulatory organizations, including the Financial Industry Regulatory Authority ("FINRA"). These laws and rules govern a wide variety of brokerage activities related to securities transactions, including advising customers, executing orders on the most favorable terms, arranging for delivery and payment, maintaining custody of customer funds and securities and delivering required disclosures such as confirmations and account statements.[5] Under FINRA rules, a broker-dealer and its registered representatives must ascertain whether a specific securities recommendation (which includes recommended transactions and recommended investment strategies) is suitable for an investor.

Investment advisers are subject to the Advisers Act and rules adopted under the Advisers Act. The Advisers Act governs an investment adviser's standard of conduct in providing advice to clients through the fiduciary duty recognized under Advisers Act Sections 206(1) and 206(2). Although the Advisers Act and its related rules impose certain requirements and prohibitions, this regulatory regime has been viewed as a more principles-based approach.[6] The fiduciary duty reflects the personal relationship between investment advisers and clients and the recognition that investment advisers are entrusted with client assets and investment authority.

As fiduciaries, registered investment advisers are expected to:

- manage portfolios in the best interests of clients;
- provide clients with undivided loyalty;
- make full and fair disclosure of all material conflicts of interest;
- seek best execution for client transactions;
- ensure that investment advice is suitable for clients' objectives, needs and circumstances; and
- refrain from effecting personal securities transactions that are inconsistent with client interests.[7]

II. Compensation Practices Within the Retail Brokerage Industry

A. The Tully Report

In response to concerns about actual and potential conflicts of interest in the retail brokerage industry, a broad-based Committee on Compensation Practices was formed in May 1994 at the request of SEC Chairman Arthur Levitt. Included within this Committee's mandates was the identification of best practices used to eliminate, reduce or mitigate actual and perceived conflicts of interest for both registered representatives and managers. The Committee became known as the Tully Committee, a reference to Daniel Tully, then Chairman and CEO of Merrill Lynch & Co., Inc. who also chaired this Committee. In its report issued in April 1995 (the "Tully Report"), the Committee noted, among other things, that some firms' practice of basing a portion of compensation on account assets is seen as one way to reduce the temptation to create inappropriate trading activity. The report further indicated that fee-based accounts may also be particularly appropriate for investors who prefer a consistent and explicit monthly or annual charge for services received, and whose level of trading activity is moderate.[8]

B. Fee-Based Brokerage Accounts and the Merrill Rule

The Tully Report caused many broker-dealers to re-evaluate their compensation practices. Many broker-dealers began to market fee-based brokerage programs, emphasizing the importance of the investment advice that was being provided. As fee-based accounts became more prevalent, however, many broker-dealers became concerned that the receipt of fees in connection with such accounts would be viewed as special compensation for investment advisory services, thereby requiring registration as an investment adviser under the Advisers Act.

The SEC attempted to address this in the form of a proposed rule under the Advisers Act. Focusing on the exception afforded to broker-dealers from Advisers Act registration requirements when investment advice was "solely incidental" to the provision of brokerage services, the SEC published proposed Rule 202(a)(11)-1 in November 1999, which came to be known as the "Merrill Rule" or the "Merrill Lynch Rule." Under the Merrill Rule, broker-dealers would not be subject to Advisers Act registration requirements just because they received fees from these fee-based brokerage accounts. The intent here was to focus on the services provided, which, in the SEC's view, could still be treated as advice that was solely incidental to the provision of brokerage services as long as broker-dealers were not receiving separate compensation for advisory services.

In July, 2004, the Financial Planning Association (the "FPA") filed a lawsuit in an effort to force the SEC to rescind the Merrill Rule. At this point in time, the Merrill Rule still remained in proposed form and had engendered much debate within the industry. Notwithstanding the controversy, the SEC adopted the Merrill Rule in the spring of 2005 even though the FPA lawsuit had yet to be decided. On March 30, 2007, the United States Court of Appeals for the D.C. Circuit vacated the Merrill Rule, holding that the SEC had exceeded its authority when creating this exception from investment adviser registration for broker-dealers.[9]

Rather than appealing the Court's decision, the SEC requested a 120-day stay to allow firms ample time to decide what to do with client assets that were in these fee-based brokerage accounts. In an article addressing the aftermath of this court decision, it was reported that the bulk of assets within these accounts were moved into advisory accounts, where financial professionals began managing them as investment adviser representatives.[10] The other client assets were moved into broker-dealer commission accounts. According to data compiled in an April 2012 article published in *Fiduciary News*, this gave rise to a significant increase in the number of dual registrants.[11]

III. The Rand Report

In 2006, the SEC commissioned the Rand Corporation's Institute for Civil Justice ("Rand") to conduct a study. Rather than evaluating the regulatory environment or making policy recommendations, the study focused on two questions:

- What are the current business practices of broker-dealers and investment advisers?
- Do investors understand the differences between broker-dealers and investment advisers?

In its report to the SEC, Rand confirmed that the industry was becoming increasingly complex, firms were becoming more heterogeneous and intertwined, and investors did not have a clear understanding of the different functions and responsibilities of financial professionals.[12] The report also concluded that the distinctions between investment advisers and broker-dealers had become blurred, and that study participants had difficulty determining whether a financial professional was a broker or an adviser and instead believed that brokers and advisers offered the same services and were subject to the same duties. One reason cited in the report for the blurring of lines was the use by brokers of titles such as "adviser," "financial adviser" or "financial consultant."

IV. Dodd-Frank Section 913 and Related SEC Study

The Rand report helped to shape the discourse regarding potential reforms within the financial services industry. Section 913 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act")[13] required the SEC to conduct a study to evaluate whether there were legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards relating to the standards of care for providing personalized investment advice about securities to retail customers.

Section 913 included other items to be considered in conducting the study, including the potential impact of eliminating the broker-dealer exclusion from the Advisers Act definition of "investment adviser" and the potential impact on retail customers if regulatory requirements change, including their access to the range of products and services offered by broker-dealers.

On January 21, 2011, the SEC Staff released its study (the "SEC Study").[14] The SEC Study recommended rulemaking to establish a uniform fiduciary standard for investment advisers and broker-dealers that would be consistent with the standard that currently applied to investment advisers under the Advisers Act. To facilitate the implementation of the uniform fiduciary standard, the SEC Study recommended that the SEC adopt rules to address the following:

- **Disclosure Requirements**. Rules should be adopted to address both the existing "umbrella" disclosures (e.g., ADV, Part II) and specific disclosures provided by broker-dealers and investment advisers when a transaction is executed.
- **Principal Trading**. Rules should be adopted to address how broker-dealers can satisfy the uniform fiduciary standard when engaging in principal trading activities.
- **Customer Recommendations**. Rules should be adopted to address the duty of care obligations that broker-dealers and investment advisers have when making recommendations to retail customers.

The SEC Study further recommended that the SEC harmonize other areas of broker-dealer and investment adviser regulation, such as regulations pertaining to advertising and communication, the use of finders and solicitors, supervision and regulatory reviews, licensing and registration of firms, licensing and registration of associated persons and maintenance of books and records. In so doing, the SEC Staff noted that harmonization could benefit retail investors by providing the same or substantially similar protections when the same or substantially similar services are provided by investment advisers and broker-dealers. Regarding the areas of regulation noted above, the SEC Study recommended that the SEC (i) undertake certain reviews, and (ii) consider certain enhancements, including certain additional requirements for investment advisers and investment adviser representatives.

As of the date of this writing, the SEC has not undertaken any rulemaking to implement the recommendations contained in the SEC Study. A number of observers have offered their views regarding how best to implement Section 913 of the Dodd-Frank Act and the SEC Study recommendations. Other observers have offered guidance regarding how to prepare for a uniform fiduciary standard for investment advisers and broker-dealers.[15] These topics, however, are outside the scope of this article. The following section addresses key compliance challenges and offers several recommendations.

V. Compliance Challenges and Recommended Practices

A. Dually Registered Firms

Financial professionals serving retail investors are increasingly choosing to operate as an adviser or as a broker and an adviser, rather than solely as a broker.[16] Association with a broker-dealer and an investment adviser can provide financial professionals with a greater array of client investment solutions. With this broad platform, however, comes the responsibility for complying with the laws, rules and regulations that apply to both broker-dealers and investment advisers. For dually registered firms, there is no shortage of challenges, as managers and compliance professionals address product and service offerings, conflicts of interest, sales practice issues, supervision and controls and disclosure concerns, to name just a few of the important areas to be addressed. The following topics have been identified as key areas of focus, from a risk management standpoint, by regulators:

- Conflicts of Interest
- Disclosure
- Suitability of Investment Advisory Accounts

1. Conflicts of Interest

In Section II above, the discussion of broker-dealer functions addresses the different roles that broker-dealers play when they act in various capacities on behalf of issuers, principal underwriters, wholesalers and retail customers. These roles can give rise to conflicts of interest. Section II also describes the responsibilities of investment advisers regarding conflicts of interest, given their fiduciary responsibilities under the Advisers Act. The SEC and FINRA are each looking closely at the ways in which firms manage conflicts of interest and potential conflicts of interest.

OCIE has indicated that the SEC staff would focus on specific conflicts of interest, steps registrants have taken to mitigate conflicts and the sufficiency of disclosures made to investors.[17] OCIE has also noted that the SEC staff would look at the overall governance frameworks that firms have in place to manage conflicts on an ongoing basis.[18]

In July 2012, FINRA announced that it was undertaking a review process to better understand industry practices and determine whether member firms were taking reasonable steps to properly identify and manage conflicts that could affect their clients or the marketplace.[19] In October 2013, FINRA published a report ("Conflicts Report") that summarized its findings, including its identification of conflicts management practices that member firms should consider and, as appropriate, tailor to their specific businesses.[20]

In its Conflicts Report, FINRA identified several categories of conflicts and provided several examples. Included among the categories were general conflicts, supervision and compliance conflicts, research-related conflicts, conflicts related to banking and capital markets and conflicts relating to retail/private wealth. The following are some of the key effective practices that were identified in the Conflicts Report:

Enterprise-Level Framework

- Define conflicts of interest in a way that is relevant to the firm's business.
- Articulate employees' roles and responsibilities with respect to identifying and managing conflicts.
- Disclose conflicts of interest to clients, taking into consideration the different needs of retail and institutional clients.
- Train staff to identify and manage conflicts in accordance with firm policies and procedures.
- Introduction of New Products
- Include within the firm's new product review process a requirement to identify and mitigate any conflicts that a new product may present.

Compensation

- Avoid or minimize thresholds that enable associates to increase their compensation disproportionately through an incremental increase in sales.
- Minimize incentives to favor one product type (e.g., equities, mutual funds, variable annuities) over another.
- Reduce the incentive to prefer one mutual fund or variable annuity over a comparable product by capping the gross dealer concession that will be credited to an associate's production.

Oversight

- Monitor the suitability of recommendations around key liquidity events (e.g., a rollover of 401(k) assets) where the impact of those recommendations may be particularly significant.
- Develop a surveillance program to identify spikes in an associate's sales of a particular product. If a significant increase is discovered, a suitability analysis can be conducted regarding recommendations of that product.

2. Disclosure

Broker-dealers and investment advisers are subject to a vast array of disclosure requirements, the applicability of which depends on the nature and scope of the product or service being offered.

For investment advisers, Form ADV, Part 2, sets forth information required in client brochures and brochure supplements. Part 2A requires an investment adviser to prepare a narrative brochure that includes plain English disclosures of business practices, investment strategies, fees, conflicts of interest and disciplinary information. Part 2B requires an investment adviser to prepare a brochure supplement that contains information about each investment adviser representative that provides investment advice to clients, including the representative's educational background, business experience, other business activities and disciplinary history. Investment advisers must deliver the brochure (and updates to that brochure) to their clients annually and the brochure supplement to a client at the time the representative begins to provide advisory services to that client.[21]

For financial professionals who recommend securities transactions, the disclosures provided to the investor might include any combination of the following, depending on the firm and the securities that are recommended: a prospectus, a summary prospectus, trade confirmations, the firm's privacy policy, a description of how the firm and its representatives are compensated, annual and semi-annual reports, account statements, the firm's anti-money laundering policy, prospectus supplements and investor notices.

One observer has expressed the view that numerous regulators and regulations have unintentionally created disclosure redundancies and disparities, often contributing to retail investor confusion.[22] For dually registered firms, disclosure requirements present quite a challenge, especially if one of the goals is to promote investor education and understanding regarding products and services that are offered. With this in mind, here are some of my recommended practices to consider:

- An emphasis should be placed on concise, plain-English disclosures that are presented in a user-friendly format.
- Provide an explanation of the brokerage services and investment advisory services that are offered by the firm.
- Explain how the firm and its financial professionals are compensated. This explanation should include all forms of transaction-related compensation, including commissions, sales loads and mark-ups, as applicable, and all fee arrangements for the firm's investment advisory programs.
- Conflicts of interest should be disclosed, including a discussion of how they are mitigated and/or managed. If applicable, this should include any financial incentives that financial professionals may have to recommend certain products or services over similar ones.
- Take steps to ensure that disclosures are presented in a balanced manner, including a discussion of risks.
- Financial professionals should be prepared to supplement written disclosures with appropriate explanations to ensure a proper understanding by the customer of the products and services being offered. This is particularly important when recommending complex products to retail customers.

3. Suitability of Investment Advisory Accounts

As noted above, broker-dealers receive transaction-based compensation. This is, in large part, in the form of commissions. Investment advisers, on the other hand, employ a variety of fee structures for the investment advisory services offered to clients. For investment advisory accounts, a commonly-used arrangement entails the imposition of a fee that is based on the level of assets in the account, independent of the level of trading activity. By deciding to pay a fee, based on services provided rather than transactions, the client may pay a greater amount than the cost of a commission alternative during periods of lower trading activity.

Fee-based advisory accounts include discretionary and non-discretionary accounts. In a discretionary account, the investment adviser, or an unaffiliated adviser retained by the investment adviser, chooses the underlying investments for the account. In a non-discretionary account, the client chooses the underlying investments, with assistance in the form of recommendations from the financial professional.

Fee-based advisory accounts are often structured as wrap-fee programs ("Wrap Accounts"), whereby a bundled fee is charged that covers all services and charges, including ticket charges (i.e., trading costs). Wrap Accounts are utilized by investors who have an intention to actively trade positions within their accounts. An alternative to Wrap Accounts is a fee-based advisory account with a lower ongoing fee that does not cover ticket charges.

An investment adviser must carefully consider whether a Wrap Account is suitable and appropriate for a client before entering into such an arrangement. In a letter to the National Association of Personal Financial Advisers, the SEC's Division of Investment Management made this point and further indicated that investment advisers have an obligation to make such a suitability determination for these accounts on an ongoing basis thereafter.[23]

The trading activity of a fee-based advisory account is just one factor to be considered when reviewing the suitability of the account. Although inactivity in a fee-based account may not, by itself, establish that an account is unsuitable, inactivity is an important factor. It should be noted that there may be a disincentive for a financial professional to trade for Wrap Accounts since the profit from the Wrap Account fee is reduced each time a trade is executed and the resulting execution costs are incurred.

The following are recommended practices when determining the suitability of a fee-based advisory account:

- All relevant factors should be considered in order to determine what is in the best interests of a client at the inception of the arrangement and thereafter.
- Relevant factors in making this determination include:
  - the client's investment objectives and goals;
  - the client's financial situation and needs;
  - past and anticipated investment activity;
  - proposed investments and eligible assets for inclusion within these accounts;
  - the nature and cost of services to be provided;
  - the entire suite of services provided by the financial professional; and
  - the client's preferences concerning available payment alternatives.
- Advisory accounts should be monitored and reviewed on a regular basis (annually, unless a reason exists to do so more frequently) to determine whether they are suitable for a fee-based environment. This should include a review for inactivity. Inactivity reports should be produced and shared with appropriate supervisory and compliance personnel.
- Where appropriate, inactive advisory accounts should be converted to accounts with more favorable pricing structures.
- Financial professionals should maintain records that show evidence of suitability for advisory accounts. Such evidence may include documented client meetings and documented account reviews, including portfolio monitoring and asset allocation reviews.

B. Becoming Dually Registered

This section will focus on two significant industry trends: (i) registered broker-dealers becoming dually registered, and (ii) financial professionals opting to create a "hybrid" practice.

1. Broker-Dealers Becoming Dually Registered

When choosing to register as an investment adviser, a broker-dealer should be mindful of common elements of compliance programs operated by broker-dealers and investment advisers. This can help the firm leverage its compliance controls and procedures to satisfy the regulatory requirements for dual registrants. In a *Regulatory Brief* issued by PricewaterhouseCoopers in 2012, the following common elements were identified[24]:

- a designated Chief Compliance Officer ("CCO");
- a knowledgeable CCO who has authority within the organization;
- the compliance program must be effectively designed to achieve compliance with certain securities laws and regulations applicable to the firm;
- the effectiveness of the compliance program must be reviewed at least annually;
- the compliance program must be dynamic (i.e., must be modified as business, regulatory and legislative changes and events dictate); and
- the compliance program must "report up," that is, report to the firm's executive management, on the effectiveness of compliance policies and procedures.

The *Regulatory Brief* concludes that CCOs and others can benefit from being aware of the commonalities in legal requirements that are applicable to broker-dealers and investment advisers.[25] A similar theme was presented in a September 2013 article entitled *Dually Registered Brokers and Advisers*.[26] In this article, the authors address the common elements cited above and also address how prospective dual registrants with pre-existing broker-dealer compliance controls and procedures can expand their programs to satisfy the requirements of the Advisers Act. The following key Advisers Act requirements are discussed:

- fiduciary duties of investment advisers;
- the investment adviser Code of Ethics;
- rules governing the use of advertising and marketing;
- pay-to-play rules; and
- dispute resolution mechanisms applicable to investment advisers.

With these common elements and the key differences as to duties in mind, CCOs can go about building effective compliance programs. For broker-dealers seeking to become dually registered, a clear understanding of the difference between the suitability standard, applicable to broker-dealers, and the fiduciary duties applicable to investment advisers, is essential. Financial professionals operating as investment adviser representatives of such dual registrants will need to be well-trained concerning their fiduciary duties to clients.

2. The Hybrid Model

For financial professionals who desire to offer investment advisory services, many have opted to operate a so-called hybrid practice. Under this scenario, the financial professional conducts a brokerage business as an associate of a broker-dealer, while also conducting an investment advisory business through an investment adviser that he or she owns and controls. The investment adviser is not affiliated with, or overseen by, the broker-dealer.

Under a hybrid model, the financial professional maintains independence with respect to the management of his/her investment advisory business while, at the same time, retaining access to a suite of products and services that are made available by the broker-dealer. With this independence comes the responsibility of managing the investment adviser in a compliant manner while also growing the business and tending to the needs of clients. This can present quite a challenge, especially in the case of financial professionals who have previously relied entirely on employers to provide compliance and back office support. To meet this challenge, some financial professionals have hired experienced compliance professionals to take on the CCO role. For those financial professionals who may not want to hire a full-time compliance officer, a viable alternative could be the use of an independent consulting firm that makes available a seasoned compliance professional that can step into that CCO role. In any event, those individuals who choose to operate a hybrid practice will need to be aware of all the key Advisers Act requirements noted in this article. In addition, the broker-dealers that are associated with registered representatives who operate unaffiliated investment advisers under this model must be aware of, and manage, the risks that they have assumed, since these broker-dealers exercise no supervisory control over the activities of the unaffiliated investment advisers.

VI. Conclusion

Given the separate regulatory regimes, the different standards of conduct and the voluminous regulatory requirements, the operation of a dually-registered firm can be a daunting task. A culture of compliance and a desire to implement best practices can go a long way toward meeting the challenges that lie ahead. Effectively managing conflicts of interest, providing meaningful and understandable disclosures and making suitable recommendations of products, strategies and platforms are just a few of the ways that dual registrants can successfully meet these challenges.

ENDNOTES

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1 SEC, Examination Priorities for 2013 (February 21, 2013); SEC, Examination Priorities for 2014 (January 9, 2014); SEC, Examination Priorities for 2015 (January 13, 2015).

2 Id.

3 Section 202(a)(11). See also Applicability of the Investment Advisers Act of 1940 to Financial Planners, Pension Consultants, and Other Persons Who Provide Others with Investment Advice as a Component of Other Financial Services, Investment Advisers Act Release No. 1092 (October 8, 1987).

4 See Investment Adviser Association, Letter to SEC commenting on Study Regarding Obligations of Brokers, Dealers, and Investment Advisers ("IAA Letter") (August 30, 2010).

5 See Exchange Act Release No. 27018 (July 18, 1989).

6 See, e.g., IAA Letter, supra, note 4.

7 See Michael B. Koffler, The Brave New World of Fiduciary Duty for Broker-Dealers and Investment Advisers, Envestnet White Paper (February 2010).

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Regulation of Municipal Advisors: 2014 Developments

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Congress passed the Dodd-Frank Act in 2010, but it took until 2014 for its regulatory implementation to hit stride. The Securities and Exchange Commission ("SEC"), Municipal Securities Rulemaking Board ("MSRB") and even Financial Industry Regulatory Authority ("FINRA") finally got on the same page and started rolling out implementing regulations.

I. The Rules That Apply to New Municipal Advisors

A. Dodd-Frank

1. Statutory Provisions

- **Dodd-Frank Requires Registration, MRSB Regulation of Municipal Advisors**

The "Dodd-Frank Wall Street Reform and Consumer Protection Act,"[1] amended the Securities Exchange Act of 1934, specifically Section 15B – the Municipal Securities provisions added by Congress in 1975.[2]

The key Municipal Securities provisions of Dodd-Frank are:

- **Registration and Oversight of Muni Advisors**

Who is Covered: Anyone who solicits or provides advice to or for a municipality or *obligated person* regarding *municipal financial products* or securities (including structure, timing, terms or similar aspects). The Act expressly includes financial advisors ("FA's"), guaranteed-investment-contract ("GIC") brokers, third-party marketers, placement agents, solicitors, finders and swap advisors.

Who is Not Covered: The Act does not require registration of otherwise regulated brokers, dealers, municipal securities dealers who are acting as an underwriter or placement agent (now narrowly defined under the regulations), investment advisers, commodity trading advisers advising on swaps, or lawyers or engineers – but only in their pure roles as such.

Who is an Obligated Person? Anyone obligated by contract or arrangement to support the payment of any part of the obligations on the municipal securities in an offering.

What is a Municipal Financial Product? Beyond municipal securities, the Act now covers municipal financial products, which includes municipal derivatives, GICs and "investment strategies" for municipal securities proceeds.

Who is Covered? Anyone who solicits or provides advice to or for a municipality or obligated person regarding municipal financial products or securities....

Registration and Regulation will include: Registration; Oversight (e.g. examinations, record-keeping, testing, continuing education and fees); Rule-making; and Compulsory arbitration among industry participants (but not as to the public).

A New Fiduciary Standard. The Act imposes a statutory fiduciary standard:

> "A municipal advisor and any person associated with such municipal advisor shall be deemed to have a fiduciary duty to any municipal entity for whom such municipal advisor acts as a municipal advisor, and no municipal advisor may engage in any act, practice, or course of business which is not consistent with a municipal advisor's fiduciary duty or that is in contravention of any rule of the Board."

Antifraud Provisions: The Act imposes anti-fraud provisions that mirror long-standing federal securities law anti-fraud rules proscribing "any fraudulent, deceptive, or manipulative act or practice." **Note:** MSRB Rules implementing the fiduciary standard will be much broader than mere anti-fraud rules.

- **MSRB Composition and Oversight:**

Expanded Composition. The Act expanded the composition of the MSRB to 15 total Board members, of whom eight must be independent (with at least one representative each for investors, municipalities, and the public) and the remaining seven industry representatives (with at least one representative each for banks, non-banks, and advisors).

Expanded Jurisdiction. The Act expanded the MSRB's jurisdiction beyond the protection of investors, to include: (a) protecting municipalities and their *obligated persons*; and (b) regulatory jurisdiction over advisors and over municipal financial products and investment strategies, not just municipal securities.

GAO Studies. Congress directed the Government Accountability Office to conduct studies on: (a) Municipal Disclosures, and particularly whether to repeal the Tower Amendment (part of the Securities Acts Amendments of 1975 that created the MSRB but prevents it and the SEC from imposing disclosure requirements on state and local governments); (b) Municipal Markets; and (c) The role and importance of Governmental Accounting Standards Board ("GASB") standards (especially those regarding unfunded pension liabilities).

SEC Changes. In Dodd-Frank, Congress formalized and elevated the SEC's Office of Municipal Securities to report directly to the Chairman (it previously was part of the Division of Trading & Markets) and also statutorily required coordination among the SEC, FINRA and MSRB.

GASB Funding. The Act authorized the SEC to require FINRA members to pay an annual fee to fund GASB.

2. Rulemaking

The SEC's and MSRB's rule-making efforts to implement Dodd-Frank's municipal-advisor provisions "stumbled out of the gate, but proved to be fast in the turn." Dodd-Frank set a firm deadline of October 1, 2010 for implementation of its MA provisions. Seemingly caught off-guard, the SEC adopted "interim final temporary" Rule 15Ba2-6T on September 1, 2010. It provided an interim web-based registration mechanism, but without the full suite of implementing Rules. The "interim final temporary" Rule was set to sunset at the end of 2011, but the Commission delayed it through September 30, 2012 and again through 2013, to accommodate the considerable comment and delay in its substantive rule-making.

The MSRB also "stumbled out of the gate" during July-August 2011 by proposing five new Rules designed to implement the MA regime. But those proposals jumped the gun on the SEC's adoption of the basic MA Rule. As a result, MSRB pulled those Rule proposals on September 9, 2011.[3]

B. SEC's MA Rule

The SEC adopted the new Municipal-Advisor Rule in September, 2013.[4]

1. Registration

Municipal advisory firms and their associated persons engaging in municipal advisory activity must register with the SEC by filing Form MA for firms, with Form MA-I for each associated person engaged in MA activity. Each has the familiar disclosure reporting pages ("DRPs"). They must be updated annually or promptly after any material changes. Forms MA and accompanying documents should be filed through the Commission's EDGAR electronic-filing system.

2. Structure and Key Elements

The SEC's new Municipal Advisor Rules, 17 CFR §§ 240.15Ba1-1 to 15Ba1-8, were to become effective Monday, January 13, 2014 but that morning were delayed until July 1, 2014.[5] Adopted last September,[6] the Rules implement Dodd-Frank § 975 by requiring registration (firm only, not individuals), imposing a fiduciary duty upon MAs (and their control affiliates), and subjecting MAs to SEC, FINRA and MSRB rules regarding Supervision; Conflicts; Gifts & Entertainment; Political Contributions; Books & Records; Business Communications; Compensation and Contracts; and Training.

The new Municipal Advisor regulatory regime focuses upon behavior in a facts-and-circumstances manner, rather than upon status. It is a fundamental departure from many aspects of the MSRB's prior "issuer-centric" status-based regime.

C. MA or Not?

The key determinant under the Rule is whether one is engaged in Municipal Advisory activities. The determinants are:

1. *Providing Advice.* Whether activities constitute "providing advice" is a facts and circumstances test depending upon the presence of a recommendation, based upon the same "call to action" touchstone in the FINRA suitability standards.[7] "Advice" excludes general widely-disseminated material (also like FINRA Rule 2111), such as:

> "Information of a factual nature without subjective assumptions, opinions, or views;
>
> "Information that is not particularized to a specific municipal entity or type…;
>
> "Information that is widely disseminated for use by" non-municipals / public;
>
> "General information in the nature of educational materials"

Adopting Rel. at 45. The staff endorsed a more expansive view in FAQs issued January 10. "Advice" also excludes a statement of qualifications responding to Requests for Proposal (RFP) (unless separately compensated).

2. *Regarding the Issuance of? Municipal Securities* (from conception to grave) or the ***Investment of Proceeds*** (the same as IRS standard[8]) ***of Municipal Securities***, including investment strategies for proceeds or escrow funds, or municipal financial products (e.g. muni derivatives) or the ***Solicitation of a Municipality or Obligated Person*** (on behalf of others, not self or affiliates; for compensation, whether direct or indirect).

3. Status-Based Exemptions. The Rules do not apply to:

a. Municipal entities or obligated persons, their employees and board members (when acting within the course and scope of their employment or board positions[9]);
b. General RFP responses "to get hired";
c. Independent Registered Municipal Advisor "IRMA" advice to a client (the "independence" requirement carries a two-year affiliation conflict look-back), with written bilateral non-reliance disclosures and the client's affirmative representation that it ***is relying*** on the independent MA (somewhat like the FINRA institutional-client safe harbor[10]).

4. Activities-Based Exclusions. The Rule also provides some activities-based exclusions, including:

a. Banks acting as such with respect to municipal clients;
b. Underwriters, but only to extent of traditional underwriting activities integral to ***the particular*** underwriting from engagement to "end of underwriting" (per the MSRB Glossary);
c. Swap Dealers, acting as such;

d. Registered Investment Advisors ("RIA's"), acting only as RIAs (and not as MAs);
e. CPAs acting in an audit or attest capacity (but not excluded as to tax or arbitrage advices);
f. Attorneys acting as attorneys (but not when acting as a financial specialist); and,
g. Engineers acting as engineers.

D. MSRB Rules – Generally

1. Registration

Municipal Advisors also must register with the MSRB (in addition to the SEC) by filing MSRB Form A-12. Filings – including updates to prior registrations – should have been completed by August 10, 2014.[11]

2. Qualifications

The MSRB determined (at its August 5, 2014 meeting) to submit for SEC approval amendments to MSRB Rules G-1, G-2 and G-3 that would establish qualifications requirements for new registration classifications for Municipal Advisor Representatives and Municipal Advisor Principals. The MSRB presently is requiring a qualification examination for MA Representatives (tabling consideration of an additional MA Principal exam – at least for the moment), with a one-year grace period for passing the exam.[12]

The MSRB presently is developing the MA Representative exam and expects to make it available in 2015. The MSRB filed the proposed Rules with the SEC on August 6, 2014.[13]

3. Conduct – Revised Draft Rule G-42: Duties, Disclosures, Do's and Don'ts

The MSRB proposed a Revised Draft of Rule G-42 ("Duties of Non-Solicitor Municipal Advisors") by Reg. Not. 2014-12 issued July 23, 2014.

The Revised Draft Rule G-42 contains the same basic structure and objectives as originally proposed. It establishes

(a) Duties owed by Municipal Advisors ("MAs") to Municipal Entity ("ME") clients and to Obligated Persons ("OPs");
(b) An engagement-letter-type disclosure regime with certain required disclosures;
(c) A suitability requirement MAs must follow (Do's); and,
(d) Various prohibitions (Don'ts)

The Draft Rule's high-points and notable revisions include:

Duties: Section (a) of the Draft Rule imposes fiduciary duties to ME clients (duties of care and loyalty), but a regular duty of care to OPs. The Supplementary Material removes the prior requirements of thorough Offering Statement review[14] and of investigating alternatives,[15] instead allowing parties to determine and define the scope of each engagement.

Disclosures: Sections (b-c) implement an "engagement letter" disclosure regime. Among the key revisions to this Draft:

- Compensation disclosures are narrowed, by requiring compensation-related conflict disclosures only when they arise from compensation contingent on the size or closing of a transaction[16] and deleting the requirement to disclose the amount of expected compensation.[17]
- Conflicts disclosures have been narrowed, limiting disclosure of other engagements or relationships to the MA (and deleting affiliates, who must disclose their relationship conflicts themselves, e.g. in OS)[18] and limiting the no-conflict certification only to "known" conflicts.
- The Revised Draft no longer requires disclosure of professional liability insurance.[19]
- Disciplinary disclosures now mimic Form MA information, with instruction on accessing the Form and the date of last change or revision.[20]
- The Revised Draft no longer requires recitation of specific undertakings requested by client.[21]
- Engagement letters must address provisions for termination or withdrawal, and require updating with any material changes during relationship.[22]

Do's: The Revised Draft merges the suitability obligation for principal MA-client recommendations and third-party review engagements (previously articulated separately) and restates the Rule positively (e.g. "if, then must").

The Revised Draft adds a new safe-harbor provision governing inadvertently-provided municipal advice. An actor not otherwise an MA under the Rule may avoid MA status for inadvertent advice if it: (a) Promptly documents by dated disclaimer and ceases the inadvertent advice; (b) provides notice to the recipient of non-disclosures that were required under the Rule; (c) makes good-faith efforts to identify the unintended advice; (d) requests client acknowledgement; and (e) conducts a self-review of compliance/supervisory procedures to prevent recurrence.[23]

Don'ts: The Revised Draft clarifies or limits some prohibitions. Key among them:

- The fee-splitting prohibition between MAs and underwriters now is limited to the transaction on which the MA advised.[24]
- The "Principal Transaction" prohibition is limited in two ways: First, it defines "Principal Transactions" as those involving the "purchase or sale of a security, derivative, GIC or financial product" for its own account to/from the counterparty ME by MA or affiliate;[25] and second, it limits it to those directly related to the transaction or product on which the MA is advising.[26] Finally, the Principal Transaction ban does not apply to the acquisition of an entire offering as permitted by Rule G-23.[27] The comment period expired August 25, 2014.

4. Supervision – Rule G-44

In October 2014, the SEC approved MSRB Rule G-44 on Supervision of municipal advisors.[28] Proposed earlier in the year in Regulatory Notice 2014-04, Rule G-44 mimics the familiar supervision and compliance rules otherwise applicable to broker-dealers under FINRA Rule 3130. Key provisions include:

- A supervisory system reasonably designed to achieve compliance with applicable securities laws;
- Written supervisory procedures;
- Designation of MA principals responsible for supervision;
- Compliance procedures reasonably designed to achieve compliance with applicable securities laws, regulations, and rules;
- Annual review and certification;
- Designated Chief Compliance Officer to administer and test the firm's procedures; and
- Accompanying books and records requirements.

II. Regulatory Expectations

A. New Focus with Congressional Mandate = New Zeal

In its January 2015 National Exam Program Priorities, the SEC's Office of Compliance Inspections and Examinations' ("OCIE") priority No. 5 included: Municipal Advisors; New Registrants under Dodd-Frank.

On August 19, 2014, OCIE announced a two-year, three-phase examination initiative targeting newly-registered municipal advisors.[29] The MA Examination Initiative hopes to engage a significant portion of newly-registered MAs.

In the first phase, Engagement, OCIE will engage in nationwide outreach to inform MAs of their obligations under Dodd-Frank, the SEC's new MA Rule and related implementing Rules by MSRB and others.

The second phase, Examination, will review identified risk areas of selected MAs including compliance with at least the following requirements: (1) Registration; (2) Fiduciary Duty; (3) Disclosure; (4) Fair Dealing; (5) Supervision; (6) Book and Records; and (7) Training and Qualifications.

The third phase, Informing Policy, is a feed-back loop using the information gathered to suggest further refinement of the new regulatory regime for municipal advisors.[30]

B. Stops & Starts in Rule-Making

As soon as the SEC originally proposed its MA Rule for comment, the MSRB jumped into the fray with a series of five proposed rules on the subject. The MSRB soon recanted and withdrew its rule proposals. Staff at both the SEC and MSRB have been relatively quick to propose implementing Rules and respond to the considerable comment received.

C. Enforcement is Engaged.

1. MCDC Cooperation Initiative

The SEC announced on July 8, 2014, its first settled administrative proceeding against a municipal issuer under its Municipal Continuing Disclosure Cooperation ("MCDC") Initiative.[31] In its Order, the SEC charged Kings Canyon Joint Unified School District with violating '33 Act § 17(a)(2) by making an untrue statement of material fact in a 2010 bond offering that the District had complied with prior continuing-financial-disclosure obligations (required by Rule 15c2-12) undertaken in other bond offerings sold in 2006 and 2007. The District certified it had complied with those obligations when, in fact, it had failed to file some of the earlier disclosures. The District neither admitted nor denied the allegations, but undertook to adopt new compliance policies and procedures, update all prior disclosure filings, cooperate with the Commission's investigations and disclose the settlement in all offerings over the next five years.[32]

The *Kings Canyon* settlement terms are standard for issuers who self-report under the SEC's MCDC Initiative. The Commission announced the Initiative on March 10 of this year, as part of its broader Dodd-Frank oversight of the nation's municipal markets. The Initiative is structured to incentivize issuers to self-report (without any fines) and disclose the securities underwriters involved – who then will face fines and similar settlement terms if they also self-report. Reporting broker-dealers face fines of $20,000-60,000 per offering (capped at $500,000), as well as requirements for independent compliance-consultant review of underwriting and due-diligence policies and procedures and continued cooperation. Commission Staff have indicated they will not vary the MCDC settlement terms and hope to foster "first-in" behavior, saying that firms not self-reporting will face harsher sanctions.

The [Dodd-Frank] Act imposes a statutory fiduciary standard.

Industry groups like SIFMA and Bond Dealers of America pushed the Commission Staff for some changes to the Initiative, and the SEC's Enforcement Division modified its MCDC Initiative to (a) extend the deadline for issuer disclosures until December 1, 2014 (from September 1) and (b) implement a tiered set of caps on fines, more proportional to underwriters' revenues.[33]

2. More Active Municipal-Securities Enforcement.

The SEC continued to ramp up its enforcement efforts in the municipal-securities realm. The agency announced a series of settled actions on November 6.

a. First "Control Person" Charge Against Issuer Officials

The Commission announced a settled administrative proceeding against municipal issuer Allen Park, Michigan and settlements in federal-court actions against the City's former Mayor and City Administrator. The SEC charged that offering documents for two bond issues knowingly painted too rosy a picture for a $146 million film-studio project which had been all but abandoned in the face of an undisclosed budget deficit by the time the bonds were issued. The Commission sued the ex-mayor and ex-administrator in federal court, asserting "control person" liability for directing and approving the City's bond issues with knowledge the offerings' disclosures were outdated and overly-optimistic. Both men were barred from participating in further municipal-securities offerings and one paid a $10,000 fine.[34] The suits were the Commission's first use of "control person" liability against elected issuer officials. "When a municipal official … controls the activities of others who engage in fraud, we won't hesitate to use every legal avenue available to us in order to hold those officials accountable," said the Chief of Enforcement's Municipal Securities and Public Pensions Unit.

Due to the 11th Amendment and the Tower Amendment to the MSRB's enabling legislation, the SEC cannot regulate municipal issuers directly. But it can, and does, prosecute them for false statements in municipal-securities offerings. Using the expanded reach of its administrative forum authorized by Dodd-Frank reforms, the SEC typically charges issuers with negligent violations of anti-fraud rules in settled administrative proceedings including "go-forth-and-sin-no-more" cease and desist provisions, without monetary penalties.[35]

But the SEC's releases, and press coverage of remarks in the days after, did not disclose that the Court vacated the settlement the day after it was entered. Judge Cohn vacated his judgment as "improvidently granted." The Court faulted the SEC for not providing "all of the relevant facts," because the filings made "no mention … of the role of financial advisors, underwriters and law firms … involved in the marketing of [the] municipal bonds."[36]

b. "Broken Windows" for Munis, too.

On November 3, the Commission announced a raft of enforcement actions against thirteen municipal securities dealers for selling Puerto Rico junk bonds to investors in amounts lower than the $100,000 minimum denomination set for the issue. The action was brought by another agency first — this time, the first Enforcement action charging violations of MSRB Rule G-15(f). The Rule has been on the books for years, and self-regulatory organization NASD (now, FINRA) first fined dealers for minimum-denomination violations in 2006. SEC Enforcement Director Ceresny pointed to the Commission's new municipal emphasis, saying "These actions demonstrate our commitment to rigorous enforcement of all types of violations in the municipal bond market."

The thirteen firms settled without admitting or denying the charges, and agreed to censure, compliance-policy reviews and fines varying from $54,000 – $130,000.

The actions amount to strict-liability offenses and are another manifestation of Chair White's "broken windows" policy seeking to spur greater industry-wide compliance by prosecuting every offense identified. These actions follow other recent mass-prosecutions in connection with, *e.g.,* 8K filings, Form-4 reports, and Rule 105 short sales.[37]

c. City of Harvey Injunction.

In June 2014, the SEC obtained an injunction against the City of Harvey, Illinois and its comptroller to stop an allegedly fraudulent bond offering that misrepresented the proposed use of proceeds and for having failed to disclose the diversion of proceeds from intended uses under prior offerings. The City later agreed to a consent injunction, remedial consultancy and audit provisions as well as a three-year ban from future offerings (unless retaining independent disclosure counsel).[38]

III. Policies and Procedures You Should Have

A. Supervision and Compliance

1. MSRB G-44 is Like FINRA Rule 3310

MSRB Rule G-44, like the FINRA Rule 3110 supervision and compliance regime, requires a supervisory system reasonably designed to achieve compliance with applicable securities laws:

- Written supervisory procedures;
- Designation of MA principals responsible for supervision;
- Compliance processes reasonably designed to achieve compliance with the firm's policies;
- Annual review and certification;
- Designated Chief Compliance Officer to administer the annual process; and
- Accompanying books and records requirements.

Like the FINRA regime, what procedures you have will be determined in large part by the contours of your firm's particular business. For example, if your firm is a registered MA and works frequently with larger issuers having their own IRMA, you may need fewer supervision and compliance procedures than would, for example, a broker-dealer un-registered as an MA and attempting to rely solely upon the underwriting exemption. The Rule becomes effective April 23, 2015.[39]

2. Rule G-37: Pay-to-Play Compliance

The MSRB requested comments on proposed amendments extending Rule G-37 to MAs in August.[40] Any MA supervision and compliance regime should extend to MAs the pay-to-play prohibitions of existing Rule G-37. The key provisions of the Rule:

- Prohibit municipal securities business with an issuer within 2 years following any contribution to an official of that issuer by any broker, dealer, associated municipal securities professional or controlled PAC – the proposed revisions would cover equivalent designations among municipal-advisory personnel;

REGULATED ENTITY SUBJECT TO A BAN	I. DEALER	II. NON-SOLICITOR MUNICIPAL ADVISOR	III. MUNICIPAL ADVISOR THIRD-PARTY SOLICITOR (FOR PURPOSES OF THIS TABLE, "MATP SOLICITOR")	IV. DEALER-MUNICIPAL ADVISOR (FOR PURPOSES OF THIS TABLE, "THE FIRM")	
CONTRIBUTOR	the dealer*	the municipal advisor**	the MATP solicitor**	the firm*	
	an MFP of the dealer*	an MAP of the municipal advisor**	an MAP of the MATP solicitor**	an MFP of the firm*	an MAP of the firm**
	a PAC controlled by the dealer*	a PAC controlled by the municipal advisor**	a PAC controlled by the MATP solicitor**	a PAC controlled by the firm*	
	a PAC controlled by an MFP of the dealer*	a PAC controlled by an MAP of the municipal advisor**	a PAC controlled by an MAP of the MATP solicitor**	a PAC controlled by an MFP of the firm*	a PAC controlled by an MAP of the firm**
	If an MATP solicitor is engaged to solicit municipal securities business on behalf of the dealer, the persons in column III**	If an MATP solicitor is engaged to solicit municipal advisory business on behalf of the municipal advisor, the persons in column III**		If an MATP solicitor is engaged to solicit municipal securities business or municipal advisory business on behalf of the firm, the persons in column III**	
	* under existing Rule G-37 ** under the draft amendments to Rule G-37				

- Are subject to a *de minimus* exception excluding contributions up to $250 to candidates for whom the contributor is eligible to vote (provided it is reported);
- Prohibit bundling and solicitation;
- Apply to bond ballot initiatives.

3. Gifts: Proposed Rule G-20

The MSRB's proposed extension of its gift-limitations Rule G-20 would encompass municipal advisors. The Proposed Rule generally limits gifts in relation to municipal securities or advisory services to $100 per year. The limit excludes normal-course (not excessive) business entertainment or sponsorships, transaction commemoratives, or personal gifts (e.g. birthdays, weddings). The comment period closed December 8, 2014.[41]

4. *Continuing Education*

The SEC approved MSRB's extension of its firm-element continuing-education requirement to municipal advisors.[42]

B. Key Documents & Safeguards

1. Engagement Letters

Like the engagement-letter disclosure regime for underwriters (MSRB Rule G-17) and for Financial Advisors (MSRB Rule G-23), Revised Draft Rule G-42 requires a series of written disclosures.

MAs may need to "train their clients" to help them adjust to the new requirements and may use an iterative process, refining the engagement letter throughout the relationship. For example, the SIFMA draft documents have a proposed preliminary engagement letter for underwriters.[43] Those relying on the Underwriter exemption should use a similar letter to comply with the Rule G-17 Underwriter Disclosure requirements, perhaps following the SIFMA Model Disclosure letter.[44]

Under Revised Draft Rule G-42, an MA's engagement letter must include:

- A writing (may be a contract, letter, exchange of emails or other); addressing:
- The scope of the representation and any limitations (although the MSRB removed the prior requirement to state any specific client requests, their inclusion may yet be a best practice);
- The form and basis of compensation (direct and indirect);
- Disclosures of:
  - All material conflicts (or certification that there are no known material conflicts);
  - Affiliates providing to client goods, services, investments, etc. related to the MA activities to be performed (which may be met by the affiliates' disclosures);
  - Payments made to obtain the business;
  - Payments received to make recommendations;
  - Fee-splitting arrangements with anyone providing services/investments to client;
  - Material conflicts arising from compensation contingent on size or closing of deal;
  - DRP Disclosures material to evaluation of MA & integrity of personnel, together with a link to the most recent Forms MA and MA-I and the date of the last material change to legal or DRP.
- Duration and termination (or withdrawal) of the relationship.

It is unlikely that municipal-entity or obligated person clients will be accustomed to using such letters, much less signing and returning them. Further, deal documentation may be "adopted" or "approved" only toward the end of the process as exhibits to or part of a formal bond approval or similar ordinance. In such cases early communication (even if not "final") with decision-makers is important. MAs and others also may need to use "estoppel" or "negative acquiesce" letters making the required disclosures and requesting immediate written notification if the client's understanding differs (instead of seeking affirmative signature and return).

2. IRMA Letters

The Rule exempts from registration those who provide municipal advice to an ME or OP which is relying upon its own Independent Registered Municipal Advisor ("IRMA").[45] The IRMA exemption under Rule 15Ba1-1(d)(3)(vi) only applies if the appropriate circumstances are properly documented (*see* discussion below). Consequently, SIFMA's MA document set includes a proposed IRMA letter.[46]

3. RFP Response Language

The Commission agreed with commenters that "responses to RFPs or RFQs alone do not constitute municipal advisory activities," and Rule 15Ba1-1(d)(3)(iv) exempts those responses, provided they are not separately compensated.[47] Consequently, SIFMA's MA document set includes proposed RFP/RFQ language for use by MEs or OPs seeking advice on particular topics within the framework of the RFP/RFQ exemption.[48]

4. Consent Certificates Regarding Bond Proceeds

The Adopting Release provides that one may reasonably rely on a written certification of a knowledgeable ME or OP official.[49] Consequently, SIFMA has included among its Municipal Advisor document set Model Negative Consent / Affirmative Consent Certificates relating to Bond Proceeds, that certify invested funds are not proceeds of municipal securities or municipal escrow investments.[50]

5. Preliminary Underwriter Letter of Intent

Given the timing sequence common among municipal-securities deals (in which the actual formal recognition of retention of the underwriter may only come in a bond resolution well after much of the actual work has been completed), SIFMA's document set includes a form of Underwriter Letter of Intent that may precede the formal MSRB Rule G-17 engagement letter and/or be sent in an email to verify a preliminary oral engagement.[51]

IV. Defining the Underwriting Exclusion

The Rule contains an "underwriter exclusion" for brokers, dealers or municipal securities dealers when serving as an underwriter of a particular municipal issue? in traditional underwriting functions.[52] When adopting the Rule, the Commission declined to adopt a "solely incidental" standard for registered brokers or dealers and instead adopted a narrowly-defined "underwriting exclusion." The starting point for that determination? is the Rule's touchstone concept of municipal "advice."

A. When Are You Giving Advice?

The Rule governs the provision of "advice" regarding municipal financial products or the issuance of municipal securities. "Advice" is "construed broadly" on a "facts and circumstances" basis and rests upon a particularized recommendation – a call to action (or to refrain) – distinguished from general and broadly-applicable factual information.

The **General Information Exclusion** encompasses

(a) professional qualification and prior experience;
(b) general market and financial information;
(c) a financial-institution's currently available investments (terms, maturities, etc) or price quotes for products specified by the ME or OP;
(d) factual descriptions of various debt-financing structures;
(e) factual / educational information about government financing and incentive programs.
(f) even some particularized information, such as current prices and yields for an ME's outstanding bonds.

Some disclosures can help, for example: (a) No recommendation is being made here?; (b) the originator is not acting as an advisor or fiduciary; (c) Acting for your own interest; and (d) Discuss with your own advisors.[53]

The **business-promotion exclusion** also could cover non-recommendatory materials including: (a) indications of hypothetical new-issue pricing using factors particular to the prospective issuer; (b) market information about an issuer's outstanding securities; (c) information regarding ranges of hypothetical rates or debt-service requirements for new-money debt of varying maturities; (d) public information regarding State and Local Government Series treasuries (SLG's)[54] for refunding; and (e) calculations of potential refunding arbitrage. This exclusion would be strengthened by disclaimers that the broker-dealer is seeking to act in its own interests as an arms-length underwriter and not as a municipal advisor, and the information is provided only for discussion.[55]

The Adopting Release generally distinguishes between providing information and making a recommendation.[56] "'[A]dvice' can be construed broadly" thus depends on a "facts and circumstances" inquiry.

Advice excludes provision of general information not involving a recommendation. For example, advice ***does not*** include general information:

- "of a factual nature without subjective assumptions, opinions, or views;"
- "not particularized to a specific ME or type of ME"
- "widely disseminated for use by the public, clients or market participants other than MEs or OPs"; or,
- general educational information (instructional or explanatory; no past or project performance figures; no recommendation; how to get more info).

Advice ***DOES*** include recommendations particularized to the needs of an ME or OP and is an objective inquiry whether the communication "reasonably would be viewed as a suggestion to" act or refrain from acting. That inquiry rests on a sliding scale, so that the "more individually tailored" to a more narrow group, "the more likely it will be a recommendation that constitutes advice."

B. What is the "Underwriting Activity"?

In its "underwriter exclusion," the Rule takes a narrow view of traditional underwriting activities that may differ materially from former roles of underwriters "quarterbacking the deal." This shift from "quarterback" to a more technical "service-provider" role may require underwriters to be diligent in training their clients to the new Rule's requirements.

The Adopting Release contains some lists of activities presumptively within the scope of traditional underwriting activities and, thus, the Underwriter Exclusion."

Fine Nine:

(1) Advice about structure, timing, terms of a particular issue (but not investment strategies or derivatives);

and advice or assistance with…

(2) Rating strategies preparation and presentations;
(3) Investor Relations road-shows and assistance for this issue;
(4) Retail order periods and institutional marketing of negotiated deals;
(5) OS preparation;
(6) Closing details and negotiations (e.g. documents, certificates, opinions);
(7) CUSIP, registration and DTC issues;
(8) Post-sale reports;
(9) Structuring refunding escrow cash flow requirements (but not investment of proceeds).

The Adopting Release also lists 12 activities presumptively outside the scope of traditional underwriting activities.

Dirty Dozen: Advice on…

(1) Investment strategies;
(2) Municipal derivatives (including valuation);
(3) Method of sale (whether competitive or negotiated);
(4) Whether to approve or authorize an issuance;
(5) Bond election campaigns;
(6) Non-issue-specific analysis or strategic advice on financing options, debt capacity, portfolio impact, variable assumption scenarios, etc.
(7) Assisting issuers with conducting competitive sales;
(8) Financial feasibility analyses of new projects;
(9) Budget planning and analysis re: debt issuance;
(10) Overall rating strategies beyond a given issuance;
(11) Overall financial controls beyond a given issuance;
(12) Forming, issuing and evaluating RFP/RFQs.

But even these activities – although precluding reliance on the underwriting exclusion – would not require MA registration if otherwise: (a) inapplicable to municipal financial products or issuance of municipal securities; (b) within RFP/RFQ exclusion; (c) within the IRMA exemption.[57]

C. The IRMA Exemption

The Rule exempts from registration those who provide municipal advice to an ME or OP which is relying upon its own Independent Registered Municipal Advisor ("IRMA").[58] The IRMA exemption under Rule 15Ba1-1(d)(3)(vi) only applies if the appropriate circumstances are properly documented, including:

(1) The IRMA and the party claiming the exemption are advising on the "***same aspects*** of the municipal financial product or issuance of municipal securities;"
(2) The IRMA is registered and has not been associated (at the entity and at the individual levels) with the party claiming the exemption within the past two years;
(3) The ME or OP provides a written representation that it is relying on its own MA and the circumstances render reliance upon it reasonable; and,
(4) The party claiming the exemption provides written "I'm not your MA, not fiduciary, and have these conflicts" disclosures to the ME or OP ***and*** to its IRMA.

Consequently, SIFMA's MA document set includes a proposed IRMA letter.[59]

D. Inadvertent Advice Safe Harbor

The MSRB's Revised Draft Rule G-42 ("Duties of Non-Solicitor Municipal Advisors") published July 23, 2014,[60] proposed a safe-harbor for inadvertent provision of municipal advice under circumstances where the parties do not intend a municipal advisory relationship. Supplementary Material .06 would provide a safe-harbor from the conflict-disclosure and engagement-letter requirements of Rule G-42(b) and (c), provided the client is promptly given a written and dated disclaimer that (a) the advice was inadvertent and has stopped; (b) the ME or OP should know that required conflicts and other disclosures have not been made; (c) the advisor has taken good-faith steps to identify the inadvertent advice; (d) asking the ME or OP to acknowledge receipt; and (e) the inadvertent advisor also must conduct a compliance review reasonably designed to prevent a recurrence.[61]

V. Sample Forms to Use

We have discussed above some forms that should be used as best practices. Many of them can be found among the Municipal Advisor Model Documents portion of SIFMA's Municipal Securities Markets forms and documents page,[62] including:

- Consent Certificates re: Bond Proceeds
- Model Disclosures / Disclaimers for General Information Exclusion
- Model IRMA Language & Confirmation
- Model RFP Language
- Talking Points for Public Finance Bankers
- Model Engagement Letter (Underwriter)

VI. Ahead for 2015.

Implementing the Municipal Advisor regulatory regime remains atop the MSRB's strategic priorities for 2015. It will submit its pay-to-play (G-37) and municipal-advisor duties (G-42) rule proposals for SEC approval. MSRB will continue to develop its municipal-advisor representative (and perhaps principal) qualification examination(s).[63] Expect municipal-advisor regulation and enforcement to continue apace in the coming year.

ENDNOTES

1 Pub. Law. No. 111-203 (111th Cong.) (H.R. 4173 at Title IX, Subtitle H, Secs. 975-979).

2 codified at 15 U.S.C. §78o-4(a), *et seq.*

3 *See* T. Potter & B. Coulter, *"Hurry Up and Wait: Municipal Advisor Registration,"* NSCP Currents at 14 (Jan./Feb. 2012).

4 17 C.F.R. § 15Ba1-1. *See Issuing Release,* SEC Rel. No. 34-70462.

5 *See SEC Rel. 34-71288*.

6 *SEC Rel. 34-70462.*

7 The FINRA Guidance in connection with the most recent iteration of its "suitability" rule used the "call to action" description to illustrate the hallmark of a covered "recommendation" in the context of a decision to hold a current investment position. *See Reg. Not. 11-25* (FINRA July 9, 2012) (Q&A#7).

8 Long-standing IRS provisions and accompanying regulations define the "investment" of municipal-bond "proceeds" for purposes of the arbitrage restrictions that – if violated – could lead to forfeiture of the bond's tax-exempt status. See IRC section 148; Treas. Reg. secs 1.148-1 to -11; Adopting Release at 90-92.

9 When municipal employees or board members act *outside* the normal course and scope of their official duties, they lose their status-based registration exemption.

10 FINRA Rules 2111(b) and 4512(c)

11 *See* MSRB Reg. Not. 2014-05. Further information can be found here: http://www.msrb.org/Rules-and-Interpretations/MSRB-Registration.aspx .

12 *See* MSRB Reg. Not. 2014-08.

13 *See* SR-2014-05.

14 Reg. Not. 2014-12(-.01).

15 Reg. Not. 2014-12(-.02).

16 Draft Rule G-42(b)(i)(F).

17 Draft Rule G-42(c)(ii).

18 Draft Rule G-42(b)(i)(G).

19 Draft Rule G-42(b)(i).

20 Draft Rule G-42(b)(ii-iii), (c)(iii-iv).

21 Draft Rule G-42(c)(v).

22 Draft Rule G-42(c)(vii).

23 *See* Supplementary Material .06.

24 Draft Rule G-42(e)(i)(D).

25 Draft Rule G-42(e)(ii).

26 Draft Rule G-42(f)(i).

27 Supplementary Material -.07.

28 Reg. Not. 2014-19 (Oct. 23, 2014); *File SR-2014-06,* here: http://www.msrb.org/Rules-and-Interpretations/SEC-Filings/~/media/Files/SEC-Filings/2014/MSRB-2014-06.ashx .

29 *SEC Press Rel. 2014-170 (Aug. 19, 2014).*

30 OCIE's August 19 letter is here: http://www.sec.gov/about/offices/ocie/muni-advisor-letter-081914.pdf

31 http://www.sec.gov/divisions/enforce/municipalities-continuing-disclosure-cooperation-initiative.shtml

32 *In re Kings Canyon Joint Unified School District,* Rel. No. 33-9610, Admin. Proc. File No. 3-15966 (SEC July 8, 2014).

33 http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542578459#.U9us0vMo7ui

34 *See SEC v. Burtka,* No. 2:14-cv-14278 (USDC EDMI Nov. 6, 2014); *SEC v. Waidelich,* No. 2:14-c-14279 (USDC EDMI Nov. 6, 2014).

35 *See In the Matter of City of Allen Park, Michigan,* Rel. Nos. 33-9677; 34-73539 (Nov. 6, 2014).

36 http://www.bondbuyer.com/pdfs/VactingOrder.pdf

37 News Release No. 2014-248 (Nov. 5, 2014) (10 companies re 8K filings); News Release No. 2014-195 (Sept. 16, 2014)(19 firms and traders re Rule 105 short-sale violations); News Release No. 2014-190 (Sept. 10, 2014)(28 officers, directors, shareholders re Form 4 insider-sales reporting). *See* SEC News Release, No. 2014-246.

38 See Lit. Rel. No. 23149 (Dec. 5, 2014); Rel. No. 2014-122 (June 25, 2014).

39 Rel. No. 34-73415.

40 Reg. Not. No. 2014-15 (Aug. 18, 2014).

41 Reg. Not. 2014-18.

42 Reg. Not. 2014-17 (approved by SEC Oct. 15, 2014).

43 Form of Underwriter Letter of Intent, here: http://www.sifma.org/services/standard-forms-and-documentation/municipal-securities-markets/

44 http://www.sifma.org/uploadedfiles/services/standard_forms_and_documentation/municipal_securities_markets/sifmamodelg-17underwriterdisclosureletter07-18-2012.pdf?n=89752

45 *See Adopting Rel. at 151-57*.

46 *See* http://www.sifma.org/services/standard-forms-and-documentation/municipal-securities-markets/

47 *See Adopting Rel. at 148-151.*

48 *See* http://www.sifma.org/services/standard-forms-and-documentation/municipal-securities-markets/

49 *See Adopting Rel. at 100-06.*

[50] *See* http://www.sifma.org/services/standard-forms-and-documentation/municipal-securities-markets/

[51] *See* http://www.sifma.org/services/standard-forms-and-documentation/municipal-securities-markets/ ; *See also FAQ § 5.*

[52] *Rule 15B(e)(4)(C). See Adopting Rel. at 157-171.*

[53] *See FAQ 1.1.*

[54] State and Local Government Series" – also known as "SLGS" – are special purpose securities that the Department of the Treasury issues to state and local government entities, upon request by those entities, to assist them in complying with federal tax laws and Internal Revenue Service arbitrage regulations when they have cash proceeds to invest from their issuance of tax exempt bonds." http://www.treasurydirect.gov/govt/resources/faq/faq_slgs.htm

[55] *See FAQ 1.2*

[56] Section III.A.1.b.i at pp. 39-47.

[57] *Adopting Rel. at 164-68.*

[58] *See Adopting Rel. at 151-57.*

[59] *See* http://www.sifma.org/services/standard-forms-and-documentation/municipal-securities-markets/

[60] Reg. Not. 2014-12.

[61] *See Reg. Not. 2014-12 at 10, 30-31.*

[62] http://www.sifma.org/services/standard-forms-and-documentation/municipal-securities-markets/

[63] *See, e.g.,* SR-MSRB-2014-08 (Nov. 18, 2014).

Forms, Templates, Tools

Recognizing that the compliance officer's task can be made simpler and more efficient by the use of various forms, templates, and tools, over time we intend to build a library of documents here for your use and reference. If you have suggestions for specific forms or templates, contact David Thetford at (847) 267-2095 or at David.Thetford@wolterskluwer.com. Also, if you'd like to share a form or template that has proven helpful to you, we welcome your contribution which will be anonymous or attributed to you or your firm, whichever you prefer; please submit in Word or Excel via email to David Thetford at the email address above.

The forms, templates and tools in this section may be helpful for use in your firm's business, however, please recognize that they are generic in nature and are not designed for any specific firm. Also, these documents are not regularly updated, and therefore may be out of date. Should you choose to use any of these forms tools or templates, they should be tailored to your firm's specific policies, procedures and circumstances before implementation.

These documents are available in the hard copy version of Practical Compliance and Risk Management for the Securities Industry. They are also available electronically to subscribers to Wolters Kluwer Financial Service's Compliance Resource Network where they can be saved to a pdf file or to a Word or Excel document.

In This Issue

- **Authorization to Release Information and Waiver of Confidentiality**

This form, in PDF format, is a sample client authorization for the financial services firm to release the client's information to, and discuss the client's information with, individuals specified by the client. This form is provided by Sandy Adams, courtesy of the Center for Financial Planning, and accompanies Ms. Adams' article above, "Client Diminished Capacity from the Compliance Perspective."

- **Personal Financial Record System & Letter of Last Instruction**

This form, in PDF format, is a single-document repository to identify and locate a person's financial records including names, numbers, accounts, wills, investments, usernames, passwords, etc. It is quite a lengthy, thorough document. This form is provided by Sandy Adams, courtesy of the Center for Financial Planning, and accompanies Ms. Adams' article above, "Client Diminished Capacity from the Compliance Perspective."

AUTHORIZATION TO RELEASE INFORMATION

AND WAIVER OF CONFIDENTIALITY

The undersigned _______________________________________(“Client”), hereby authorizes ________________________________ (Advisors) (Client and Advisors, are collectively referred to herein as the “Parties”) to release information and/or waives his/her right to confidentiality as indicated below:

1. **EXPRESSED GENERAL WAIVER OF CONFIDENTIALITY**. All communications between the Parties are confidential and will not be disclosed to anyone without your expressed written consent. Notwithstanding the foregoing statement, I waive my right to confidentiality with respect to the following person(s), thereby authorizing the Advisor/Center for Financial Planning, Inc. to discuss with and release any and all confidential information and documents to the following list of individuals:

   My Accountant/CPA:____

   Address/Phone: ____

   My Attorney: ____

   Address/Phone: ____

My Family Members or other authorized persons:

Name: ____

Address/Phone: ____

____

Name:____

Address/Phone: ____

Name:____

Address/Phone: ____

Dated: ____

Signed: ____

____

Witness: ____

____

Center for Financial Planning, Inc.
Independent Registered Investment Advisor

PERSONAL FINANCIAL RECORD SYSTEM
&
LETTER OF LAST INSTRUCTION

CLIENT NAME:

SPOUSE / SIGNIFICANT OTHER NAME:

The Center for Financial Planning has prepared these two forms (together) to assist you in your financial record keeping. You may use this system two ways. The first is simply to print off this PDF document and fill in the information by hand. We encourage you to use the second method, which is to save the document in your own computer where you may then fill it in and more easily update it periodically.

This PDF document is an interactive form, which means you can simply open the document in Adobe Acrobat Reader which is a free program and can be downloaded at www.adobe.com. We do recommend having the latest available download when completing this form.

We suggest you update this information at least annually. Many clients find tax time is an opportune time to do this. The Center would be happy to securely store this document along with your other financial records.

Good luck and congratulations for taking this step!

24800 Denso Drive, Suite 300 Southfield, MI 48033 Fax (248) 948-1008 Phone (248) 948-7900
www.CenterFinPlan.com
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Center for Financial Planning, Inc.
Independent Registered Investment Advisor

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PERSONAL FINANCIAL RECORD SYSTEM

LETTER OF LAST INSTRUCTION

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PERSONAL FINANCIAL RECORD SYSTEM

This Personal Financial Record System is not a legal document but is intended to be a practical listing of personal and financial information and the whereabouts of documents that would be needed by an executor or other person called upon to administer the client(s)'s affairs in the event of a prolonged absence, illness or death. It is the client's responsibility to update this document as circumstances warrant. If the client desires his/her planner to have a copy of the document, please forward to the Center for Financial Planning.

Note: See Letter of Last Instruction section for information regarding Safe Deposit Box, name of Attorney, Name of CPA, Name of Financial Planner

COPIES OF DOCUMENTS

Client name: ____

Spouse / Significant other name: ____

This revision date(mm/dd/yyyy): ____

Location of original Personal Financial Record System: ______________________________

Copies are held by:

Name: ____

Phone #: ____

Name: ____

Phone #: ____

Name: ____

Phone #: ____

Name: ____

Phone #: ____

DURABLE POWERS OF ATTORNEY Regarding Health Care & Life-sustaining Treatment

Location of original(s): ____

Copy(ies) also on file at Health Care Provider(s): ______________________________

☐ I have created no such document.

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PERSONAL FINANCIAL RECORD SYSTEM

PHYSICIANS AND HEALTH CARE PROVIDERS

Client's primary physician

Name: ____________________

Phone: ____________________

Spouse/Significant other's primary physician

Name: ____________________

Phone: ____________________

INCOME TAX Where Financial Records are Kept

State & Federal Tax Returns (and supporting documentation)

Most recent year: ____________________

Previous years: ____________________

Ongoing/pre tax filing information: ____________________

CREDIT CARDS

Type (Visa, etc)	Name on Card	Account Number	Exp	Phone Number

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