IA Watch
WEEKLY BRIEFING
COMPLIANCE NEWS, GUIDANCE & BEST PRACTICES

■ INSIDE...

July 24, 2017

Enforcement case's lesson states once again to disclose revenue sharing

KMS Financial Services ($5.9B in AUM) in Seattle freely disclosed in its Form ADV that it had a relationship with a clearing broker. The dual-registrant's mistake was it didn't also alert its advisory clients that that relationship paid the adviser.

Now the firm must pay $550,000 in disgorgement and fines. Earlier this year, another enforcement action concerned the same type of payments and lack of disclosure (**IA Watch**, March 9, 2017).

The broker paid KMS "a certain percentage of revenues the Clearing Broker received from certain mutual funds KMS recommended to its clients," according to the **SEC**. Like the earlier enforcement case, the payments came from a "no-transaction-fee mutual fund program." "These payments provided a financial incentive for KMS to favor the mutual funds in the NTF Program over other investments," states the SEC.

Although KMS' new Form ADV, filed in June, doesn't mention the just-settled enforcement action, it does allude to the revenue sharing:

> *KMS participates in **Pershing**'s FUNDVEST® no transaction fee mutual fund platform …. In lieu of transaction-based commissions, KMS is eligible to receive revenue based on the assets in the FUNDVEST® platform. KMS does not share FUNDVEST® revenue with Advisors. Such revenue relates to KMS' cost of*

(Revenue Sharing, continued on page 6)

New SEC document request letters shed more light on what OCIE's interested in

Some dispute that the recent **SEC** document request letter on business development companies that we shared with you comes from a sweep exam (**IA Watch**, June 29, 2017). Sources had told us at the time that that letter indeed hails from a sweep.

There's no doubt, though, that OCIE's interested in BDCs. You can see this via a new document request letter obtained by **IA Watch** that focuses on them.

This second BDC letter runs far shorter than its predecessor, although it hits many of the same topics. It seeks a copy of all written compliance P&Ps adopted by the board for the companies.

This new letter also requests P&Ps for determining if an entity is an eligible portfolio company, along with a list of those that lost the designation due to the issuance of "margin eligible" securities.

(Exam Trends, continued on page 2)

Part of a series: Form ADV

In-house or outsourced, some CCOs oversee many advisory firms

You can assume **Andrea Sayago**'s busier than the average CCO – given that she's the named CCO for 11 RIAs.

Like Sayago, **Cheryl Vohland**'s name comes up as CCO at 11 advisers. Log another 10 firms where **Linda Wondrack** carries the title.

IA Watch wanted to ask Sayago, who is CCO at **RCG Longview** ($1.2B in AUM) in New York, among other firms, how she does it but she declined to speak. Vohland (**Vantage Investment Advisors**, $1.1B in AUM in Leawood, Kan.) and Wondrack didn't return our inquiries.

How many is too many?

Wondrack, CCO at **Fidelity** ($919B in AUM in Boston) and many of its affiliated RIAs, just could have the most challenging compliance job of all given that she's the named CCO at RIAs as far away as Hong Kong and Tokyo.

(Very Busy CCOs, continued on page 3)

Exam Trends *(Continued from page 1)*

The SEC also wanted to see a "list of all service providers used by each Company" along with an indication of what services they provide. Other topics queried included cross-transactions, two years' worth of portfolio turnover, third-party valuation reports and evidence of what the adviser does to prevent insider trading.

Exchange-traded funds

Another new SEC document request letter obtained by **IA Watch** looks at advisers who manage ETFs. The letter asks for data on "all Funds in the fund complex," including 15 specific items. The items included everything from registration number to date of delisting, names of portfolio managers to portfolio turnover rate for the last two years.

Examiners were checking on the adviser's compliance with SEC exemptive relief. They wanted to know the identity of third parties, such as a distributor, administrator or custodian. They quizzed the adviser on its use of leverage and transaction fees.

Compliance received special attention. Besides a list of compliance risks, the letter sought a "detailed description of any group or committee responsible for monitoring compliance." Examiners also requested the results of compliance testing and a copy of the annual report "submitted to the Board by the Chief Compliance Officer."

A confirmed best practice

It's been said before but another CCO – located in the south – recommends you take some recent SEC document request letters, assign staff to locate the records requested and test their ability to do so. For the firm's recent SEC exam, this CCO created an Excel spreadsheet that tracked each document requested, who was responsible for it and whether it had been gathered for examiners.

The CCO says the firm's exam was rather broad but did look at the RIA's partnerships.

You can attempt the best practice recommended by this CCO with another new SEC document request letter obtained by **IA Watch**. This one comes from the SEC's Boston Regional Office.

It appears as a typical request letter, although it does focus on the entity's private funds. One thing unique about this letter is it actually mentions an accounting firm by name. Examiners wanted to see any engagement letters with **PricewaterhouseCoopers**.

The private fund interest extended to a list of public and privately-held securities and data on each fund, including "Investment strategy," who performs its annual audit and on- and off-balance sheet leverage (including "futures and certain other derivatives").

Other topics of interest included all sub-advisory agreements; financials; any breaches of compliance P&Ps and how they were communicated to firm leaders; and receipt of "gifts and gratuities from third parties" by employees. ■

International

Long-awaited guidance arrives for advisers that will be affected by MiFID II

January can seem a long way away in July but the start of MiFID II early next year will require certain firms to take actions long before then (**IA Watch**, Jan. 18, 2017).

The UK's **Financial Conduct Authority** this month released its Policy Statement II for MiFID II. "This is the main thing that we've all been waiting for for a long

(MiFID II Guidance, continued on page 3)

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1. BDC Exam Letter
2. SLOA Decision Tree
3. Sample DOL Rule Form
4. Background Check Attestation
5. Gifts & Entertainment Log ■

MiFID II Guidance *(Continued from page 2)*

time," says **Leonard Ng**, a partner with **Sidley Austin** in London.

This should be the final policy statement before MiFID II goes into effect Jan. 3, 2018. It runs more than 1,000 pages but Ng says the two main issues relevant to U.S.-based managers who work in the EU are research and recordings.

Research

The EU doesn't call it "soft dollars" but MiFID II targets the practice of the costs of research being bundled into a security's transaction. Such expenses would have to be unbundled under the coming directive.

"U.S. brokers are going to have to receive hard dollars for research if they want to continue dealing with these European managers or these global managers who want to run the European model," he says.

Many large international firms and even some hedge funds are moving to a "global model" that unbundles the costs of research, adds Ng.

The argument goes that it would be easier for a U.S. manager with an EU presence to give up soft dollars research and pay hard dollars than risk part of the entity complying with MiFID II and another part violating it.

The new policy statement cautions firms to "be mindful of their obligations … if establishing and maintaining a Chinese wall, which requires them to have policies in place permitting certain individuals to withhold information from other persons."

"This is an issue that must be solved in the U.S.," says Ng. "It is not a European issue," he adds.

SEC Chairman **Jay Clayton** was asked on Capitol Hill last month about what he may do ahead of MiFID II and its restrictions on research (**IA Watch**, June 29, 2017). "We're engaged with our colleagues in Europe and we're also looking at other ways to deal with it," answered Clayton.

Recordings

The new policy statement relieves anxieties that firms were going to have to record all phone calls, says Ng. Instead, firms can apply what he dubbed "an intention test" to determine which calls must be recorded. If the communication includes an intention to transact, then it should be recorded.

"Firms are required to record conversations that result in a transaction being undertaken or that are intended to result in a transaction being undertaken," reads the policy statement.

"It's a practical challenge for firms to work out when it's appropriate to record calls," adds Ng. Firms will welcome guidance to record fewer calls, because the calls will have to be monitored for compliance and the records kept for five years.

He interprets the guidance as meaning that recordings of calls would have to be made when the conversation relates "to the execution or the arranging of a transaction."

The policy statement addresses face-to-face meetings, and gives firms an alternative. "The ability for retail financial advisers to choose between: making a written record, or recording relevant conversations, should enable these firms to make cost effective decisions." ■

Very Busy CCOs *(Continued from page 1)*

Of course, Wondrack's going to have a large staff of compliance helpers, including in far-flung locales.

But it does beg the question: How many firms can one CCO adequately cover?

If you're in the market for an outsourced CCO, that number hovers between 3-5, says **J.R. Morgan**, counsel with **Andrews Kurth** in New York. **Guy Talarico**, CEO of **Alaric Compliance** in New York, which provides outsourced CCO services, places the benchmark between 3-8 firms – depending on their size and complexity.

"Right now, I'm at my limit," says **Gery Sadzewicz**, CEO of **Gery Sadzewicz Consulting** in Plainfield, Ill. Sadzewicz serves as outsourced CCO at 27 RIAs.

Form ADV changes coming

You're just two months away from a new Form ADV that will inquire about a CCO's compensation (**IA Watch**, April 13, 2017). A new question will ask if your CCO "is compensated or employed by any person other than you," and, if so, to report that "person's name and IRS Employer Identification Number."

The answers the **SEC** receives will go into its big data bank and be used to decide exam targets, believes Morgan. OCIE may spot "a yellow flag" if one outsourced CCO firm's name keeps coming up, he adds.

That's a profound prophecy. "I've had the same questions asked of me by the SEC," says Sadzewicz, regarding how he can serve so many firms. He's also experienced many exams of his clients without a whiff of trouble. "My firms are clean," he says. "These are ethical folks."

Two years ago, the SEC filed an enforcement action

(Very Busy CCOs, continued on page 4)

Very Busy CCOs *(Continued from page 3)*

against an outsourced CCO and his firm (**IA Watch**, April 2, 2015). Soon after, OCIE released a new risk alert that looked at the use of outsourced CCOs (**IA Watch**, Nov. 9, 2015). It found "the outsourced CCO was generally effective in administering the registrant's compliance program." That success increased with regular visits and access to firm records, the alert found.

Cipperman & Company in Wayne, Pa., may be the nation's most prominent CCO outsource provider. It serves some 50 firms, placing at least two team members with each RIA and making at least six in-person visits to each RIA annually, says President **Robert Prucnal**.

In addition, time spent on each account is tracked down to the half hour like a law firm's accounting, he adds.

How it works

The firm usually signs a three-year deal that charges the client a monthly fee. The services can vary greatly, as can the fee, which ranges from $4,000 to $15,000 a month, says Prucnal.

Talarico says his team engages in some work for each RIA client on a daily basis, even if it's just reviewing staff e-mails or thumbing through trading logs.

Kyle Bubeck used to serve as an in-house CCO. In 2009, he started his own outsourcing firm, **Beacon Compliance Consulting** in Overland Park, Kan. His clients have undergone a total of a dozen exams. It occurred to him that the SEC may have been targeting his firms because they saw his name over and over again. "That thought crossed my mind," he says. Most of his clients are smaller firms. He places monthly calls with each one.

All he does is compliance, says Bubeck, arguing his role at a small firm beats giving someone in-house yet another hat to wear without appreciating all that it takes to be a real CCO.

Matthew Hardin has quantified the role. The owner of the outsourcing firm **Hardin Compliance Consulting** in Wexford, Pa., has tabulated 180 compliance tasks for each of his firms. "We set up calendars to make sure all of those tasks are completed," he says.

His team of 27 employees ensures it all gets done.

Pros and cons

Andrews Kurth's Morgan used to serve as an outsourced general counsel. But he discourages clients from opting for an outsourced CCO. "You can't really outsource the compliance liability," he says, a point former SEC Chair **Mary Jo White** would remind the industry (**IA Watch**, April 28, 2016).

"There are pros and cons" to outsourcing the CCO role, states Prucnal. A pro of going with an in-house CCO is that "you have 100% control of what that person does all day," he says. On the other hand, should that CCO leave, you have a huge hole to fill.

Talarico points out an outsourced firm can fire a client that fails to properly appreciate the compliance role. An in-house CCO who has a mortgage to pay may be forced to silently accept such conditions, he adds.

He estimates 10% of RIAs outsource the CCO role – a percentage future Form ADV data should be able to

(Very Busy CCOs, continued on page 5)

Ask these questions before your next compliance software purchase

Here are more questions you should consider before buying compliance software (see related story):

1. What determines the software price? Is it per seat or per user or per processor?
2. What types of on-site services are included in the purchase?
3. Is there a guarantee of satisfaction with your software?
4. What is the turnaround time for getting "bugs" fixed?
5. How often do program updates go out and do you notify customers?
6. Is the proposed software scalable?
7. Can the system be customized to meet our business needs?
8. What are the typical hurdles that you can expect with your planned installation?
9. What are the hours of support and how does your support department operate?
10. What's expected to be included in the next update?

Very Busy CCOs *(Continued from page 4)*

confirm. That percentage increases if you look at firms that have an in-house person named as CCO but largely outsource the job's function.

Bubeck concedes an outsourced CCO isn't appropriate for larger, more complex firms that certainly could afford the in-house role. Morgan evaluates outsourced CCOs as "an important part of the eco-system" for smaller RIAs.

Hiring tips

Test an outsourced CCO candidate by giving him a project to complete, says **Cassandra Borchers**, a partner with **Thompson Hine** in Cincinnati. Check references. Interview the person. Ask how many other firms the person serves. Inquire how often the person would be onsite, the frequency of their communications with you and their use of technology, recommends Talarico.

This leaves CCOs like Sayago, Vohland and Wondrack, who may well work for affiliated RIAs. "Sometimes, with these related entities, there's a lot of overlap" via back office operations, personnel, access persons, says Borchers. "Hiring one CCO who could look across the entire affiliated structure actually might have some advantages," she adds. ■

New FAQs provide guidance on mutual fund modernization rule reporting

Get ready to submit some "test" filings of new Forms N-PORT and N-CEN later this year when the **SEC** releases a new version of EDGAR. These tests will give you experience before the real thing will be demanded as early as next year.

This news appears in 30 new FAQs related to the SEC's investment company reporting modernization rule (**IA Watch**, Feb. 23, 2017). Many of the FAQs cover very technical subjects tied to the new forms and Regulation S-X.

The FAQs lay out the various compliance dates for the forms and the regulations. August 1, 2017 is the compliance date for "amendments to Form N-1A, N-3, and N-CSR" for securities lending reporting and for amendments to Regulation S-X.

The deadlines for filing the new forms begin next year and extend into 2019 for smaller entities (**IA Watch**, Oct. 20, 2016).

The SEC has indicated it will use all of the new data that will be reported for "more targeted examination and enforcement efforts" as well as to monitor the health of the mutual fund industry. ■

FINRA FAQs tackle upcoming enhanced price disclosure for bonds

Needed new guidance on coming fixed income confirmation disclosure requirements has been released by **FINRA**. The guidance—in the form of 45 FAQs—is aimed at helping broker-dealers navigate a new rule requiring enhanced price disclosure to retail investors for trades in corporate and agency bonds slated to kick in next May. The **Municipal Securities Rulemaking Board**, which is implementing comparable requirements at the same time as FINRA, simultaneously released its own guidance.

The new disclosure rule, approved by the **SEC** last November, will require firms to disclose on retail-customer confirmations the "mark-up" or "mark-down" for certain transactions in corporate and agency bonds. The new rule further requires all retail confirmations for such trades to include the execution time and a reference (and hyperlink if the confirmation is electronic) to trade-price data in the security from TRACE.

FINRA reported that it has found that some individual investors pay "considerably" more than others for similar trades. The SRO added that it believes that the end result of the rule will be the provision of meaningful and useful pricing information to assist customers in monitoring costs and the enhancement of investor confidence in the market.

Just the FAQs

In the new guidance, FINRA reveals the answers to the 45 questions spanning four sections, including 1. When Mark-Up Disclosure is Required 2. Content and Format of Mark-Up Disclosure 3. Determining Prevailing Market Price and 4. Time of Execution and Security-Specific URL Disclosures. The FAQs include the following:

- **When does Rule 2232 require mark-up disclosure?**

A member is required to disclose on a customer confirmation the mark-up on a transaction in corporate and agency debt securities with a non-institutional customer if the dealer also executes one or more offsetting principal transaction(s) on the same trading day as the customer transaction in an aggregate trading size that meets or exceeds the size of the customer trade. A non-institutional customer is a customer with an account that is not an institutional account, as defined in rule 4512.

FINRA added that any intentional delay of a customer execution to avoid triggering the mark-up

(FINRA FAQs, continued on page 6)

FINRA FAQs *(Continued from page 5)*

disclosure requirements may violate rule 2232, rule 5310 (best execution and interpositioning) and rule 2010 (standard of commercial honor and principles of trade).

- **What information must be included when members provide mark-up disclosure on a confirmation?**

When mark-up disclosure is provided on a customer confirmation, rule 2232(c) requires firms to express the disclosed mark-up as both a total dollar amount and a percentage of PMP. The mark-up should be calculated and disclosed as the total amount per transaction, disclosure of the per bond dollar amount of mark-up (e.g., $9.45 per bond) would not satisfy the requirement to disclose the total dollar amount of the transaction mark-up.

- **How should members determine PMP to calculate mark-ups?**

Members must calculate mark-ups from a security's PMP, consistent with existing rule 2121 and the supplementary material thereunder, particularly Supplementary Material .02 (Additional Mark-Up Policy for Transactions on Securities, Except Municipal Securities). Members may rely on reasonable P&Ps to facilitate PMP determination, provided the P&Ps are consistent with rule 2121 and are applied consistently.

- **How should the time of execution be disclosed?**

Members should disclose the time of execution, expressed to the second, as they report it to TRACE. FINRA understands that the MSRB may provide different guidance on this point, based on its different reporting requirements.

Future FAQs coming

FINRA stated that it welcomes feedback and additional questions to be considered for future FAQs. ■

Revenue Sharing *(Continued from page 1)*

> *providing such services, but receipt of this revenue constitutes a conflict of interest. KMS addresses this conflict by not sharing the revenue it earns from FUNDVEST® with the Advisors who recommend or direct the trading, and by monitoring all trading activity and related costs to Clients.*

The SEC settlement notes that in 2014 KMS negotiated a $1 per trade reduction in execution costs with the broker but the RIA "did not pass this reduction" on to clients. This led the SEC to cite the firm for failing to seek best execution. The firm also didn't have compliance P&Ps for analyzing introducing, clearing and execution costs.

KMS's CCO **Casey Dougherty** didn't immediately respond to an **IA Watch** request for comment. ■

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