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Philadelphia Roundtable Session – March 13, 2018

Session 1: The Regulatory Landscape for Advisers

Speakers: Sarah Buescher, Associate General Counsel – Investment Advisers Association; Laura Grossman, Associate General Counsel – Investment Advisers Association

The Spring Session of the Philadelphia Compliance Roundtable that met recently on March 13, 2018 provided some interesting insights on what is happening in Washington, DC. The Roundtable, which consists of Philadelphia-area investment advisers, broker-dealers, hedge fund and private fund managers and consultants, meets periodically so that the local compliance community can network and further their investment development.

The first session of the afternoon featured Ms. Grossman and Ms. Buescher of the Investment Advisers Association (the "IAA" or the "Association"), who discussed IAA's 2018 policy priorities. They noted that the Association, a not-for-profit organization representing the interests of SEC-registered investment adviser firms, shares its policy priorities each year with top policymakers at regulatory agencies. In forming these policy priorities, the Association focused on the ever-growing list of regulatory challenges affecting investment advisers, with the aim of making regulatory oversight of asset managers more efficient and effective.

Ms. Buescher and Ms. Grossman discussed the need for review and improvement of key Advisers Act rules, and ensuring that regulators consider their rule impacts on smaller advisers. They acknowledged the SEC's oversight of advisors, but noted that the IAA would also like to see the careful rationalization of regulatory overlap between the SEC and the CFTC. In addition, they discussed the IAA's goal of helping to preserve the Advisers Act's fiduciary duty and to extend fiduciary principles to broker-dealers vis-à-vis a strict "best interest standard" under the Exchange Act.

In addition to these overarching issues, the Association wants to address issues such as cybersecurity threats to advisors and the need to protect advisor's senior clients from financial abuse. Furthermore, the Association made it clear that a few of its 2018 priorities stem from their opposition to certain new requirements imposed on advisers under the Dodd Frank Act, such as the stress testing requirement and the lack of transparency in FSOC's designation of Systemically Important Financial Institutions (SIFIs).

After Ms. Grossman and Ms. Buescher outlined the IAA's main policy priorities for 2018, they addressed some other areas of advocacy for the Association this year, namely the need to re-write the Custody Rule, which can be confusing and lead to "foot-faults" by advisers, increase the amount of permissible political contributions under the Pay-to-Play Rule, make Electronic Delivery of Form ADVs and other documents easier, and to raise the $25 million threshold of what constitutes a "small adviser" as defined by the Advisers Act.

After discussing the IAA's regulatory priorities, Ms. Grossman and Ms. Buescher shifted their discussion to the SECs 2018 priorities. The highest priority, according to the Association, is the SEC's consideration of proper maintenance and expansion of the Fiduciary Rule and the standards of conduct for giving investment advice. In a comment letter to SEC Chairman Walter J. Clayton, the Association urged the SEC not to meddle with the Advisers Act fiduciary standard in order to make a more uniform standard between broker-dealers and advisers, as that would have the effect of watering down the already well-established fiduciary principles in the Advisers Act. Alternatively, the Association suggested that the SEC should focus solely on extending fiduciary principles to broker-dealers through a strict best interest standard that is as robust as the fiduciary standard.

Ms. Grossman and Ms. Buescher touched upon the status of the DOL Fiduciary Rule, and the potential fallout during the pre-implementation period as state legislatures took preemptive measures in adjusting their standards of conduct for financial services professionals doing business in their states. The Association gave examples of certain recent state actions, such as the February 2018 Massachusetts Complaint filed against Scottrade for failure to supervise compliance with the DOL Rule, and the Nevada legislature's recent amendment of the definition of a "financial planner" to include investment advisers and broker-dealers, who must adhere to a fiduciary duty. Echoing the recent comment letter, the IAA submitted a response to the Nevada legislature's action cautioning the states not adopt any regulations or take any legislative action that would encroach on the jurisdiction of the SEC.

Ms. Grossman and Ms. Buescher discussed some top items on the SEC's Regulatory Flex Agenda, Chairman Clayton's agenda of rulemaking actions pursuant to the Regulatory Flexibility Act. One item on the agenda is the Advertising Rule, which has spurred the Association to form a working group dedicated to revising the rule. The next item discussed was the definition of an "accredited investor," which the Association believes is too limiting as it currently stands. The next item discussed was the withdrawal of proposed Business Continuity and Transition Plans Rule, as this rule is already contemplated in the Advisers Act Compliance Rule, as well as the withdrawal of third-party exams. The last item discussed was the proposal to allow registered investment companies to use derivatives, which has been postponed from entering into final rule stage.

Ms. Grossman and Ms. Buescher then shifted the discussion to recent developments within the SEC's various divisions. The Division of Enforcement's main focus has been the share class selection disclosure initiative. Advisers are eligible to participate in this initiative if they have made inadequate disclosures on their Form ADVs regarding their receipt of 12b-1 fees, or the receipt of 12b-1 fees by a supervised person of their firm or an affiliate broker-dealer. The Division of Enforcement will recommend settlement by way of disgorgement of the adviser's ill-gotten gains and prejudgment interest, but there will be no civil penalty or any other related charges filed against the adviser. The deadline for eligible advisers to self-report is June 12, 2018. The Association cautioned that the Office of Compliance Inspections and Examinations (OCIE) will closely scrutinize all eligible advisers that fail to self-report before the June 12th deadline.

The presentation concluded with a brief glance at other hot regulatory topics of interest, both domestic and international. Ms. Grossman and Ms. Buescher spoke about the status of regulation and potential legislation surrounding cryptocurrency. The SEC has issued a number of enforcement actions based on their position that initial coin offerings (ICOs) may be subject to federal securities laws, while the CFTC has issued its own set of enforcement actions based on its belief that cryptocurrencies are commodities. These regulatory agencies have issued their own respective warnings to investors, market professionals, and gatekeepers alike to take caution in entering into transactions involving cryptocurrencies. Ms.

Grossman and Ms. Buescher also touched upon developments with whistleblowing legislation, as the Supreme Court recently ruled in favor of a narrow definition of the term "whistleblower," which will significantly limit the scope of anti-retaliation measures meant to protect whistleblowers under the Dodd-Frank Act.

On the international stage, the General Data Protection Regulation (GDPR), which becomes effective in May 2018, aims to ensure better data privacy for all EU citizens and to simplify the regulatory environment for international business by unifying the current privacy regulation within the EU. This regulation will affect any adviser with clients who reside in the EU, and non-compliance with the rule can result in potentially severe penalties.

Session 2: SEC & FINRA Enforcement Trends

Speakers: Amy J. Greer – Partner, Morgan Lewis; Timothy Levin – Partner, Morgan Lewis, Christine Lombardo – Partner, Morgan Lewis; Ariel Gursky – Associate, Morgan Lewis

The second session of the afternoon featured Ms. Amy Greer, Mr. Timothy Levin, Ms. Christine Lombardo and Ms. Ariel Gursky from the investment management practice of Morgan, Lewis & Bockius LLP, who discussed recent developments within the SEC's Division of Enforcement during the past year. They noted that with new staff in place at the SEC, a "personnel is policy" modus operandi can be expected and that right now, "Principle #1" for Enforcement is protecting retail investors. The Division of Enforcement is also focusing on cybersecurity enforcement/policy, in particular, firm-level cybersecurity, as opposed to customer-level risk, where the Morgan Lewis team feels the attention is lacking.

Morgan Lewis outlined recent cases in which the SEC served as a litigant, and emphasized the impact these cases may have on how enforcement cases will brought in the future and the relief that will be available to the SEC. For example, in *Kokesh v. SEC*, 137 S. Ct. 1635 (2017), the U.S. Supreme Court decided that disgorgement is a penalty under federal law, and therefore, it is subject to a five-year statute of limitations, despite its conspicuous absence from the list of remedies for federal proceedings.

Morgan Lewis then shifted the discussion to developments within FINRA's Division of Enforcement during this past year. The Morgan Lewis team touched upon "FINRA 360," a self-evaluation initiative spearheaded by FINRA President and CEO Robert Cook that was launched early last year. The focus has been in three key areas: i) the organization and operation of the regulatory function at FINRA; ii) the use of data and technology at FINRA; and iii) the tools and metrics used to measure success at FINRA. Also, stemming from the initiative is a move toward consolidation and consistency within the Division, which is evident in the merging of FINRA's two enforcement groups: the Market Regulation Enforcement (a legacy division from the NASD/NYSE days) and the Department of Enforcement into one department. This move by President Cook signals the Division of Enforcement's overall push toward creating a more unified team, with a consistent philosophy and set of principles, that apply the same approach to enforcement across all regional offices.

Morgan Lewis then discussed FINRA's emphasis on their use of fines, which served as one of the six Financial Guiding Principles that accompanied their 2018 Annual Budget Summary released earlier this year. FINRA is adamant that their use of fines is subject to special procedures and restrictions only, and

are not used to compensate their employees. To ensure this message is continually emphasized, FINRA will publish a description of their approved use of fine monies on yearly basis in conjunction with the release of their annual budget summary.

Morgan Lewis then offered some thoughts on where the Division of Enforcement stands currently and where it is heading, most notably, that they are trying to shift away from a prosecutorial mindset toward a regulatory mindset. The Division's key philosophy is simply: if you follow the rules, FINRA will partner with you to cut back the red tape so they can restore money to clients. After all, there was an uptick to about $66 million in restitution payments this past year.

Morgan Lewis concluded with a general overview on issues raised in 2017 that may return in 2018. Recent SEC actions involve undisclosed compensation and loans (i.e. funds making loans to undisclosed parties), advertising, suitability, American Depository Receipts, Anti-money laundering and Suspicious Activity Reports and complex & structured products. Recent FINRA actions involve issues such as market access rule controls, order reporting (through TRACE, OATS, LOPR, etc.), mutual fund sales charge waivers, recordkeeping, order handling and supervision. Other notable cases from 2017 include related-party transactions, broker-dealer expenses, miscalculation of fees, custody, exchange-traded funds complying with exemptive orders, and outsourced CCOs who rely too heavily on CIOs to verify AUM data. The common thread that Morgan Lewis saw woven through these cases is the importance of raising issues with authorities, obtaining consent before embarking on a chosen course of action, and documenting processes and determinations for the sake of regulatory inquiry.