

# ACA Insight

The weekly news source for investment management legal and compliance professionals

“You’re preparing for any number of kinds of unpredictable events – one of which might very well occur.”

## Inside Insights

7 New SEC appointments

### Don’t Fall Victim to a Black Swan: Prepare Now for the Unexpected

**Long Term Capital Management.** Russia’s debt default. **Enron.** **Arthur Andersen.** The 2008 mortgage crisis. **Bernie Madoff.** It’s what you don’t expect that will get you.

Most risk management programs help your firm prepare for the expected – a change in interest rates or the inflation rate, a change in the White House, most new rules from the SEC. Unexpected events, on the other hand, are close to impossible to predict.

What you can do, however, is know that there will be unexpected events and prepare for the unexpected, also known as “black swans,” even if you don’t know the exact  
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### Inconsistent Policies and Followthrough Lead to SEC Charges on Advisory Fees

Make sure your left hand knows what your right hand is doing.

**Transamerica Financial Advisers**, which on April 3 settled charges<sup>Ⓜ</sup> with the SEC that it improperly calculated advisory fees and overcharged clients, probably would have benefitted from this advice. Among the problems the agency claimed it uncovered were a miscommunication as to which office would aggregate client funds, failure to ensure that a third-party vendor mailed a policy insert (according to the SEC, it didn’t), and two policy and procedure manuals with conflicting policies on the application of advisory fee breakpoints.

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### SEC Beginning Outreach Seminars to Prepare Advisers for Never-Before-Examined Initiative

The SEC has begun notifying select investment advisers of outreach seminars to help them prepare for upcoming examinations under its never-before-examined initiative.

Those notified of the seminars are the same advisers who received letters, dated February 20, 2014, from the agency’s Office of Compliance Inspections and Examinations, informing them that they may be examined in the near future (*SEC Insight*, 2/24/14<sup>Ⓜ</sup>). The outreach seminar is being conducted in coordination with the **National Society of Compliance Professionals**, and is expected to be conducted in

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## Don't Fall Victim to a Black Swan

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nature of the black swan that will strike. The result will be that your firm is likely to weather whatever storm hits, from both a compliance and a business perspective, better than firms that take no preparatory measures.

Black swan events can occur from external or internal sources. External sources include natural disasters, like a tornado or hurricane; a major market event, like a significant Dow drop or a large bankruptcy; or a major political event, such as a government shutdown. Internal sources might be a rogue employee who discloses confidential information, an IT error, a high-speed trading error, a whistleblower, misappropriation of client funds, or a custodial failure.

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*"The premiums you pay for insurance may seem a waste if your house never burns down, [but] given fires that have occurred, I'm sure those homeowners are very glad they paid them."*

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Firm CEOs and other upper management may look askance at spending more time and financial resources preparing for events that are unlikely to happen, but the reality is that black swans do occur – you just don't know the nature of the event and when it will strike. Your firm will be far better off preparing for a broad array of possibilities than not, said **Dechert** partner **Adam Wasserman**, who spoke on the topic March 27 at **ACA Compliance Group's** Spring 2014 Compliance Conference in Orlando. "You really aren't preparing for one specific black swan. You're preparing for any number of kinds of unpredictable events – one of which might very well occur," he said. In fact, a majority of those informally surveyed during the session at the conference had experienced at least one black swan during the course of their career.

"The premiums you pay for insurance may seem a waste if your house never burns down," said **DLA Piper** partner **Nicolas Morgan**, but "given fires that have

occurred, I'm sure those homeowners are very glad they paid them."

### Enterprise risk management and disrupter analysis

Among the first steps that firms should take is designating an internal enterprise risk management person or team whose job it is to look for areas where you firm may be exposed to risk, said Morgan, who noted that having a person in such a position can pay off. "If that person is incorporated into your operations, his feedback is listened to, addressed, and policies are changed," he said. "That person goes from being a quasi-whistle-blower to your best defensive witness."

In fact, noted **Haynes and Boone** partner **Kit Addleman**, former director of the SEC regional office in Atlanta, the existence of an enterprise risk management function within advisory firms is something OCIE examiners look for. "It's high on the SEC's radar screen this year."

Next, go beyond enterprise risk management, which focuses on likely events, to perform disruptor analysis, which prepares your firm for the truly unexpected, said Morgan. Done effectively, it consists of four parts:

- **Enterprise mapping.** Create a map of your organization, one that incorporates not only its "geographical footprint," Morgan said, but other aspects, including its regulatory environment, operations, supply chains, channel positions, industry structure, and competitive dynamics. "Go beyond first-order relationships" to find additional areas of vulnerability, he said, giving the example of Apple products, many of which rely on batteries to function. The relationship to the battery vendors should be included in the maps, as well as any dependencies the battery vendors themselves have that may affect the battery supply.
- **Disruptor lists.** Compile a directory of events that could impact your firm, by event type, such as market events or cybersecurity.
- **What if's.** In this list, describe how each event in your disruptor list may impact the firm.
- **Contingency plans.** For each "what if," come up

with a potential solution. Some of these may resolve multiple situations, said Morgan. “Even devoting a few hours to this effort can pay huge dividends in the long run.”

### Small firm challenges and solutions

Not all firms, of course, have the resources to devote a team of people to black swans. “The most important thing is to give black swans the time, thought and attention that are needed,” said Wasserman. If you have a small firm with only three or four employees, consider gathering everyone one day over the weekend and spending a few hours reviewing the black swan possibilities, he said. “Smaller firms might have an easier time getting their hands around the issues than larger firms will,” he said, as all the people with responsibility and knowledge are right there in the room.

Small firms can also address the resource issue by simply scaling the program back, suggested Morgan. “Have the same function performed by one person instead of three, and spend 20 percent of your time on it instead of 100 percent.” Firms with limited resources can choose to outsource part of the work. Those that choose not to outsource may instead choose to add it to existing responsibilities, if that is realistic.

### Creation of black swan teams and drills

These are the people who will take responsibility for key aspects of any unexpected crisis, said Addleman. “Have the right people from the outset,” she said, as you don’t want to find out, halfway through a crisis, that some members lack expertise you thought they had.

Those on the teams should represent a range of expertise, including IT, risk management, compliance, legal, human resources, operations and external professionals with expertise in key areas. “Put all the information you have on (these team members) in a book with contact information, and widely circulate it,” she said. Black swans are not only unexpected, they can occur during unexpected periods, such as during the evening or on weekends. When that happens, you want everyone to have the book of team members.

Just like a fire drill, stage a mock black swan, Addleman said. Her firm, she said, has done that with some clients, where the chief compliance officer interrupted a scheduled meeting to say, “Oh my gosh, put your agenda aside, we have an event we have to deal with.” The ruse cannot continue for long, she said, but “this has been very effective to grab the attention of senior management.”

### The black swan strikes

Preparation is important, but what do you actually do when the unexpected occurs? One of the first steps is to deal with the psychology of the situation, said Wasserman. Acknowledge the event and the impact it had. Don’t attempt to shrug it off – that will just make it more difficult to handle as the severity of the event becomes apparent.

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Your first steps should be to gather necessary information from documents and individuals, said Morgan. Then, check with either internal or external counsel. Later steps – contacting investors, self-reporting to the SEC, handling the public relations, and calling your insurance – should ideally be done “after you have ascertained as many of the facts as possible,” said Morgan. That said, when these events do occur, depending on the specific circumstances, doing these in that order is not always possible.

Using a technique he called “active passiveness,” Wasserman said you should assess the situation and take stock of its effect on the firm before rushing into action. Focus on the facts, then concentrate on finding a solution, rather than assigning blame, he said.

This is when you choose which members of the black swan team to notify, depending on the nature of the situation, said Addleman. It would be a good idea to have attorneys or other external experts involved, as you will be engaged in running the business while deal-

ing with the crisis. “It’s like flying the plane while repairing the wing,” she said. External professionals, such as public relations firms, can deal exclusively with their aspects of the crisis, freeing you of that burden.

### Task-specific steps

Public relations can be critical during such a period, as you want to avoid as much negative press as possible. Your firm’s reputation is at stake. This includes not only traditional press, like newspapers and web sites, but social media. You want someone following Twitter and Facebook to see what is being said about the event and your firm’s place in it.

Since many black swan events deal with IT, it is critical you have a data response team ready to preserve information that may otherwise be damaged or lost. Addleman said. The data response team can also prevent additional technical problems from occurring. After the crisis is over, it can help to determine how the crisis began and where responsibility lies.

Knowledge of IT will also be helpful in non-disaster recovery events, Wasserman said, such as an SEC enforcement investigation into your firm. It will be very useful if your legal/compliance departments already know how emails, instant messages and trading data are stored and retrieved. “It’s better if compliance staff understands such issues in advance rather than have to learn about them on the fly in the middle of a crisis,” he said. ☞

## Inconsistent Policies

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The result was more than \$1.1 million in combined client reimbursement, interest and civil money penalties for the Florida-based firm, which has more than \$3.1 billion in assets under management and more than 22,500 client accounts nationwide, the agency said.

### The case

In a nutshell, Transamerica allegedly failed to follow through on promises it made to investors. The firm offered “breakpoint discounts” that would reduce the fees that clients owed when they increased their

assets in certain investment programs, the agency said. Clients were allowed to aggregate the values of related accounts in order to get the discounts.

“Transamerica failed to properly aggregate client accounts so that they could receive a fee discount, and this systemic breakdown caused retail investors to overpay for advisory services in thousands of client accounts,” said **Julie Riewe**, co-chief of the SEC Enforcement Division’s Asset Management Unit.

The case “highlights the importance of investment advisers making sure that their internal policies are consistent within the organization and with their disclosures to clients” said **Mayer Brown** partner **Matthew Rossi**, former senior counsel in the SEC’s asset management unit, which was involved in investigating this case. “Investment advisers should also have clear lines of authority and responsibility,” particularly when qualifying investors for fee discounts.

“We are pleased to have concluded this matter,” Transamerica Financial said in a statement, adding that the company has taken action to ensure the accounts of clients in the investment programs involved have been properly linked for purposes of obtaining advisory fee discounts. “The failure to link accounts was unintentional. Current and former clients in these programs who were entitled to these discounts for the affected period have now received the discounts.”

### What happened

Transamerica Financial offered reductions or “breakpoint” discounts in the administrative fee component of its advisory fees in three of the investment programs it offered retail clients. In order to earn these discounts, the firm allowed clients to aggregate certain related accounts to achieve the necessary account minimums, according to the administrative order. “For instance,” the SEC said, Transamerica Financial “permitted clients in these programs to aggregate accounts held by ‘their spouses, domestic partners (as recognized by applicable state law), and children under the age of 21, whom reside with the clients.’”

Transamerica Financial informed its clients in “certain

account opening documents” about the aggregation opportunity that would help them qualify for breakpoint discounts, the agency said. In addition, the aggregation policy was included in Form ADV Part 2 for two of the company’s investment programs, and was also stated in an internal policy, according to the administrative order.

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“In 2009,” the agency said, “the Commission’s staff conducted an examination of a (Transamerica Financial) branch office and in 2010 notified (Transamerica Financial) that, among other things, it had not properly aggregated certain client accounts in the branch office,” the administrative order said. “The examination staff identified several ... clients (of one of the investment programs) in the branch office who had requested aggregation of related accounts, but did not receive breakpoint discounts.”

Transamerica’s explanation to the examiners was that the aggregation failure occurred “because of a miscommunication,” according to the administrative order. According to Transamerica Financial, the agency said, “the staff of that particular branch office mistakenly believed that (Transamerica Financial’s) headquarters was automatically aggregating the accounts” when, in fact, headquarters was doing no such thing. “As a result, the branch office failed to notify the appropriate staff at (Transamerica Financial’s) headquarters which accounts should be aggregated or whether certain clients had requested account aggregation,” the order said.

What’s more, the examination staff noted that Transamerica Financial “might not be aggregating accounts on a systematic basis.” It recommended that Transamerica Financial review all of its investment advisory accounts in all branches to ensure that the

breakpoint discounts were being properly applied. Although the firm did provide refunds to clients in that particular branch, the SEC said, “despite the examination staff’s recommendation, (Transamerica Financial) did not undertake a review of all of its branches.”

It was going to wish that it had.

#### The February 2012 examination

The examination staff conducted a subsequent firm-wide review in February 2012, and found that “in certain instances the aggregation issues identified in the previous branch office examination existed nationwide and were ongoing.”

“Most significantly,” the administrative order said, and despite the creation of new account documentation after the 2009 branch examination, Transamerica Financial “was still failing to aggregate certain accounts for clients in (one of its investment programs) and was similarly failing to aggregate the related accounts of certain clients (in another of its investment programs).”

“The failures occurred because of inadequate policies and procedures at (Transamerica Financial’s) headquarters to implement the breakpoints policy,” the SEC charged. The firm “has two teams involved in establishing new accounts – the New Business Team and the Suitability Review Team – but the firm’s policies and procedures did not clearly delineate which team was responsible for reviewing new account forms for aggregation purposes. As a result, (Transamerica Financial) did not review many new account forms for aggregation purposes and, therefore, failed in certain instances to appropriately link accounts together to apply breakpoints in the billing process.”

Advisers beware: Failure to follow through on remediating deficiencies is a red flag for the SEC. The asset management unit has said that it will focus on cases where deficiencies were not corrected that were found in initial exams, Rossi said.

#### Remedial steps and followthrough

Transamerica Financial did, in fact, take steps after the 2009 exam to solve the problem, something the SEC

said counted in Transamerica Financial's favor, along with the cooperation it offered the SEC staff in negotiating the settlement.

Specifically, according to the SEC, after the 2009 examination the firm took the following steps:

- **Issued a firmwide compliance alert** in June 2010, reminding its investment account representatives to inform clients of the benefits of aggregation and the possible advisory fee reductions. "The alert also stated that the IAR was responsible for notifying ... headquarters if the client wished to aggregate its account balances," the SEC said.
- **Modified its account opening documentation** for two of its investment programs to clearly document whether a client wished to aggregate related accounts. "If a client declined to aggregate, (Transamerica Financial) required the client to write the reasons for the none-aggregation on the form," the agency said.
- **Modified its policies and procedures** to state that if a client selects aggregation, "the IAR was required to reduce the advisory fees through the advisory fee reduction schedule."
- **Committed itself to including a one-time mailing insert** in its quarterly statements to apprise clients of its account aggregation policy and the need for clients to notify their IAR if they wished to aggregate
- **Added disclosures to its Form ADV Part 2** stating that clients of two of its investment programs could aggregate account balances in related accounts to receive possible fee reductions.

Unfortunately, in relation to the one-time mailing inserts, Transamerica Financial "failed to ensure that the information was disseminated to clients," the SEC claimed. Specifically, it said, the firm's "third-party mailing service, which was responsible for mailing the insert, never sent it to ... clients."

#### Two manuals and more

The SEC made the following specific allegations:

- **Fee calculation and disclosure.** Transamerica Financial, "despite the 2009 branch office examination findings," failed to implement policies and procedures "reasonably designed to ensure that it calculated clients' fees in a manner consistent with its disclosure to clients."
- **Advisory fees and aggregation.** The firm "failed to adopt and implement adequate policies and procedures reasonably designed to ensure that its IARs reduced advisory fees when clients opted to aggregate accounts" in its investment programs.
- **Two manuals.** Transamerica Financial maintained two policy and procedure manuals. One was a Registered Investment Adviser Manual (RIA Manual), while the other was an Investment Adviser Representative Manual (IAR Manual). "These manuals contained conflicting policies on the application of advisory fee breakpoints," the agency said. "The RIA Manual stated that if a client selects aggregation, the IAR was 'required to reduce the advisory fees through the advisory fee reduction schedule.' However, the IAR Manual appeared to give IARs discretion on whether to pass on the breakpoint fee reductions. The IAR Manual stated that the IAR 'may reduce the advisory fees through the advisory fee reduction schedule.'"

#### Punishment

The firm was charged with violating Section 206(2) of the Advisers Act, which prohibits an investment adviser from engaging in fraud; Section 207 of the Advisers Act, which makes it unlawful to make an untrue statement about a material fact in a registration application or report to the Commission; and Section 206(4) of the Advisers Act and its Rule 206(4)-7, which require an adviser to adopt and implement written compliance policies and procedures.

In addition to the \$553,624 paid in refunds and interest to 2,304 clients and former clients, Transamerica Financial also paid a \$553,624 civil money penalty, the administrative order said. It also agreed to hire an independent compliance consultant, who will conduct a review and submit a report, recommendations from which Transamerica Financial has agreed to adopt. ☞

## SEC Beginning Outreach Seminars

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various locations throughout the country in the coming months.

Advisers within the jurisdiction of the agency's New York regional office received an email April 3, letting them know that an outreach seminar will be held for never-before-examined advisers located in New Jersey and New York on May 28 in New York City. "The event will consist of panel discussions addressing information about OCIE's exam process and priorities, and best practices in handling an SEC examination," the email said. "We are inviting chief compliance officers and other firm personnel to join us for this event."

Seattle has a seminar set for April 30. Dates are still being finalized for other cities, said **Judy Werner**, NSCP executive director. Cities lined up so far include Chicago, Boston, Atlanta and Kansas City.

The never-before-examined program was announced by OCIE in a January 9 National Exam Program letter<sup>1</sup> stating the office's 2014 exam priorities. Never-before-examined advisers may face either of two kinds of exams: risk-assessment, which "may include a high-

level review of an adviser's overall business activities, with a particular focus on the compliance program and other essential documents needed to assess the representations made on disclosure documents" or a "focused review," which will entail a "comprehensive, risk-based examination" on one or more of five specific "higher-risk areas," OCIE said.

The five specific areas listed are the compliance program, filings and disclosures, marketing, portfolio management, and safety of client assets.

The February 20 announcement letter, a copy of which was sent to each firm's chief compliance officer, also states that if serious deficiencies are found, in addition to sending an examination summary letter, the staff "may refer the deficiencies to the Commission's Division of Enforcement, state regulatory agency, or other regulator for possible action." <sup>2</sup>

## New SEC appointments

The SEC recently announced two appointments to its Office of Municipal Securities, as well as a new associate regional director.

**Rebecca Olsen** is the Office's new chief counsel, where she will oversee analysis of legal issues. Her responsi-

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bilities will include review of rulemaking at the Municipal Securities Rulemaking Board, as well as analysis of disclosure policy issues. She joined the Office of Municipal Securities in 2013, where she was involved in the municipal adviser registration rulemaking project, reviewed rulemaking, and consulted with the SEC Division of Enforcement on municipal securities enforcement matters, the agency said.

Prior to joining the SEC, Olsen spent more than 10 years at **Ballard Spahr**, where she practiced primarily in the municipal securities area. She holds a J.D. degree from **Georgetown University**, and an LLM degree in international business law from **Vrije Universiteit Amsterdam**.

In other SEC appointments in the Office of Municipal Securities, **Jessica Kane** was named the Office's deputy director. She "will play a leading role in overseeing all aspects of the Office of Municipal Securities," the agency said, including implementation and operation of the municipal adviser registration regime, oversight of Municipal Securities Rulemaking Board rulemaking,

municipal market structure initiatives, disclosure policy, and coordination on municipal enforcement matters.

Kane joined the SEC in 2007, working on corporate securities disclosure matters in the Division of Corporation Finance until 2012, and then working in the Office of Legislative and Intergovernmental Affairs until 2013. During the past year, she has served as senior special counsel to the director of the Office of Municipal Securities. She received her J.D. degree from **George Mason University School of Law**.

The SEC, on March 25, made another appointment, naming **Jeffrey Boujoukos** associate regional director for enforcement in the Philadelphia office, where he will oversee the office's enforcement efforts in the Mid-Atlantic region. Boujoukos joined the SEC in 2009 as a regional trial counsel, more recently supervising the Philadelphia office's trial unit. Prior to joining the SEC, he was a partner in the litigation department of **Morgan, Lewis & Bockius**. Boujoukos graduated **Temple University School of Law**. ☞

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