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ACA Insight

The weekly news source for investment management legal and compliance professionals

"Create a culture of compliance and let everyone know that there will be consequences if they violate it."

Inside Insights

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Don't Fear the Grinch: Catch Employees Who Violate Holiday Gift Policies

With the holiday season upon us, the question of compliance with gift and entertainment policies and procedures rises anew. Advisory firms with strong cultures of compliance may believe that they have few, if any, violators of their firms' gift requirements. Yet even with a 99 percent compliance rate, a firm with 100 employees will still have one violator.

Firms without strong and entrenched cultures of compliance will doubtless find

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DOL Finalizes 18 Month Delay for Fiduciary Rule Exemptions

What everyone expected to happen, happened on November 29. The Department of Labor published in the Federal Register its decision to extend the transition period for compliance with three Fiduciary Rule exemptions by 18 months: from January 1, 2018 to July 1, 2019. It also extended its non-enforcement policy regarding those exemptions for the same time period.

In making these moves, the DOL surprised no one. They are the latest in a chain of events undertaken by the Department that have pushed back elements associated

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IAA Issues Checklist to Help Advisers Comply with Form ADV Part1A Changes

The **Investment Adviser Association** has issued a checklist that should make life a little easier for those completing the SEC's new and amended items on Form ADV Part 1A. Those items, adopted by the agency in August 2016, address a number of key topics, including reporting on separate accounts and private funds managing multiple entities.

The 16-page checklist, which includes links to frequently asked questions and more, will help guide advisory firms as they seek to comply with the Form's amended requirements, which became effective in October. The checklist "outlines the new

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Don't Fear the Grinch

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higher percentages of non-compliance from those who intentionally or unintentionally violate gift policies and procedures. Preventative measures, such as training or sending reminders of advisory firm gifting policies as the holiday season approaches, will help these from occurring.

But compliance is not complete without monitoring and, when necessary, catching those who commit the violations and then taking appropriate action. With that in mind, the question becomes, what are the best methods to determine when gift violations occurs and who violated them?

"There is a tendency for these checks to focus on the investment staff and the trading staff. This is not necessarily the right approach."

Start with the assumption that you won't catch every violation or every violator, said **Pepper Hamilton** partner **John Falco**. "It's difficult in any compliance program to catch things that happen outside the office. A lot depends on the honesty and integrity of the people that you hire."

Making all this a bit more complicated is that the SEC does not have a specific rule saying that gifts shall not be given. This is an area where the agency has made a point of not being prescriptive. It did issue guidance in February 2015 about gifts and fund advisory personnel, and it will come down hard on an adviser that violates its own compliance rules on gifts, as it did in at least one enforcement action.

Otherwise, the Investment Company Act regulates fund advisory personnel in regard to accepting gifts and entertainment, and FINRA limits the practice for broker-dealers under its Rule 3220. There are also various local anti-bribery and/or anti-corruption statutes that come into play. When doing business overseas, these include the Foreign Corrupt Practices Act, which prohibits bribery of public officials.

Most violations will not be from those who intentionally sought to get past firm requirements, but from those who made mistakes. Nonetheless, advisers should consider monitoring for such violations and take action per their firm's policies.

Catching the violators

Here are some suggested practices that an adviser might employ to find gift violations:

- **Monitor email and instant messenger activity.** "Around holiday season, step up the monitoring of email," said **King & Spalding** partner **Jennifer Daly**, who previously served as chief compliance officer at a hedge fund and a broker-dealer. "Work keywords and phrases into your search, like 'gift,' 'thoughtful gift,' and 'thinking of me.'" Words and terms like these, as well as others like "tickets," "please accept this gift," and "complimentary" "will bring up a lot of hits, much of it is just noise," said Falco, but they may also help to narrow down the results. **Morrison & Foerster** counsel **Kelley Howes** suggested avoiding phrases like "happy holidays," which she said will "get a lot of false hits."
- **Monitor social media.** People on social media sites like Facebook, Twitter or LinkedIn tend to be a bit more informal than on email and may reveal more, said **Day Pitney** attorney **Michael Cummings**. You may not be able to do keyword searches here, but visits to employee sites, subject to applicable state and federal law, may be occasional spot checks. "Ultimately, it's just another method of communication," he said.
- **Work with the mailroom.** When gifts are sent during the holiday, they may be sent to a number of individuals at the firm. "Set up a process so that the mailroom, prior to bulk sets of packages being delivered to the employee, contacts you," said Daly. "If people catch wind that compliance is visiting the mailroom periodically, they will become more cautious." Also consider visiting the mailroom periodically yourself, she said.
- **Maintain communication with the chief financial officer.** "Start a dialogue with the CFO during the

holiday season," said Falco. "Ask about strange requests." The CCO isn't the only gatekeeper at an advisory firm, he said, and working in tandem with the CFO can produce results. This step can also be employed alongside email monitoring, so that a suspicious email might lead a CCO to check with the CFO about unusual expense requests at about the same time.

- **Check expense reports.** "These are always a good way to find 'blips,' spikes in spending on individual employee expense reports," said Howes. "If someone seems to be trending upward around the holidays, this might be a good time to pull the report."
- **Tap professional assistants.** This might sound a bit much, but if it is done in an open manner as part of an overall culture of compliance, it can help, said Daly. "People's professional assistants around holiday time can be your best friend," she said. "Be very transparent and inclusive about it. Tell the bosses that you would like to ask the assistants to send gifts they receive and open for their professionals to compliance for approval. They might appreciate the help in not having to make the determinations themselves around what to report."
- **Walk the floor.** "Be more of a presence and keep an eye out for bottles of alcohol, anything that has gift wrapping, and then have a conversation with that person," Daly said. "If you do it once, word gets around."

Big ticket items

The methods listed above may work well for smaller gifts, whether they are being sent to clients or vendors, or are being received from those parties. But such gifts also may be perfectly acceptable and fall within an adviser's *de minimis* gift policy. Such policies allow the exchange of gifts below certain dollar amounts, such as $100 to $250.

But what about larger gifts that result from long-term relationships between the adviser and vendors, or that may be sent from the adviser to a big client or to a prospective client?

These may be more difficult to catch, said Howes. "Increase the surveillance of email and IM traffic between employees and vendors that are already big relationships or those on the verge becoming big relationship." As for clients, she said that her experience is that most clients will not send advisers large gifts, that it is the other way around – and advisers should step up email and IM monitoring here, as well.

Don't forget to spread the net. "There is a tendency for these checks to focus on the investment staff and the trading staff," Howes said. "This is not necessarily the right approach. Mid-level people in other roles, for example those dealing with large printing and mailing vendors might be where big-ticket gifts are sent from vendors like printers."

Nor should you fall into the trap of believing that upper management, because they make more money than employees, is less likely to be influenced by low-dollar-value gifts. Consider including them in your monitoring efforts.

When you catch them

What should you do when you find a violation and identify the employee? "If you do find something, make an example of the situation, but in a nice way," said Daly. "For instance, go down to the trading floor and ask the person when he or she has time to meet with you so you can review the gift policy together in light of that gift he or she received. Don't chastise the person in public or run afoul of Human Resources requirements, of course. But others will see and hear that you brought it to the employee's attention."

"You don't want to create an environment where people aren't effective in their jobs because they feel like someone is hovering over them," said Falco.

Keep a record

Memorialize what you uncover. Consider keeping track of gifts given or received that you uncover. If any cross your firm's *de minimis* threshold, they are required by regulation to be noted on a violations log. CCOs should also keep copies of emails or other communications sent to these employees to remind them that it is against the firm's policy to give or accept these gifts.

Finally, consider this: If executives and employees are reminded that a violation to the gift policy must be logged and maintained, and can also be requested and reviewed by SEC examiners, they may be less likely to violate the gift policy. If they know that CCOs will keep copies of memos sent to executives and employees when they violate that policy, they may be more likely to think twice. Such documentation will also serve as good protection for the CCO against potential SEC charges.

In the end, though, "the best you can do is to create a culture of compliance and let everyone know that there will be consequences if they violate it and, perhaps just as importantly, that you are there to help solve the problem, not create awkward or unpleasant situations," said Daly. Self-reporting will always be the most efficient and effective way to catch violations." Howes agreed. "If you create a culture of compliance, your employees will do the right thing," she said.

DOL Finalizes 18-Month Delay

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with its Fiduciary Rule since the Trump administration took office in January 2017.

The three exemptions affected by the deadline extension are:

- **Best Interest Contract Exemption.** Under this exemption, those providing fiduciary retirement advice, would, in many cases, be required to enter into enforceable written contracts with investors. The contracts would need to state that fiduciaries will act in the best interest of the investor. This has raised concerns among advisers and broker-dealers because, as the DOL stated in its proposed amendments to extend the deadline, "IRA owners, who do not have statutory enforcement rights under ERISA, would be able to enforce their contractual rights under state law."
- **Class Exemption for Principal Transactions.** Under this exemption, an adviser or financial institution would be able to take part in the purchase or sale of a principal traded asset in certain transactions with a plan, participant or beneficiary account, or IRA, and receive a mark-up, mark-down or other similar payment for themselves or an affiliate. It also includes a contract requirement.
- **Prohibited Transaction Exemption.** This exemption would allow a person who serves as a fiduciary for employee benefit plans to execute securities transactions under certain circumstances.

During the extension of the transition period, the Department said, fiduciary advisers will continue to have an obligation to "give advice that adheres to 'impartial conduct standards.'" These standards require advisers to follow a best interest standard when making investment recommendations, charge no more than reasonable compensation for their services, and refrain from making misleading statements.

> *"The landscape for the DOL Fiduciary Rule is likely to change significantly, but not in the near future."*

The DOL's decision to continue not enforcing compliance with the exemptions until July 2019 comes with a caveat. The Department will not pursue claims against fiduciaries "working diligently and in good faith to comply" with the Fiduciary Rule and the related prohibited transaction exemptions. What this means, said **Wagner Law Group** partner **Stephen Wilkes**, is that "firms do not have a totally free hand to exercise during the extended period. Financial fiduciaries should review their internal compliance policies, supervisory activity, as well as external marketing and advertising programs, to ensure that they are 'good faith' players working diligently, and honestly, to comply with and meet their fiduciary responsibilities with regard to retirement account clients, as required by the prohibited transaction exemptions," he said.

The big picture

Overall, "the takeaway for investment advisors is that the landscape for the DOL Fiduciary Rule is likely to change significantly, but not in the near future," said **Mayer Brown** partner **Lennine Occhino**. "The DOL's

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non-enforcement policy provides some relief during this transition period; but still requires advisers and other plan fiduciaries to make diligent, good faith efforts to comply. Investment advisors should also be aware that the DOL's policy will not protect them from private claims."

"It doesn't really change anything – it truly and simply extends the status quo for 18 months until July 1, 2019," said Wilkes.

"Advisers should take steps now, if they have not done so already, to update their policies and procedures to support good faith compliance with these requirements," said **Drinker Biddle** partner **Joan Neri**. "They should also review and update their Form ADVs, if needed, to disclose the conflicts of interest that arise under the current fiduciary definition and how those conflicts are mitigated under the BIC exemption, PTE 84-24 or other applicable exemption."

One key thing to remember, said **Eversheds-Sutherland** counsel **Allison Wielobob**, is that while these delays affect the conditions of exemptive relief, "the Fiduciary Rule itself is still in effect." The enforcement ban may take the pressure off fiduciaries to make large-scale changes to their practices, she said, but it "will not obstruct the plaintiff's bar," members of which may bring legal actions under the Rule.

In addition, Wielobob said, the fact is that some fiduciaries have already changed their practices to meet many requirements of the Rule, "have accepted being fiduciaries and are going to stay the course."

Review

In announcing its decision, the DOL said that it would use the additional 18 months to review public comments submitted in regard to its July request for information, as well as comments submitted in response to the February 3 Presidential Memorandum that set this whole process in motion (*ACA Insight*, 2/13/17). In that memorandum, President Trump called for the Department to reexamine the impact of the Fiduciary Rule.

The Rule, issued by the Obama administration, had an original applicability date of April 10. After Trump's Presidential Memorandum, the DOL on March 2 proposed delaying that date by 60 days (*ACA Insight*, 3/6/17). The Rule officially became effective on June 9. It raised the standard that financial professionals making retirement investment recommendations must meet. All such professionals, including advisers and broker-dealers, now are considered fiduciaries, meaning they must always act in the best interest of the investor.

On May 22, the Department said that it would not enforce the Rule or the exemption requirements against advisers, broker-dealers and others until January 1, 2018 (*ACA Insight*, 6/5/17). It also issued a request for information on June 29 to gather further public feedback (*ACA Insight*, 7/10/17). With the November 29 action, the DOL has now delayed the exemptions and enforcement of the Rule for another 18 months.

Working with the SEC and more

The Department is also expected to use the additional 18 months to consider further changes to the exemptions and possibly to the Rule itself. "The Department anticipates that it will have a much clearer sense of the range of such alternatives only after it completes a careful review of the responses to the request for information," the DOL said in its commentary to the extension. "The Department also anticipates that it will propose in the near future a new streamlined class exemption."

The DOL is also considering working with the SEC on standards of conduct for advisers and broker-dealers.

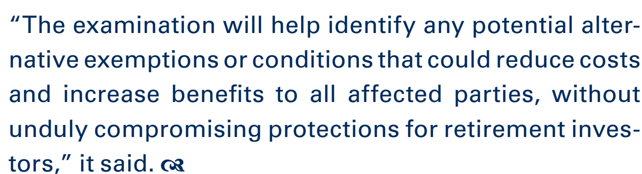
"The Chairman of the SEC has recently published a statement seeking public comments on the standards of conduct for investment advisers and broker-dealers," the DOL noted in its commentary to the November 29 extension, "and has welcomed the Department's invitation to engage constructively as the SEC moves forward with its examination of the standards of conduct applicable to investment advisers and broker-dealers, and related matters."

The DOL also said that it "has not yet completed the reexamination of the Fiduciary Rule and prohibited transactions exemptions, as directed by the President

on February 3, 2017. More time is needed to carefully and thoughtfully review the substantial commentary received in response to the multiple solicitations for comments in 2017 and to honor the President's directive to take a hard look at any potential undue burden."

"Whether, and to what extent, there will be changes to the Fiduciary Rule and PTEs as a result of this reexamination is unknown until its completion," it continued.

"The examination will help identify any potential alternative exemptions or conditions that could reduce costs and increase benefits to all affected parties, without unduly compromising protections for retirement investors," it said.



IAA Issues Checklist

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and amended items that include information about the asset types held in an adviser's separately managed accounts, as well as derivatives and borrowings information in the SMAs for advisers with certain minimum SMA registered assets under management and account sizes," the association said.

"This is the biggest change to Form ADV in quite a while," said IAA associate general counsel **Monique Botkin**, in explaining the association's motivation in creating the checklist. "We needed to put something together, with everything in one place, to help advisers out. If firms haven't looked at this yet, they need to start looking at it."

Advisers should also be aware, she said, that if they seek to amend their Form ADV, "they will be looking at the new Form Part 1A and questions. The old Part 1A of Form ADV is gone."

Changes

The minimum threshold required for advisers to report RAUM for aggregate SMAs may well have been the most important change to the reporting requirements. It was raised from $150 million to $500 million.

The SEC, in making the change, noted that several commenters to the proposed Rule – one of which was the IAA – had argued that increasing the threshold to $500 million would allow the agency to collect 95 percent of the data that it would need using the $150 million threshold, while at the same time relieving approximately 3,000 advisers from having to report derivatives and borrowings information. As a result of the change, advisers with a least $500 million but less than $10 billion in separately managed account RAUM are now required to report the amount of separately managed account assets and the dollar amount of borrowing attributable to those assets that correspond to three levels of gross notional exposure.

"We are pleased that the SEC has adopted enhanced data reporting for investment advisers with separately managed accounts, which will further strengthen the SEC's ability to oversee asset managers and conduct risk-based examinations," said IAA president **Karen Barr** at the time the amendments were adopted. "The IAA appreciates that, as we recommended, the SEC raised the threshold from $150 million to $500 million in separately managed accounts for advisers to report clients' use of derivatives, which will alleviate the burden on thousands of smaller advisers while still allowing the SEC to meet its regulatory objectives."

Another key change to Form ADV welcomed by the investment advisory community was the ability for private fund advisers managing multiple entities as a single business to register and report on just one form. Those choosing this "umbrella registration" option will find information about new Schedule R in the checklist.

"Given the two significant new pieces of Form ADV, the umbrella registration option and the portfolio reporting for SMAs that is similar to what is required in Form PF, registrants are sure to have many questions as to both what the SEC is expecting, as well as how the industry is initially addressing some of the less understood requirements," said **Faegre Baker Daniels** partner **Jeffrey Blumberg**. "This checklist gives registrants a good starting point for addressing those issues and will help them determine when external help, whether a compliance consultant or outside counsel, is necessary."

In addition, the checklist covers the following new and amended items about an adviser's business, including:

- Number of clients and RAUM attributable to each of 14 client categories;
- Website addresses of publicly available social media sites over which the advisory firm controls the content (but not the sites of its employees);
- The 25 largest branch offices;
- Custodians that account for at least 10 percent of SMA RAUM and the amount of such RAUM held at the custodian, as well as its location;
- Whether the adviser's CCO is outsourced; and
- Whether the adviser has parallel managed accounts relative to registered investment companies and business development companies.

The checklist

The IAA checklist contains questions on more than 20 specific Form ADV items, as well as information on Schedule R and other key information.

Much of the information is presented in three columns:

- The first column identifies the Item (i.e., Item 1.F(5), Number of Offices);
- The second column listing the requirements and questions (i.e., "List the total number of offices, other than your principal office and place of business, at which you conduct investment advisory business as of the end of your most recently completed fiscal year."); and
- The third column containing additional information and guidance (i.e., "The SEC amended the instructions of the Form so that changes to Item 1.F of Schedule D need only be updated annually.")

Items and topics

Following is a sampling of the Form ADV, Part 1A Items, Schedules and other topics that the checklist covers:

- Item 1.I. / Section 1.I of Schedule D – Social Media
- Item 1.O. – Balance Sheet Assets
- Item 5.D. – Types of Clients
- Item 5.G.(3) – Parallel Managed Accounts to Registered Investment Companies You Advise
- Item 5.I.(2) – Wrap Fee Programs

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- Item 5.K.(1) / Section 5.K.(1) of Schedule D – Separately Managed Account Clients Asset Categories
- Item 5.K.(3) / Section 5.K.(2) of Schedule D – Do you engage in Derivatives Transactions on behalf of SMA clients you advise?
- Item 8.H.(1) – Participation or Interest in Client Transactions
- Item 9 – Custody
- Conditions for New Schedule R – Umbrella Registration for Private Fund Advisers
- Worksheet on Form ADV Part 1A Amendments and Completing Section 5.K.(2)
- New terms and glossary.

IM Deputy Director Named

Another appointment has been made in chairman **Jay Clayton's** SEC. **Paul Cellupica** is the SEC Division of Investment Management's new deputy director.

The agency announced his appointment November 20. As deputy director, Cellupica will oversee a number of the Division's strategic, rulemaking and industry engagement initiatives. In addition he will also serve as a senior adviser to Division director **Dalia Blass**.

Prior to accepting his new position, Cellupica was managing director and general counsel for securities law as **Teachers Insurance and Annuity Association of America**. Before holding that position, he served as chief counsel for the Americas at **MetLife**.

Cellupica is no stranger to the SEC. He was employed by the agency in a number of capacities in the Investment Management Division, as well as the Division of Enforcement, between 1996 and 2004. One of those positions was as assistant director in the Division of Investment Management, a position he held from 2001 to 2004, according to the agency.

Cellupica clerked for judge **David Nelson** of the U.S. Court of Appeals for the Sixth Circuit. He hold a law degree from **Harvard Law School**, where he also received his baccalaureate degree.

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