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INSIDE...

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Analyze more than share class fees to avoid trouble with SEC examiners

You've been put on notice that OCIE will be doing a sweep exam looking at compliance P&Ps over the selection of mutual fund share classes that clients get placed into (**IA Watch**, July 13, 2016).

One of your peers shares her recent exam experience to warn that OCIE examiners may interpret a fiduciary duty violation in selecting a NTS, or no transaction fee fund.

"You have to look at those expense ratios as well because those are typically higher than I shares," she warns. I shares have traditionally offered the lowest mutual fund costs, in contrast with A shares that generally include 12b-1 fees.

Some advisers may reason that it's best to place a client in an NTS fund. But **SEC** examiners have faulted an adviser for doing this because other costs connected with these funds were higher than the share classes. The problem can occur in reverse, too. Say, an adviser elects to place a client in a mutual fund class that lowers the adviser's trading costs but ups the client's fee. Examiners aren't likely to look kindly at this outcome, our source warns.

Advisers "have to do a calculation [across all three classes]" and consider how often you anticipate trading for the client, she recommends. Conduct a reasoned analysis of which class is best for the client overall, she continues.

Editor's Note: Have you seen OCIE's sweep exam letter? If so, please share it with us. We'll keep your identity anonymous. Simply e-mail us the letter by clicking here. ■

Wrap fee programs

Absorb lessons from enforcement case and keep disclosure current and robust

If there's one solid takeaway from the recent RiverFront enforcement action it's to be as clear as you can in describing your step-out trades within wrap fee programs.

The **SEC** fined the Richmond, Va.-based **RiverFront Investment Group** ($5.5B in AUM) for Form ADV disclosures that didn't keep up with the firm's increasing step-out trades in a wrap fee program (**IA Watch**, July 14, 2016).

"Whenever you've had a change in practice," revisit your disclosures, recommends **Jeremiah Williams**, counsel with **Ropes & Gray** in Washington, D.C.

"I saw this case as one that sends a message to the adviser community about the need to do interim updates" to their Form ADV, says **Conor Mullan**, counsel with

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Reader-suggested story

Best practices for keeping an eye – or an ear – on staff who meet with others

Dating from at least the **SEC**'s heightened interest in adviser use of expert networks a few years ago, compliance officers have developed various methods to monitor staff to ensure they're not tempted to trade on material, non-public information learned in meetings.

"We're aware of every scheduled meeting," says a CCO at a New York firm. The adviser maintains an online calendar and requires that staff file documents after each meeting. "Notes are completed and sent to our research repository" where compliance can read them, continues the CCO.

His concerns are diminished because staff meet with top officials at public companies. "They're Reg FD people," says the CCO. He's referring to the SEC rule that requires that issuers "make public disclosure" of MNPI shared with financial professionals.

The tactic used by **Pzena Investment Management** ($23.7B in AUM) in New York also doesn't include

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Wiggin and Dana in Philadelphia. He adds that it also stresses that compliance must have a "seat at the table when business goes through" major changes.

RiverFront's CCO **Karrie Southall** wasn't available for comment. The firm has updated its Form ADV brochure following last month's enforcement action. It's much more detailed in explaining trades within wrap fee programs (see the text below).

Too much disclosure?

Mullan read through RiverFront's revised disclosure at **IA Watch**'s request. He commends its detail but notes that the new language highlights a "downside" to the SEC's distaste for words like "generally" and "may" in disclosures (**IA Watch**, March 1, 2016).

"If you have to describe the general practice, plus every exception to the general practice, the document becomes too cumbersome and inconsistent with the SEC's plain-English mandate," asserts Mullan. The SEC's stance challenges firms to "strike the right balance" between being definitive while avoiding wordy, technical and complicated language in a document that's supposed to be easy for clients to read.

"I think you have to remove the conditional language [such as 'generally' and 'may'] and state affirmatively what you are and are not doing," says **Jennifer Klass**, a partner with **Morgan Lewis** in New York, when asked to assess the lessons from RiverFront.

If a firm chooses to trade away from the wrap fee sponsor – and thus incur for the client an additional charge on top of the wrap fee – then it should be doing so to achieve best execution, she says.

A New York-based CCO who asked not to be identified reports that experience proves you must document best execution when stepping out trades. Ironically, adds the CCO, you need to trade away at times as a measure of determining whether the wrap fee program offers you best execution.

Be sure to disclose to the wrap fee sponsor what your trading practices are. Respond accurately to sponsor due diligence questionnaires "because it's a high-risk area for examiners," stresses the CCO.

A departure for the SEC?

Some wonder if the RiverFront case marks a departure for the SEC – questioning trading away in bonds. Ropes & Gray's Williams doesn't see it this way, joining a number of other attorneys who agreed with this view.

However, Mullan disagrees. "If you read between the lines in this order, they're still focused on markups for bonds," he notes. But the hallmark of best execution for equities are "not really the case with fixed income," he says. "For the SEC to look at fixed income in the same light [as equities] is wrong," Mullan continues. You combat this attention from your regulator with "explicit disclosures" that explain the differences in best execution of bonds versus equities, he adds.

RiverFront's revised language

In its revised Form ADV brochure, RiverFront lists 16 factors it considers before stepping out trades, ranging from "our experience with the firm on prices and other results obtained in prior trading transactions" to "any past issues we encountered when using a particular broker-dealer for similar trades."

The disclosure begins by defining two types of trades, a model trade ("almost always executed through a 'step-out transaction'") and a maintenance trade (with the sponsor firm). It goes on to state that "RiverFront

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3. Branch Office Inspection Checklist
4. SEC Document Request Letter
5. Political Contributions Matrix ■

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Step-Out Trades (Continued from page 2)

will often, pursuant to its duty to seek best execution, determine to execute using step-out transactions (also referred to as 'trade-aways'), even though such transactions require payment of a commission that is not covered by the wrap fee. Whenever RiverFront makes such a determination with respect to such a transaction, RiverFront will cause the account and, in the case of a block trade, any other included client accounts, to pay the executing broker-dealer the commission or commission equivalent such broker-dealer requires. These commissions or commission equivalents are charged to the client's account in addition to the wrap fee paid to the Sponsor Firm, and are netted into the price received for a security and will not be reflected as individual items on the client trade confirmation. Because RiverFront has found that step-out transactions for model trades almost always allow it to obtain better trade executions for its clients, all or nearly all of the transactions in some client accounts will be traded away from the Sponsor Firm via step-out transactions. Given RiverFront's trading practices, a wrap account with RiverFront as the appointed investment manager may not be suitable for clients with minimal maintenance trades."

It then notes that a client may wish to pursue an "unbundling option" that would involve a separate charge for the trade. The brochure further reads that "Because RiverFront places a significant amount of trades away from the Sponsor Firms, and the commissions or other fees for these trades may be considered redundant to the wrap fee, you may wish to explore the unbundling option to determine if it would be advantageous to select if offered by your Financial Advisor's Sponsor Firm." ■

Rep bilked failing elderly client, CCO cited for lacking P&Ps to spot the fraud

A new **SEC** settlement suggests the prudence of compliance monitoring withdrawals when a rep serves as trustee over a client's account.

Rep **Gary Oliver** brought a previous client to his new firm, **Fortius Financial Advisors** in Salt Lake City. He created a trust for the elderly woman. Soon after, she broke her leg, spent a month in the hospital and her doctor diagnosed her as suffering from dementia. Oliver placed her in an assisted living facility.

But he also began to misuse the trust. Before he was fired, he would take $136,000 from the trust that he didn't deserve and invest some of the trust assets in securities inappropriate for a client "residing in a dementia unit and in poor health," according to the SEC. The client would die at 88 in 2010.

Clueless compliance

The settlement finds that the firm lacked compliance P&Ps to uncover Oliver's fraud and it violated the custody rule by not having ordered a surprise exam of the trust account. Fault fell to Fortius' founder – and CCO, at the time – **Jeff Bollinger**.

The SEC states that Bollinger used an "off-the-shelf template that he obtained from a compliance consulting company" as his compliance manual yet he "failed to fill in the blanks or edit significant portions of the template to specifically address risks associated with Fortius' operations," according to the settlement.

Another red flag that Bollinger missed is that Oliver and the elderly client "entered into their own agreement to separately compensate Oliver, up to a monthly maximum amount, for financial and personal services that he rendered to" her. Even with this, Oliver took more money from the trust than he was entitled to.

The adviser also created conflicts of interest by routing $600,000 of the client's assets into a private fund run by Fortius, which provided the men and the firm with additional fees that were undisclosed.

The SEC barred Oliver from the industry, ordered $150,000 in disgorgement and instituted a $125,000 fine. Together, Fortius and Bollinger must pay $120,000.

The firm's current CCO, **Jeanne Deitz**, didn't return an **IA Watch** phone call. ■

Playing Chaperone (Continued from page 1)

chaperoning staff who meet with expert networks or public company officials. But "we do have the right to step in on [and listen to] expert network calls, and we do frequently do that," says GC/CCO **Joan Berger**.

We've shared best practices before for advisers that use expert networks (**IA Watch**, June 27, 2011). These steps also can apply to meetings with public company

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officials. In our Compliance Toolbox at www.iawatch.com, you'll even find P&Ps that permit "random and unannounced monitoring."

Dexter Buck, the CCO at **Financial Engines Advisors** ($113B in AUM) in Sunnyvale, Calif., recalls the approach he took at a prior firm. "We kept a log of all of those meetings," he says. The log would list the name of the company and the names of staffers in the meeting. For up to six weeks after each meeting, he would surveil the personal trading of the staffers who attended the gathering "just to see if they're trading in that company's securities," he says.

Another tactic he used was to increase the personal trading reviews after news articles appeared on public companies. Buck would retreat to three weeks before the news broke to see if any staffers traded in the securities prior to the news "to see if anyone got ahead of it," he adds.

Wafra Investment Advisory Group ($9.9B in AUM) in New York has compliance P&Ps for expert networks. It's now codifying the approach for other staff meetings, says CCO **Vincent Campagna**. It would rely on self-reporting. He doesn't expect it to include the ability for compliance to chaperone meetings, although firm compliance staff would have the right to tag along.

A little help from your experts

Expert networks have responded to all of the attention by upping their game. Many offer "a portal" that allows compliance officers to "see every call," meeting or webinar that their investment staff participates in as well as to read "a full bio" of the expert(s) they will meet with or have met with, says Wafra's Senior Compliance & Legal Analyst **Beth Dwyer**.

This gives compliance the ability to decide whether to listen in on an upcoming call. For instance, if the expert's bio indicates she used to work at the firm being disclosed, that may prick compliance's interest.

The firm's policies permit compliance to sit on calls "either on a disclosed basis or on an anonymous basis," says Campagna. Employees must self-report that they are having these discussions "and then we would randomly decide which ones we want to participate in and or review their notes" on the meeting, he adds.

Many of the public companies the adviser deals with insist on non-disclosure agreements. The NDAs usually contain wording warning against trading on MNPI. Adviser staff often alert compliance when certain companies should go on the firm's restricted list.

A process to consider

Your process of oversight should begin with determining if you even want staff to talk with current or even recently departed employees of public companies, says **Susan Grafton**, a partner with **Dechert** in Washington, D.C.

Assuming you do, then "you want to have a process to obtain prior approval so that compliance checks can be performed," she adds. You may base compliance's consent on who the public company employee is and if she has permission from her firm to talk, Grafton continues. Some firms' P&Ps may prohibit such conversations.

Next, ask to see a list of questions your staffer will ask, "somewhat of a script that would be pre-approved by compliance," she says. Don't force your staffer to read it but make it clear that the questions define the territory of discussion. They shouldn't stray from the list.

As the meeting starts, make sure there's a warning given (or in an e-mail ahead of time) that your staffer doesn't seek any MNPI or confidential information, Grafton continues. Also make clear that the conversation can end at any time.

"Then you want a debriefing," she recommends. Discuss the meeting with your staff. Understand what the staffer got out of it versus the compliance risk of attending it. Compliance or legal should produce a memo for the file to document the debriefing, she adds. ■

The independent model: some trips and tips

Supervising independent networks is hard. How do you incentivize diverse groups of advisors to follow the rules of the road? What structures are best suited for sharing information and concerns?

Here's a recipe from **Tom Horack**, CCO of **John Hancock**'s retail distribution arm: Communicate—repeatedly—about the rules and regulations. But he also impresses upon the advisors why it is in their self-interest to pay attention. "You have to sell them on why it's important and why it's critical to their business to think about the things we are saying," Horack says.

"You got to find out what drives the point home," he adds. "Over the last few years, it's been equity and succession planning. It's the value of their practice."

One way Hancock does that: a monthly webinar for supervisors in the field, where upcoming changes in procedures and regulations are discussed.

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The Independents (Continued from page 4)

Quarterly business-owner meetings are another tactic. One such meeting featured a business-unit owner and his compliance specialist talking about their relationship and the need for mutual support.

Wearing the white hat

LPL Financial publishes a monthly compliance alert including recent rule and policy changes. Home office employees participate in a post-alert call to make sure they understand the changes and can be responsive to questions. There's also a special phone line for advisors to call in and ask questions.

The message LPL is trying to convey? "We are not just out there to do exams or catch them during surveillance," says **Suzy Auletta**, executive VP/CCO of LPL. "We are there to protect their business, their livelihood, and their licenses."

LPL also regularly communicates via:

√ Monthly meetings with CCOs of member firms;

√ Monthly meetings with larger OSJ offices and home-office supervision and compliance; and

√ A regular "large entity call" for the largest member firms.

Hancock imposes restrictions on hiring and outside activities as a way to head off trouble. All hiring decisions must come through the home office. And in only a relatively few cases does the firm allow individual reps to have their own **SEC**-registered investment adviser.

The firm gets copies of the advisor's rule 206(4)-7 reports, and "if they want to change their [Form] ADV … we have to have a discussion about it," Horack says.

His goal: "Have the confidence in that individual that he is going to put the money into it and have the systems in place."

Centralizing discipline and supervision

Discipline at Hancock is meted out via a central committee that includes members from finance, supervision, sales, and corporate. A compliance team investigates allegations of misconduct, writes a report and enforces recommended sanctions.

That team alone has the authority to address certain low-level offenses, handing out letters of reprimand and the like. "It can speed up the process so things do not drag down in a committee-type environment," Horack says.

LPL has an Advisor Business Conduct committee to consider allegations of misconduct whether self-reported or uncovered via supervision, branch exams or surveillance. Besides levying fines, it has the power to strip OSJ offices of their authority and put branches under home-office supervision.

Auletta said LPL is already moving to centralize supervision of complex products and other activities to "ensure consistency."

"I see that as the way of the future," she says, adding that reaction among advisors has been mixed. "Some of them are happy to be relieved of particular supervisory functions. And others are like, 'this is my business, and I want to do that.'"

Hancock is moving review of all new products into the home office. But Horack is wary of taking too much away from the local supervisors for fear of losing touch with what reps are doing.

"There is still in my mind a place for [onsite supervision] in the field office so we can know this rep forgot to tell us about his OBA that we walked in on and saw in the office," Horack says. "Things like that you are not going to get when you have that distance." ■

SEC exam reveals hedge fund manager fraud scheme targeting the terminally ill

Issuers of medium and long-term bonds and notes paid out more than $100 million in early redemptions as the result of misrepresentations by a hedge fund manager and his firm, the **SEC** alleges. Charged August 15 with fraud were **Eden Arc Capital Management**, **Eden Arc Capital Advisors** ($31M in AUM) and **Donald Lathen** for engaging in a scheme of paying terminally ill individuals to use their names on purportedly joint brokerage accounts so Lathen could purchase investments on behalf of his hedge fund and redeem them early by invoking a "survivor's option."

An SEC examination of EACM ultimately uncovered the scheme. The Commission alleges that Lathen—the sole owner and control person, CEO, CFO and CCO of EACM and 100% owner of EACA—used his contacts at nursing homes and hospices to identify patients with less than six months to live.

Individuals lured with $10K apiece

EndCare was the marketing vehicle that Lathen founded to attract the terminally ill individuals. In EndCare's marketing materials, Lathen described EndCare as an "end of life financial assistance program." The pitch worked with Lathen successfully recruiting at least 60 individuals by paying them $10,000 apiece to use

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their names on accounts, the SEC alleges.

When a patient passed away, the SEC states in its order, Lathen would redeem the instruments at full face value by sending a letter to the issuers stating that the "joint owner" or "joint and beneficial owner" on the account that held the investment had died. In actuality, Lathen's hedge fund was the true owner of the survivor's option investments, the SEC notes.

Not entitled to survivorship rights

The hedge fund employed a strategy to exercise the survivor options with sufficient speed and certainty to lock in high yields resulting from the ability to quickly sell the investments back to the issuers at par. The Commission notes that "as Lathen himself was aware," the hedge fund couldn't lawfully be a joint owner on the accounts because, as a corporate entity, it would not have been entitled to "survivorship" rights.

Since May 2011, the SEC found that the hedge fund purchased 2,350 investments from dozens of issuers through the joint accounts. The scheme proved lucrative. Through December 2015, the hedge fund's profits—achieved through management and performance fees—were $9.5 million, the SEC claims. For the period spanning May 2011 through September 2015, EACM claimed total returns for the hedge fund of nearly 75%.

The SEC also charged that EACA violated the custody rule by failing to properly place the hedge fund's cash and securities in an account under the fund's name. ■

Click here to read this entire story. ■

IA Watch YouTube video on the BIC

Click the box below to watch our video with **Marcia Wagner** of the **Wagner Law Group** in Boston. She lists 10 elements of a BIC under the DOL's new fiduciary duty rule. ■

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