Regulatory Update

October 2022

Contents

Introduction 3

News for Investment Advisors 4

Marketing Rule Compliance Faces EXAMS Scrutiny 4

Lessons Learned 5

With Elections Coming Up, SEC Announces Four Pay-to-Play Settlement Cases 5

Something New to Worry About – Identity Theft Red Flags Rule Violations 5

Leaving Wrap Accounts to Run on Auto-Pilot Costs Advisor $700,000 in Fines 6

A Persuasive Argument for Centralized Trading 6

Worth Reading, Watching, and Hearing 7

To Do Checklists for the Month of October 2022 8

Introduction

Welcome to the ACA Regulatory Update - October Edition.

This month, we reflect on the latest regulatory updates and developments of note. Topics of focus include the U.S. Securities and Exchange Commission's (SEC's) upcoming Marketing Rule exams, new crackdowns on pay-to-play violations and identity theft prevention, and tips for wrap fee program advisers. Read on for our unique insights and practical thought leadership as well as a checklist of important dates for the month of October.

News for Investment Advisors

Marketing Rule Compliance Faces EXAMS Scrutiny

by Jaqueline Hummel

With the **new Marketing Rule** coming into full force on November 4, 2022, the SEC's Division of Examinations (EXAMS) is hitting the ground running. In a recent **announcement**, they stated that future examinations will include a focus on compliance with the new rule, specifically:

- advisers' marketing rule policies and procedures
- firms' ability to substantiate material statements of facts in advertisements
- compliance with performance advertising requirements
- updates to books and record procedures to comply with the Marketing Rule

Finally, the Alert reminds firms to answer new questions in Form ADV about their marketing practices as part of the next annual update.

Lessons Learned

With Elections Coming Up, the SEC Announces Four Pay-to-Play Settlement Cases

by Jaqueline Hummel

The SEC settled four cases against investment advisers for violations of Advisers Act **Rule 206(4)-5**, more commonly known as the Pay-to-Play Rule. The rule prohibits investment advisers from getting paid for providing advisory services to a government client for two years following a campaign contribution by their firm or certain associates. Government clients include "candidates or officials in a position to influence the selection or retention of investment advisers to manage the assets of public pension funds or other public entities."

As noted by **Commission Hester Peirce**, these four cases share similar facts. They involved "one-time, small-dollar contributions by one or two people, and all the investment advisers had established advisory relationships with the relevant government entities before the contributions occurred."

These cases serve as a reminder that the Pay-to-Play rule is based on strict liability. The advisers in these cases ended up paying civil penalties ranging from $45,000 to $95,000. With elections coming up in November, investment advisers should remind their employees of the strict penalty for non-compliance: being barred for two years from providing advisory services for compensation to that government entity.

Something New to Worry About – Identity Theft Red Flags Rule Violations

by Jaqueline Hummel

The SEC recently **charged** three broker-dealers for violations of the SEC's Identity Theft Red Flags Rule, aka **Regulation S-ID**, for the first time since 2018. This regulation requires financial institutions to implement and administer a written program designed to detect, prevent, and mitigate identity theft for customers with "covered accounts." Covered accounts are defined as:

> (1) an account that a financial institution or creditor offers or maintains, primarily for personal, family, or household purposes, that involves or is designed to permit multiple payments or transactions; or
>
> (2) any other account that poses a reasonably foreseeable risk to customers of identity theft. Although no client harm was alleged, the firms had to pay penalties ranging from $425,000 to $1.2 million.

In **one case**, the SEC alleged that the broker-dealer's policies were perfunctory and contained no detail on how the firm identified or responded to red flags. Moreover, the firm failed to assess its service providers annually as required by its procedures and provided no training to its staff on spotting identity theft.

Given the increase in cyberattacks and breaches in cybersecurity, it's not surprising that the SEC targeted these firms for not developing robust policies and procedures to identify and prevent identity theft. Advisers and broker-dealers should review their Identity Theft Prevention Programs to ensure they are up-to-date and sufficiently address current methods of identity theft facing their businesses.

Leaving Wrap Accounts to Run on Auto-Pilot Costs Advisor $700,000 in Fines

by Jaqueline Hummel

In 2019, the SEC warned advisers that their fiduciary duty included reviewing the suitability of accounts in its **Commission Interpretation Regarding Standard of Conduct for Investment Advisers**. In a recent **settlement action**, the Commission took an adviser to task for failing to meet this responsibility. The adviser had offered wrap accounts, where the clients paid one fee to cover both advisory fees and brokerage commissions. As noted in the settlement order, wrap fee programs are not suitable for all clients. For clients that do not trade frequently, it may be cheaper to maintain their assets in an advisory account and pay their trading costs as incurred.

According to the SEC, for over three years, the adviser failed to review the wrap accounts to determine whether they continued to be in the clients' best interest. Consequently, some wrap-fee clients with little or no trading activity continued to pay a higher fee than they would have in a non-wrap account. Moreover, some client accounts ended up paying additional trading costs even though the firm disclosed that the wrap fee would cover brokerage execution costs.

Advisers offering wrap accounts should be paying attention and consider taking these steps:

- ☑ Reviewing wrap accounts periodically for inactivity and include in their policies and procedures parameters to assess whether the account remains suitable for each client
- ☑ Reviewing wrap accounts to ensure that clients are not being charged for brokerage commissions
- ☑ Reviewing disclosures to wrap clients to ensure that they accurately describe any transaction costs wrap clients might pay in addition to the program fee.

A Persuasive Argument for Centralizing Trading

by Jaqueline Hummel

The SEC **fined** an advisory firm $400,000 for failure to supervise an **investment adviser representative** who allocated profitable trades to his personal and family accounts over seven years. The IAR was barred from the industry and required to pay a fine of $300,000 and disgorgement of approximately $600,000.

This is not a new story – there have been many other cases of cherry-picking, where IARs or portfolio managers make trades in an omnibus account and then allocate the more profitable ones to their own accounts and the less profitable ones to clients. Cases like this illustrate how hard it is to control risk when IARs trade in client accounts. Firms following this model should monitor trading activity daily and institute procedures that ensure someone other than the IAR is reviewing trades. Firms can also greatly decrease their risk of cherry-picking by requiring trades to be placed through a centralized trading desk run by the operations department.

As compliance officers know, trading is a high-risk activity for advisers. Firms should allocate their supervisory resources accordingly.

Worth Reading, Watching, and Hearing

» **Custody Rule Violations and Inaccurate Form ADV Disclosures**
Check out this cautionary tale about nine advisory firms who violated the Custody Rule.

» **Implications of the SEC's Draft Strategic Plan**
Read our analysis of the SEC's long-term plan to understand what the Commission's next moves will be.

» **Drafting RIA Advisory Agreements: Best Practices and Essential Elements to Include**
What should your advisory agreement say? This article lays it all out for you.

» **New Marketing Rule Performance Net Return Calculation Methodologies**
Get your questions answered about calculating net returns under the new Marketing Rule with this article.

» **The Securities Compliance Podcast**
The SEC's new Marketing Rule is fast approaching, find out what steps you should take to be prepared in this podcast hosted by Patrick Hayes, partner at Calfee, and Carlo di Florio, ACA Group's Global Advisory Leader, and sponsored by the NSCP and ACA Group.

» **Electronic Communications Recordkeeping Failures Cost Large Firms More than $1.1 Billion**
ACA provides guidance on the latest SEC sweep on the use of electronic communication applications.

» **SEC Issues Risk Alert for Municipal Advisors**
ACA's Patrycja Savignano provides a summary of the latest alert from the SEC's Division of Exams focusing on Municipal Advisors.

To Do Checklists for the Month of October 2022

Investment Advisers

- [ ] **Form 13H:** Amendment to Form 13H due promptly for advisors that already have a Form 13H filing obligation and have changes to any of the information reported.

  Recommended due date: October 13, 2022

  (Note: Neither the SEC nor its staff has provided guidance on the definition of "promptly" for Form 13H.)

Hedge/Private Fund Advisors

- [ ] **Form PF for Large Liquidity Fund Advisors:** Large liquidity fund advisors must file Form PF with the SEC on the IARD system within 15 days of each fiscal quarter-end.

  Filing for Q3 2022 is due October 15, 2022

- [ ] **Blue Sky Filings (Form D):** Advisors to private funds should review fund blue sky filings and determine whether any amended or new filings are necessary. Generally, most states require a notice filing ("blue sky filing") within 15 days of the first sale of interests in a fund, but state laws vary.

  Due October 15, 2022

Mutual Funds

- [ ] **Form N-MFP:** Form N-MFP (Monthly Schedule of Portfolio Holdings of Money Market Funds) reports information about the fund's holdings as of the last business day of the prior calendar month and must be filed no later than the fifth business day of each calendar month.

  Due October 7, 2022

Broker/Deakers

- [ ] **FINRA Accounting Support Fee:** Quarterly invoice to support the GASB budget. Based on the municipal securities the firm reported to the MSRB. De Minimis firms (that owe less than $25) will not receive an invoice. Invoices are sent to the firm via WebCRD's E-Bill.

  Due date to be determined

- [ ] **SIPC-3 Certification of Exclusion from Membership:** For firms with a Fiscal Year-End of August 31 AND claiming an exclusion from SIPC Membership under Section 78ccc(a)(2)(A) of the Securities Investor Protection Act of 1970, this annual filing is due within 30 days of the beginning of each fiscal year.

  Due October 1, 2022

- [ ] **Customer Complaint Quarterly Statistical Summary:** For complaints received during the third quarter, FINRA Rule 4530 requires firms to submit statistical and summary information regarding complaints received during the quarter by the 15th day of the month following the calendar quarter.

  Due October 15, 2022

- [ ] **Quarterly FOCUS Part II/IIA Filings:** For quarter ending September 30, FINRA requires member firms to file a FOCUS (Financial and Operational Combined Uniform Single) Report Part II or IIA quarterly. Clearing firms and firms that carry customer accounts file Part II and introducing firms file Part IIA.

  Due October 26, 2022

Broker/Deakers (continued)

- [ ] **Quarterly Form Custody:** SEC requires that member firms file Form Custody under Securities Exchange Act Rule 17a-5(a)(5) for the quarter ending September 30.

  Due October 26, 2022

- [ ] **Supplemental Statement of Income ("SSOI"):** For the quarter ending September 30, FINRA requires firms to submit additional, detailed information regarding the categories of revenues and expenses reported on the Statement of Income (Loss) page of the FOCUS Report Part II/IIA.

  Due October 31, 2022

- [ ] **Supplemental Inventory Schedule ("SIS"):** For the month ending September 30, the SIS must be filed by a firm that is required to file FOCUS Report Part II, FOCUS Report Part IIA or FOGS Report Part I, with inventory positions as of the end of the FOCUS or FOGS reporting period, unless the firm has (1) a minimum dollar net capital or liquid capital requirement of less than $100,000; or (2) inventory positions consisting only of money market mutual funds. A firm with inventory positions consisting only of money market mutual funds must affirmatively indicate through the eFOCUS system that no SIS filing is required for the reporting period.

  Due October 31, 2022

- [ ] **Annual Audit Reports for the Fiscal Year-End August 31, 2022:** FINRA requires that member firms submit their annual audit reports in electronic form. Firms must also file the report at the regional office of the SEC in which the firm has its principal place of business and the SEC's principal office in Washington, DC. Firms registered in Arizona, Hawaii, Louisiana, or New Hampshire may have additional filing requirements.

  Due October 31, 2022

- [ ] **SIPC-3 Certification of Exclusion from Membership:** For firms with a Fiscal Year-End of September 30 AND claiming an exclusion from SIPC Membership under Section 78ccc(a)(2)(A) of the Securities Investor Protection Act of 1970, this annual filing is due within 30 days of the beginning of each fiscal year.

  Due October 31, 2022

- [ ] **SIPC-6 Assessment:** For firms with a Fiscal Year-End of March 31 SIPC members are required to file for the first half of the fiscal year a SIPC-6 General Assessment Payment Form together with the assessment owed within 30 days after the period covered.

  Due October 31, 2022

- [ ] **SIPC-7 Assessment:** For firms with a Fiscal Year-End of August 31. SIPC members are required to file the SIPC-7 General Assessment Reconciliation Form together with the assessment owed (less any assessment paid with the SIPC-6) within 60 days after the FYE.

  Due October 31, 2022

About ACA

ACA Group ("ACA") is the leading governance, risk, and compliance (GRC) advisor in financial services. We empower clients to reimagine GRC and protect and grow their business. Our innovative approach integrates advisory, managed services, distribution solutions, and analytics with our ComplianceAlpha® regulatory technology platform with the specialized expertise of former regulators and practitioners and a deep understanding of the global regulatory landscape.

For more information, visit
www.acaglobal.com

About the Author

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Jaqueline M. Hummel is Director for ACA's US Regulatory Advisory Group. She is a securities attorney and regulatory compliance consultant with extensive experience as an in-house attorney working in the areas of investment adviser, broker-dealer, and investment company regulation and compliance. Ms. Hummel provides compliance consulting services to registered investment advisors, working to develop effective compliance programs and solve complex regulatory issues, including serving as an Outsourced CCO.

Before joining ACA, she served as a partner at Hardin Compliance Consulting LLC, which was purchased by Foreside in June 2021. Before that, Ms. Hummel held the position of Chief Compliance Officer for PNC Capital Advisors and PNC Realty Investors, investment adviser affiliates of PNC Financial Services Group, Inc. She also served as in-house counsel for National City Corporation's investment adviser and broker-dealer affiliates where her responsibilities included being the Chief Compliance Officer for Allegiant Asset Management Company. Prior to joining National City, Ms. Hummel served many years as in-house counsel for MassMutual Financial Group, a diversified financial services organization, where she advised the investment management division, including affiliated registered investment advisers and registered investment companies.

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