IAWatch
WEEKLY BRIEFING
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INSIDE...



January 26, 2015

## Another enforcement case spirals from lies to firm's CCO

The CCO's review of firm e-mails detected that the CEO had taken out a loan from another investment adviser and judged it a conflict of interest. When the CCO asked about the situation, the CEO stated the loan had been repaid.

That was a lie, which began a cascade of events that led the advisory firm, **Consulting Services Group** ($22B in AUM) in Memphis, Tenn., to withdraw its **SEC** registration last year. CEO **Edgar Lee Giovannetti** left his position in 2011, only months after OCIE began examining CSG.

The SEC has filed fraud charges against Giovannetti for lying about the $50,000 loan taken out in 2009, when the CEO was "undergoing significant personal financial challenges," according to the Commission. This is at least the second time the agency has filed charges against a staffer for lying to a CCO (**IA Watch**, Sept. 2, 2013).

Other Advisers Act violations stem from filing false Form ADVs caused by Giovannetti's lies. The SEC alleges

*(Lying to a CCO, continued on page 6)*

## It's permissible to use predecessor performance but beware of missteps

Here's the scenario: Your firm hires a new portfolio manager whose history makes him look like the Wall Street version of a titan. The marketers can't wait to include his marvelous performance history in their next ad. Tell them to slow down.

While it's acceptable to include predecessor performance data in an adviser's ads, the **SEC** has long been concerned that the re-telling can be misleading. A series of "no-action" letters released over the decades spells out the rules.

"Most stay away from it," says **Les Abramowitz**, senior consultant at N**ational Compliance Services** in Delray Beach, Fla. "Usually the sticking point" is difficulty getting the records from the person's prior employer, he adds. A firm would need these records

*(Performance Data, continued on page 2)*

## FSOC to entertain bringing greater transparency to SIFI process

Pressure from Congress and the industry and suggestions from the **GAO** led the **Financial Stability Oversight Council** last week to hear recommendations for shining more light on how it decides which non-banking institutions – such as large investment advisers – deserve to be labeled systemically important financial institutions (SIFIs) (**IAWatch**, May 26, 2014).

Recommendations for changes presented to FSOC would increase the council staff's contacts with companies under SIFI consideration, add public transparency about the process and revise FSOC's annual review of SIFIs. The council didn't vote on the recommendations, presumably because they may seek public comment on them. Another change would result in earlier notification of a company's primary

*(FSOC & SIFIs, continued on page 3)*

## Performance Data (Continued from page 1)

to confirm the performance results and to prove them accurate to inquiring SEC examiners.

**IA Watch** found a firm that said it uses such historical data. The adviser said the numbers appear as a supplement within its regular ads, serving to underscore that the performance was achieved at another firm.

"It's very tricky," says **Annie Lazarus**, CCO at **Landmark Partners** in Simsbury, Conn. She had considered assembling an ad with predecessor data a few years ago when the private equity firm hired some new managers and contemplated offering a new product.

### Get those old books and records

"It's something we could have done," Lazarus says, in large part because the new employees had received permission from their prior employer to take with them the relevant books and records confirming the performance. "That's the tough part," she notes. She thinks it would be a wise exit strategy for PMs to request their performance books and records. Landmark abandoned the advertising idea when it decided not to launch the new product.

"If you can't get the books and records to do your calculations, you really can't do it," stresses Abramowitz. He adds that any advertisement containing the data should disclose that "some of these results were achieved at a prior firm."

"The key is good disclosure about the performance that's being bought over," cautions **Jason Brown**, a partner at **Ropes & Gray** in Boston. Any ad should be clear about who was responsible for the prior performance and who will be in charge of the strategy being advertised. Show any differences in the old and new investment strategies along with "any other reasons the performance may not be representative," he continues.

Performance advertisements are "clearly a priority for the SEC," Brown states. "It is something that will come up on [an] exam."

### Few turn to compliance P&Ps

Many sources tell **IA Watch** that they don't have P&Ps around the use of predecessor performance data in ads but would simply follow the relevant SEC no-action letters. One peer did share the firm's P&Ps 💻, which are based on GIPS rules. Some say the GIPS standards are even tougher than the SEC's. Note that the P&Ps mandate that the CCO must approve the "use of the performance results from the prior advisory firm in an advertisement."

Below are recaps of the key applicable SEC no-action letters in chronological order. The links take you to the actual no-action letters on **www.IAWatch.com** 💻:

√ **Fiduciary Management Associates** 💻 (1984): This letter concerned the acquisition of a PM and past results. While it warns that the performance data can be "misleading if it implies something about, or is likely to cause an inference to be drawn concerning ... the possibility of a prospective client's having an investment experience similar" to the past results, it ends with a green light. The key is the PM must have "played a significant part" in the prior results and the new accounts can't be "materially different" from the past ones.

√ **Conway Asset Management Incorporated** 💻 (1989): This no-action letter builds on Fiduciary Management and emphasizes four other items, ranging from noting that performance figures don't "reflect the deduction of investment advisory fees" to a chart showing advisory fees over the years could display the "total value of a client's portfolio." *(Performance Data, continued on page 3)*

# IA Watch.com's Compliance Corner

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Use our search box at **IAWatch.com** and put in the name of each tool below or click now directly to each one if you're a reader of our PDF version:

1. OCIE 2015 exam priorities list 💻
2. Code of ethics training template 💻
3. Annual review matrix 💻
4. Cybersecurity checklist 💻
5. IA Watch 2015 compliance calendar (first quarter) 💻 ■

## Performance Data (Continued from page 2)

√ **Great Lakes Advisors** (1992): This is the no-action letter most point to. While repeating one of the main tenets of the use of predecessor data (the manager must have achieved it), the letter adds that the firm can't cherry-pick the transferred manager's results from the prior firm. The SEC actually rejected the no-action request because the manager wasn't in charge of the old accounts for the entire time.

√ **Bramwell Growth Fund** (1996). This request came from a fund and the letter communicates that neither Investment Company Act section 34(b) or Investment Advisers Act section 206 "prohibits an investment company from including in its prospectus the performance of its adviser's other accounts" if the inclusion is not misleading. One key is that the "same persons" must have been responsible for the old data and will be doing investment management "at the new entity."

√ **Horizon Asset Management** (1996). This letter takes up a case where several persons are responsible for selecting securities through an investment committee. It would be acceptable to use data from a prior firm that were achieved by a "Controlling Manager" who sits on the committee as long as that manager is "actually responsible for making [ongoing] investment decisions" and he need not attract a "consensus of the other members of the committee" in making those decisions. This letter also lays out a five-item list of requirements, including that "accounts managed at the predecessor entity are so similar to the accounts currently under management that the performance results would provide relevant information to prospective clients." ■

## SEC actions against IAs/ICs drop, yet cases against B-Ds surge

For the second year in a row, **SEC** enforcement actions against investment advisers and investment companies have dropped, according to new data from the Commission. The numbers also highlight the trend toward more administrative proceedings as opposed to taking entities and individuals to federal court.

The Commission has released its annual *Select SEC and Market Data FY 2014*. The chart below shows the number of enforcement actions by year since 2008. The 130 cases against IAs/ICs last fiscal year were the lowest since 2010. The Enforcement Division set its sights on other targets, especially broker-dealers, in hitting the highest number of enforcement actions since **IA Watch** began tracking the numbers in 2008.

The chart on page 4 compares the enforcement actions by those brought in federal court versus the SEC's internal, administrative proceedings' section. Note the significant increase in cases brought internally. Also, broker-dealers made up the top group targeted, representing 22% of all enforcement actions. Investment advisers/investment companies came in second. Delinquent filings placed third (14%), while insider trading cases (7%) finished seventh out of 11 categories. ■

## FSOC & SIFIs (Continued from page 1)

regulator during the SIFI naming process.

"I'm supportive of the proposed initiatives discussed today," said **SEC** Chair **Mary Jo White**. **Richard Cordray**, director of the **Consumer Financial Protection Bureau**, said none of the proposals would have changed prior SIFI designations.

FSOC Chairperson and **Treasury** Secretary **Jacob Lew** addressed efforts in Congress to rein in the council's reach. He recalled the lessons of the financial crisis in saying any changes in the council's mandate "would be a grave mistake" and vowed they won't happen on his watch. ■

## Marketing your private fund in the E.U.? Deadline nears for Form PF-like filing

Depending on the size of the private fund marketed into the European Union, this could be the week for your firm to have to file its first *Annex IV* report with the regulator in the member state where you're registered to market the fund.

The technical deadline for private funds with AUM at or above $1 billion is Feb. 1. For smaller funds, the deadline will be six months after the first quarter's end following your registration under the E.U.'s AIFMD regulatory regime.

*(AIFMD Form Due Soon, continued on page 4)*

**SEC Enforcement Actions FY 2008-2014**

| Category | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|
| Investment Advisers/Companies | 87 | 76 | 113 | 146 | 147 | 140 | 130 |
| Broker-Dealers | 67 | 109 | 70 | 112 | 134 | 121 | 166 |
| Total | 671 | 664 | 681 | 735 | 734 | 686 | 755 |

Source: **SEC** ■

## AIFMD Form Due Soon (Continued from page 3)

The reporting must be made online to the individual regulator for non-E.U.-based managers. "There is no centralized reporting, which is a pity," says **John Young**, a senior lawyer with **Ropes & Gray** in London. Also, the U.K.'s **Financial Conduct Authority** requires one version of the Annex IV form while other E.U. member regulators have opted for the other version, he adds.

### May affect only marketed feeder funds

The obligation to file the form – the continent's version of the **SEC**'s Form PF – falls only to registered managers. The reporting only need relate to the private fund marketed in the jurisdiction. "They're only filing Annex IV for the feeder fund, in most cases," e.g., a Cayman Islands-based fund that's marketed in the E.U., says **Leonard Ng**, a partner with **Sidley Austin** in London. The Annex IV form is "nowhere near as complex as filing Form PF," he adds.

Still, if your firm must submit the form, know that the document differs substantially from Form PF. You should identify the data you need, where it resides (usually with the fund's administrator), create an Excel spreadsheet to record the data and perform necessary calculations and then input the data into the online form. You can get more information on the online forum used for filing, which is called *Gabriel*, by clicking here.

One adviser **IA Watch** spoke with passed on what the firm's outside counsel recommended. If you're no longer marketing the fund or if the marketing attracted no E.U. investors, de-register the fund – which removes the Annex IV reporting obligations. Even if the fund was registered as of Dec. 31, 2014 – technically prompting the reporting – member state regulators have informally confirmed that de-registration is an acceptable route, says the CCO.

The CCO recommends you document the circumstances, your decision and, if applicable, that your firm sought legal counsel advice on the matter.

Of course, if you're registered and actively marketing in the E.U., you face the obligation to complete Annex IV. That obligation continues each quarter, depending upon the fund's size.

Sources disagree if there's any penalty for not complying. Ng points out that U.K. regulators have a cooperation agreement with the SEC and could urge the local regulator to punish violators.

The upshot is this is the new world – regulators scouring your data. "This is the future," says **Michelle Moran**, a Ropes & Gray partner in London. Regulators will use data reported via Annex IV to look for outliers, "providers who are not consistent with the herd," she adds. ■

## IM Director Norm Champ to leave SEC

The **SEC**'s Director of the Division of Investment Management **Norm Champ** will be leaving the Commission at the end of this month. Champ, a former compliance officer at an RIA, joined the Division in 2012 and championed such initiatives as money market fund reforms, rules on identity theft red flags and the creation of IM's Risk and Examination Office. The agency states he will become a visiting scholar at **Harvard** Law School.

Champ had the unique distinction of also serving within OCIE, first as an associate director in the New York Regional Office and later as OCIE's deputy director. As a former general counsel at **Chilton Investment Company** ($5.2B in AUM) in Chilton, Conn., Champ brought his industry experience to bear while leading a restructuring of the Commission's National Exam Program.

**Editor's Note**: Champ has been invited to be a featured speaker at **IA Watch**'s *IA Compliance: The Full 360 Degree View* conference Feb. 25-27 in Washington, D.C. To see the agenda and register, click here. ■

**Summary of Investment Adviser and Broker-Dealer SEC Enforcement Cases FY 2014 v. 2013**

| Regime | Civil Actions 2014 | Civil Actions 2013 | Adm. Proceedings 2014 | Adm. Proceedings 2013 | Total 2014 | Total 2013 | % of Total 2014 | % of Total 2013 |
|---|---|---|---|---|---|---|---|---|
| Investment Advisers/ Investment Companies | 10 (34) | 21 (61) | 120 (171) | 119 (163) | 130 (205) | 140 (224) | 17% | 21% |
| Broker-Dealers | 7 (10) | 7 (16) | 159 (179) | 114 (131) | 166 (189) | 121 (147) | 22% | 18% |

Source: Comparison of SEC's FY 2014 and FY 2013 *Select SEC and Market Data* report (**IA Watch**, Feb. 10, 2014). Totals compare all cases, including those against other registrants, e.g., transfer agents and public company filings. The parenthetical numbers indicate individuals charged. ■

## Fidelity Brokerage fined for supervisory and disclosure deficiencies

**FINRA** spells out the benefits of strong supervisory systems as a key protection against inadvertent harm to customers in its 2015 exam priorities letter (**IA Watch**, Jan. 8, 2015). **Fidelity Brokerage Services** just had this lesson driven home as the large multi-service broker-dealer has settled FINRA charges that its supervisory systems were lacking, resulting in inaccurate fees being charged to its customers.

In the settlement, the SRO reported that at various times spanning a seven-year period, the firm overcharged 20,663 customer accounts a total of $2.4 million. FINRA found that Fidelity's supervisory systems and procedures did not ensure that customers were charged accurate fees for accounts managed by third-party investment advisers.

The supervision lapses ultimately lead to erroneous and duplicate fees charged in certain customer accounts utilizing asset-based pricing, duplicate fees in certain customer accounts managed by third-party wrap providers and erroneous markups on certain fixed income investments. Fidelity has since voluntarily reimbursed the disadvantaged customer accounts.

## Disclosure of fees inaccurate

Disclosure issues also tripped up Fidelity. FINRA determined that Fidelity failed to ensure that customers received accurate disclosures relating to the firm's "Asset-Based Pricing Program" for accounts managed by third-party investment advisers. The firm further failed to monitor billing in these fee-based brokerage accounts to make sure customers were charged in accordance with the firm's disclosures.

FINRA discovered that Fidelity had distributed a version of its customer agreement that did not accurately reflect the fees charged to customers in the ABP program. The supplement identified certain securities as "non-chargeable" but in reality they were treated as chargeable assets to the detriment of certain customers. Some customers weren't even provided with the supplement and were overcharged. Pricing and billing errors further lead to overcharges.

Fidelity clearly did not delegate responsibility for the supervision of fee-based accounts, FINRA states. The SRO added that the firm failed to establish a reasonable supervisory system to periodically test and evaluate the fees charged to customers. FINRA fined Fidelity $350,000, declaring the amount to be proportional to the total amount of overcharges. ■

## FINRA emphasizes that outsourcing doesn't diminish compliance duties

Think **FINRA** is serious about outsourcing breakdowns? Ask **Thrivent Investment Management** ($90.4 billion in AUM).

In November, the SRO fined the Minneapolis dual-registrant $375,000 because of a flaw in its system for delivering confirmations for mutual fund transactions. The defect had widespread consequences: 454,426 confirmations with a value of $3.3 billion were not delivered between 2004 and 2013. But the system had been built and maintained by a third-party vendor, and Thrivent even had alerted FINRA to the problem, according to the settlement.

FINRA recognizes more firms are using outside technology and financial and product expertise. But know this: the SRO is also making clearer than ever before that you remain liable for the risk if anything goes wrong. FINRA feels these risks are substantial enough that it has made outsourcing one of its 2015 exam priorities. And in enforcement actions it is showing little sympathy for firms that have problems with vendors.

### Your regulatory obligation

"The regulatory view is, 'That is too bad. You had the regulatory obligation. Whether or not you did it yourself or relied on a third party is irrelevant," says **Gary DeWaal**, special counsel with **Katten Muchin Rosenman** in New York, adding that B-Ds need to be careful in how they go about selecting a third-party vendor, and actively monitor and supervise subsequent performance.

"Make sure they have the system you need. Make sure they have a business continuity plan. Make sure the person has competence and a proven track record and stays on top of relevant industry developments," said DeWaal. "The same type of things you would expect of yourself if you develop a system you need to expect from the third party outsourcer."

### Don't forget to test

Thrivent apparently ignored a golden rule of execution: test the system. FINRA noted that the firm did not become aware of the problem until 2012 when a customer contacted its call center to report that she had not been receiving confirmations relating to redemptions. Further investigation by Thrivent and the vendor turned up that thousands of confirmations had not been generated due to system coding errors.

Outsourcing "in no way diminishes a broker-dealer's

*(Outsourcing Duties, continued on page 6)*

## Outsourcing Duties (Continued from page 5)

responsibility" for compliance with laws and regulations and supervising a service provider's performance, FINRA stated in its priorities letter. It said 2015 exams will include "an analysis of the due diligence and risk assessment firms perform on providers, as well as the supervision they implement" for the outsourced activities and functions.

### Additional cases

Last October, **Prudential Investment Management Services** ($918 billion AUM) was fined $300,000 and censured because 69,282 retirement account customers did not receive required mutual fund prospectuses within three days of purchase.

According to its settlement with regulators, the firm had utilized a third-party vendor to deliver the prospectuses. But they never were delivered because of a programming defect and manual input errors. ■

Click here to read this entire story. ■

## Lying to a CCO (Continued from page 1)

he continued to claim to have repaid the loan to the firm even after telling examiners that it was still outstanding.

The adviser eventually disclosed the existence of the loan in its Form ADV. Giovannetti paid off the loan in 2012 – with payments totaling $63,000 – one day after **FINRA** suspended him for three months for "three separate episodes of alleged misconduct."

Neither Giovannetti or the firm's last CCO returned **IA Watch** inquiries. Some could question if the original CCO who discovered the loan pressed hard enough, especially considering Giovannetti's history of regulatory run-ins. It can be difficult, though, for a CCO to aggressively question the boss.

### Poor compliance program cited

In an enforcement settlement announced last week, the SEC assessed a $50,000 fine against a now-unregistered RIA **du Pasquier & Company** in New York. According to the SEC, the firm skipped many compliance obligations – from using an off-the-shelf compliance manual to not conducting an annual review, failing to track personal securities transactions to neglecting to amend its Form ADV. The firm's CEO, **James Moran**, didn't return an **IA Watch** phone call. ■



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