STARK & STARK
ATTORNEYS AT LAW

Investment Advisor Compliance Update

A complimentary service to our clients.

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1. Service Offering: Outsourced Compliance Services

As you are already aware, Stark & Stark, PC has assisted countless investment advisers with regulatory, legal, and compliance matters over the past thirty plus years. We have assisted our clients with registration issues, preparing policies and procedures, interpreting and advising on new rules and regulations, avoiding and defending litigation, and serving as counselors. We look forward to continuing to be able to serve our clients in this manner for countless more years to come.

We have historically been reluctant to provide outsourced compliance services for several reasons, but chief among them was our belief that an investment adviser must own its compliance program. We have received numerous inquiries over approximately the last five years from clients and prospective clients to see if we could assist them with carrying out certain routine and required elements of their compliance program.

After continued discussions with these clients, building out the essential infrastructure and hiring the necessary personnel, we began successfully offering these services to a small subset of clients about three years ago. These efforts are running smoothly and we believe our clients are happy with our services. We have now stood by several of our outsourced compliance clients through examinations conducted by the U.S. Securities and Exchange Commission and withstood their scrutiny.

We are now in a position to make these additional outsourced compliance services available to all of our clients.

We remind clients and future investment adviser seeking out our services, that there is no one-size fits all program or approach to compliance. We tailor the scope of our services to each client depending upon their specific needs. As such, we will customize our engagement to fit your specific needs and won’t force you to pay for services that are not required or that can easily be performed in-house.

Some of the services that we currently perform for clients include:

- Review and maintain Form ADV;
- Prepare and submit Forms U-4 and U-5;
- Prepare and update policies and procedure manual;
- Conduct email review;
- Determine requirements for and submit state notice filings;
- Prepare and submit Form 13F, 13H and Schedules 13D/G;
- Conduct advertising reviews;
- Assist with performing annual reviews of the firm’s policies and procedures;
- Conduct annual compliance meetings with firm employees;

- Conduct branch office reviews; and
- Engage in monthly compliance calls.

We have waited until now to announce this quasi-new offering, because we wanted to make sure that it would live up to our client's expectations and our high standards. We would be happy to discuss this offering with you and look forward to helping our clients with their additional compliance needs.

Please contact Tom Giachetti, via email at tgiachetti@stark-stark.com, if you would like to discuss this service.

2. Custody Alert

The staff of the U.S. Securities and Exchange Commission's Division of Investment Management (the "Division") recently released updated guidance to Rule 206(4)-2 (commonly referred to as the "Custody Rule") under the Investment Advisers Act of 1940. The staff's updated guidance comes in the form of two new additions to its Custody Rule Frequently Asked Questions. Specifically, the new guidance seeks to clarify on a concept addressed by the staff in its February 2017 Guidance Update— "Inadvertent Custody." Inadvertent Custody can arise where an investment adviser "may inadvertently have custody of client funds or securities because of provisions in a separate custodial agreement entered into between its advisory client and a qualified custodian."

The staff's first new FAQ provides guidance for advisers who may not be aware of whether its clients' agreements with their qualified custodian grant the firm "Inadvertent Custody" and whether they would be required to comply with the Custody Rule.

The staff provides what initially seems to be helpful guidance for advisers that are not aware of the terms included in their clients' custodial agreements. The staff's FAQ response states that "[a]n adviser that does not have a copy of a client's custodial agreement, and does not know, or have reason to know whether the agreement would give the adviser Inadvertent Custody, need not comply with the [C]ustody [R]ule with respect to that client's account if Inadvertent Custody would be the sole basis for custody." There are some nuances created by the staff's guidance, particularly since many advisers maintain records of their clients' custodial agreements. Accordingly, advisers that maintain such records would likely be unable to rely on this guidance since they would "have reason to know" the permissions granted to the adviser through the custodial agreement.

The staff's FAQ response goes on to state that "…this relief is not available where the adviser recommended, requested, or required a client's custodian." This may impact a large number of advisers, as many of them recommend to clients where to maintain their accounts. Also, on the face of the guidance, it appears that advisers who only have relationships with a single or select custodians could be viewed as having "recommended, requested, or required a client's custodian."

This guidance may be useful for advisers that manage retirement accounts within participant-directed retirement plans or subaccounts for variable annuities. These assets are typically required to be held through a particular platform, and therefore, the adviser is often forced to use that platform provider, rather than recommending their own preferred custodian. However, these platforms may create other issues under the Custody Rule. Certain of these platforms provide users with the ability to transfer funds, change addresses of records for participants and beneficiaries, or disburse funds by checks. As a result, advisers would not be able to rely on the guidance, as Inadvertent Custody would no longer be the sole basis for imputing custody to the adviser.

While we believe that the new guidance is extremely limited, it does bring the issue of Inadvertent Custody back to the forefront. As such, it appears that Inadvertent Custody remains an important examination topic for the National Exam Program and the Office of Compliance Inspections and Examinations. Accordingly, it is important to remind advisers of previous guidance issued by the Division in 2017. Specifically on the topic of Inadvertent Custody, the Division provided the following guidance: "One way for an adviser to avoid such inadvertent custody would be to draft a letter (or other form of document) addressed to the custodian that limits the adviser's authority to 'delivery versus payment,' notwithstanding the wording of the custodial agreement, and to have the client and custodian provide written consent to acknowledge the new arrangement."

As such, any adviser that wishes to avoid ambiguity or questions of Inadvertent Custody should consider taking advantage of this prior guidance.

To discuss the Division's updated guidance in more detail or to put in place a process to address concerns surrounding Inadvertent Custody, please feel free to contact the attorney that regularly assists you.

3. DOL Update

On Thursday June 21, 2018, the Fifth Circuit Court of Appeals issued a mandate implementing its decision to vacate the much-maligned Department of Labor ("DOL") Fiduciary Rule (the "Rule"). The Fifth Circuit's order means that, for all intents and purposes, the Rule - and its corresponding Best Interest Contract Exemption (the "BICE") - never existed.

So where do we stand now? To begin, without the availability of the BICE, many transactions that took place from the beginning of the Rule's Transition Period (June 9, 2017) until now may technically be considered prohibited transactions without an exemption. The BICE was intended to be a broad-scope exemption, with somewhat limited requirements for advisers during the Rule's Transition Period.

In an act of understanding, the DOL recently issued Field Assistance Bulletin 2018-02, in which it stated that the DOL "will not pursue prohibited transactions claims against investment advice fiduciaries who are working diligently and in good faith to comply with the impartial conduct standards for transactions that would have been exempted in the [BICE]." As a reminder, the impartial conduct standards require advisers to give advice that is in the best interest of the client, charge no more than reasonable compensation, and make no misleading statements about transactions, compensation, or conflicts of interest. This temporary enforcement policy should alleviate concerns about otherwise prohibited advice previously provided in reliance on the BICE.

With respect to next steps, firms would be wise first to carefully review their compliance manuals. Many firms have made significant revisions to their policies and procedures to proactively account for the Rule. Although the Rule may now be dead, any implemented policies and procedures should still be followed until further revisions are made and adopted. Be mindful of the enforcement action being brought against Scottrade, Inc. in Massachusetts, in which the State argues that the firm violated its own policies and procedures which had been implemented in anticipation of the Rule. A firm's policies and procedures effectively form a second set of regulatory requirements to which a firm must adhere, and so the demise of the Rule will not alleviate a firm of the Rule's requirements until that firm's policies are updated.

Regardless of the state of a firm's compliance manual, firms are advised as to the continued value of the rollover analysis. Originally introduced as an integral component of the BICE, the rollover analysis has drawn its share of critics. Much of this was due to the scope of the criteria required to be considered as part of the analysis and the difficulty in obtaining such information.

While the BICE (and its rollover analysis requirement) is no longer present, the Securities and Exchange Commission ("SEC") appears to be positioning itself to take the reins in this respect. In *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers* (Release IA-4889), the SEC indicated its belief that all advisers' fiduciary duties consist of both a duty of loyalty and a duty of care. In describing an adviser's duty of care, the SEC stated that "[t]he obligation to provide advice that is suitable and in the best interest applies not just to potential investments, but to all advice the investment adviser provides to clients, including advice about an investment strategy or engaging a sub-adviser and advice about whether to rollover a retirement account so that the investment adviser manages that account."

In order to satisfy its duty of care, then, the SEC appears to be suggesting that advisers develop an objective basis for making a rollover recommendation. And the best means to establish such an objective basis remains through a documented best interest analysis.

It is not all bad news, however! Thanks to the demise of the BICE, the enumerated criteria for consideration in a rollover analysis are now gone. That means the analysis process can potentially be streamlined to provide a more palatable set of criteria for advisers to obtain and review prior to making a recommendation.

But before firms begin chipping away at their analysis process, it is vital to keep in mind that the SEC has not opined on what it would consider to be important factors in performing such analysis. The analysis, then, should not be pared down to its foundation. Any analysis should still compare the client's services received and fees/expenses paid pre- and post-rollover. Many other considerations, though, can be disregarded, unless they are of particular importance to a specific client---in other words, if credit protections in an ERISA account compared to an IRA are uniquely relevant to a client, the differing protections should be considered as part of the analysis, even though many clients would disregard the distinction.

It is important to note that the SEC's above-referenced release purports to apply the fiduciary standard to "all advice the investment adviser provides to clients." Taken at face value, this would indicate that the duty of care would not attach when no advice is given. This would seem to give firms discretion as to whether they wish to advise clients on rollovers at all. While the Rule remained in place, a number of firms determined to prohibit rollover recommendations and, instead, relied exclusively on client directions to execute rollovers. By avoiding any recommendations, firms theorized that they could avoid the rollover analysis requirement entirely.

This approach appears to align with the SEC's proposal and continues to be a valid alternative in the event a firm wishes to recuse itself from the rollover process. However, firms should be aware that, in the absence of documentation that would indicate the contrary, regulators will likely presume that all rollovers stemmed directly from adviser recommendations. As such, all firms should thoroughly document the fact that the client has directed the rollover, or else risk a regulator assuming that the rollover was recommended by the firm without a corresponding best interest analysis.

In short, it is incumbent on all firms to:

- Maintain adherence to the impartial conduct standard for the time being;
- Review their policies and procedures and make appropriate revisions; and
- Determine a course of action with respect to rollovers:
- Perform and document a best interest analysis, or
- Refrain from providing rollover recommendations.

Please contact your regular Stark & Stark attorney with any questions.

4. DOL's New ESG Bulletin

Just when you thought it was safe to go outside again, another "clear, concise, and totally unambiguous" DOL release has been provided to the advisory industry. This time, the DOL has revised, and. reversed, in part, its previous guidance that it provided during the Obama administration. I spoke with my colleague, and DOL expert, Ryan Walter, about it.

Ryan advised that on April 23, 2018, the Department of Labor ("DOL") released Field Assistance Bulletin 2018-01, in which it discussed fiduciary responsibilities with respect to Environmental, Social, and Governance ("ESG") investments. In doing so, the DOL made clear that, while ESG factors may be included as part of the analysis when selecting investments, economic interests must be the ultimate determinative factor.

The DOL's stance can best be summed up in its own language: "fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals." In other words, economic factors must be the primary driving force in investment decision-making, rather than social policy preferences. The DOL does allow ESG-based criteria to play a part in investment analysis, to the extent the ESG factors create actual economic opportunities or risks for the issuer. In addition, if the risk and returns for two separate investment options are equal, ESG factors may be used as a tie-breaker. However, the DOL warns that "[f]iduciaries must not too readily treat ESG factors as economically relevant.”

Perhaps most surprisingly, the DOL opened the door to potential issues between plans and advisers when it extended its analysis to advisers operating within the constraints of an Investment Policy Statement. Per the DOL, “if it is imprudent to comply with the investment policy statement in a particular instance, the manager must disregard it.” The adviser’s fiduciary duty trumps the adviser’s obligation to adhere to the Investment Policy Statement, meaning advisers actually have an affirmative obligation to deviate from a retirement plan’s Investment Policy Statement, to the extent adhering to the document would disadvantage the plan. So, even if a plan sponsor accepts the risks and potential for decreased returns associated with an ESG-centric Investment Policy Statement, an adviser’s strict adherence to that Investment Policy Statement could cause harm to the plan in that the plan may necessarily be by-passing other investment options which could better serve the plan’s interests. In doing so, the adviser could be deemed to be in breach of its duty of prudence to the plan, even if its actions were only meant to maintain compliance with the Investment Policy Statement. However, what the DOL didn’t address is what happens if the ESG portfolio outperforms? Is the adviser, while exercising its fiduciary duty seemingly consistent with DOL guidelines, now responsible to the Plan for the lost profit?

In sum, ESG-based criteria can play a part in investment analysis, to the extent such ESG factors create economic opportunity or serve to differentiate two otherwise identical investment options. But overestimating the role of ESG factors in economic projections or adhering to ESG-focused mandates to the detriment of a retirement client could ultimately leave an adviser in hot water.

5. GDPR: What Advisory Firms Need to Know

The European Union’s (“EU”) General Data Protection Regulation ("GDPR") took effect on May 25, 2018. The regulation aims to protect personal data that can directly or indirectly identify a natural person (whether or not the person is an EU citizen) that resides in the EU ("Data Subjects") and whose personal data is in the possession of an organization or another person ("Recipient"). The regulation’s extraterritorial scope applies to Recipients across any industry on a global level. Accordingly, many U.S. organizations and businesses, including U.S. investment advisers, and their affiliates, will be impacted by the GDPR.

Whether your firm is acting in the capacity of a "Controller" or a “Processor” in the receipt and management of personal data will determine what conditions and requirements your firm may be subject to under GDPR. Although a seemingly binary approach, in practice, these roles may not be mutually exclusive.

The GDPR regulates any entities that have an “establishment” in the EU. As such, investment advisers that have a physical presence in the EU by having EU-based employees, branch offices and/or offices of its affiliates will likely be subject to the GDPR. U.S.-based investment advisers that do not have a physical presence in the EU will become subject to the GDPR if such investment advisers either (i) offer goods or services to Data Subjects that reside in the EU; or (ii) monitor the behavior of Data Subjects that reside in the EU. Accordingly, investment advisers that have EU-based investors and/or clients may be subject to the GDPR. The GDPR may also apply to investment advisers that have a virtual EU presence through the firm’s marketing and business strategies via the internet and the firm’s website or offer investment management services to EU-based clients.

In addition to regulating the collection and processing of personal data, the GDPR promulgates an international data breach notification requirement. Under the GDPR, Recipients will be required to notify the applicable Data Supervisory Authority (“DSA”) within 72 hours from the time a data breach occurs and possibly be required to notify the affected Data Subjects.

Moreover, penalties for a Recipient’s noncompliance with the GDPR are grave and can result in fines the greater of €20 million or 4% of the Recipient’s total worldwide annual revenue.

Investment advisers preparing to become GDPR compliant should consider taking the following steps:

1. Evaluate all aspects of your firm’s data privacy processes, including your firm’s data privacy processes with third-parties. U.S. investment advisers should consider the GDPR’s impact on third-party

relationships with transfer agents, funds, investment managers, and any other third parties involved in the production of investor documentation such as investor notifications and financial statements.

2. Review your firm's privacy data policies, procedures, and privacy notices to determine whether any amendments are required to address GDPR requirements such as GDPR Data Subject rights.
3. Review your firm's currently existing agreements with Data Subjects to determine whether any such agreements need to be modified in accordance with GDPR. Such modifications may include demonstrating your firm obtained "informed consent" to receive and manage the Data Subject's personal data and notified the Data Subject of the Data Subject's ability to withdraw such consent.
4. Review your firm's third party contractual arrangements to determine whether any such agreements should be amended to ensure they are GDPR compliant.
5. Assess whether your firm is required to appoint a Data Protection Officer ("DPO") or conduct a Data Protection Impact Assessment ("DPIA").
6. Develop a compliance monitoring program that incorporates risk management practices, data breach notification requirements, and employee training to increase firm-wide awareness on GDPR's impact to your firm's business.

GDPR is brand new territory that will impact many U.S.-based registered investment advisers. To assess whether GDPR applies to your firm and how your firm can become GDPR compliant, please contact Melissa Cefalu, Esq., M.B.A., M.A. for a consultation today.

6. CFP Board Releases New Code of Ethics and Standards of Conduct

On March 29, 2018, the Board of Directors of the Certified Financial Planner ("CFP") Board announced the approval of a new Code of Ethics and Standards of Conduct ("Standards") setting forth enhanced ethical standards to be exercised by CFP professionals. The new Standards are the culmination of over two years of work by the CFP Board and its Commission on Standards. The CFP Board worked very closely with the financial industry, engaging in numerous public forums and considering hundreds of public comments as it developed the final Standards document.

As highlighted in CFP Board release, the Standards include "an expanded scope of the fiduciary standard that requires CFP professionals to act in the best interest of the client at all times when providing financial advice." The CFP Board also made available a side by side comparison document which allows certificants to view the current rules versus the incremental changes presented in the new Standards.

The CFP Board set the effective compliance date of October 1, 2019, by which time CFP professionals are expected to comply with the new Standards. It is expected that the CFP Board will use this time to provide more education and training information to CFP professionals and their respective organizations as they prepare for the compliance date. The CFP Board has commented that the 18-month implementation period should be helpful to firms in designing compliant programs and allowing these firms to effectively implement any needed procedural changes.

CFP certificants are well advised to review the new Standards. The new guidance requires all CFPs, even when acting as a broker, to act in the best interests of client when providing financial advice. Previously, the fiduciary standard only applied where the CFP was engaged in the financial planning process with a client. Similarly, the guidance calls upon CFP professionals to "adopt and follow business practices reasonably designed to prevent Material Conflicts of Interest from compromising the CFP's professional ability to act in the Client's best interests." This suggests the implementation of programs to manage (not eliminate) conflicts of interest in the CFPs day-to-day practice.

The new Standards also highlight CFP duties in relation to disclosure of their compensation method. The new guidance speaks to "Fee-Only" versus "Fee-Based" representations regarding compensation and the various components that may be considered relative to how the CFP discloses this information. CFPs must be careful to avoid holding themselves as "Fee-Only" if they earn both fees and commissions. The guidance also addressed disclosure information to be provided to the client at the outset of an engagement, but allowed for this disclosure to be provided at the time of an engagement, rather than prior to signing up the new client.

The new Standards represent a raising of the bar with respect to CFP activity, independent of the DOL fiduciary rule or any advice standard proposal that the SEC may release in 2018. In addition, there is no change to the manner in which the CFP Board enforces its Standards. The CFP Board does not audit or conduct field examinations to review compliance with its rules. It does, however, bring actions against certificants when it otherwise becomes aware of potential violations. Such matters are handled through a CFP disciplinary review process.

7. Time to Update Policies and Procedures

It is important make sure that Your Policies and Procedures remain current.

<u>Recommended Actions</u>: If you have not updated your Policies and Procedures in the last 6-12 months (or longer), now is the time to do so. Please contact cpike@stark-stark.com or jcanela@stark-stark.com to begin the process of bringing your Policies and Procedures up-to-date.

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