IA Watch
WEEKLY BRIEFING
COMPLIANCE NEWS, GUIDANCE & BEST PRACTICES

INSIDE...

October 9, 2017

OCIE exam may have instigated probe that led to NCAA basketball scandal

Louis Martin Blazer III billed his investment advisory firm as a concierge for professional athletes. But after OCIE examined the firm in 2013, it detected a Ponzi scheme.

It appears the OCIE exam may have set the wheels in motion that culminated in 10 arrests last month and criminal charges filed against **NCAA** men's basketball coaches for allegedly accepting bribes.

News reports highlighted that the bribes were used to steer promising high school basketball players to commit to play at certain universities. But a second charge relates to the defendants allegedly accepting bribes to push the players and their parents to hire Blazer as their financial adviser.

Adviser wore a wire

Court documents and reports reveal Blazer cooperated with law enforcement, wore a wire and, in one case, paid $91,500 to a former **NBA** player who had solicited the bribe in exchange for urging parents to hire the adviser.

Blazer will plead guilty to five criminal counts – including lying to OCIE examiners – that could result in him being sentenced to 20 years in prison. He could draw five years alone on the lying charge. He's not likely to face that time given that he wore the wire and will testify against others.

The adviser's troubles began with the OCIE exam.

(As the Ball Bounces, continued on page 6)

SEC releases 16 new Form ADV FAQs as revised form goes into effect

The complication of answering new Form ADV Item 5.D. (clients) just evaporated. Count your clients the "way you normally" do, according to a new **SEC** FAQ released in a batch.

The SEC recognizes that some advisers "treat multiple members of the same family" as a single client, while others would tabulate the same situation as two or more clients. New Item 5.D. requires you to report your client count. One of the new FAQs permits you to count them as you usually do, giving advisers great flexibility.

That answer comes among 16 new Form ADV FAQs that the agency released Sept. 29, just two days before the revised Form ADV took effect (**IA Watch**, Sept. 21, 2017).

Should you lack any clients in a given category in a column under Item 5.D.(1) (number of clients), the SEC "encourages you to report '0'" (zero).

(Form ADV FAQs, continued on page 2)

Hack of SEC's EDGAR system increases concerns over CAT data security

The first phase of data reporting for the Consolidated Audit Trail scheduled for the middle of next month coupled with the recent announcement of the **SEC**'s EDGAR system hack have led to growing security concerns surrounding the CAT (**IA Watch**, Sept. 21, 2017). SEC Chairman **Jay Clayton** is among those expressing concerns. He pledges that the CAT rollout will reflect an ongoing assessment of the data sensitivity and related security concerns and protections.

When asked for cyber assurances about CAT data in an Oct. 4 hearing before the **House Financial Services Committee**, Clayton said he has asked his own staff "do we need the sensitive information?" "We're not going to take it [CAT data] until those questions ... are answered to my satisfaction," he stated. "I've made it clear that I don't want information unless we need it for our mission," added Clayton.

"Of paramount concern to the Commission is the protection of sensitive CAT data," stated Clayton. He

(CAT Concerns, continued on page 4)

Form ADV FAQs *(Continued from page 1)*

Foreign private advisers can make sure of the safe harbor under Advisers Act rule 202(a)(30)-1 when defining a client, another FAQ states.

Another FAQ states you're under no obligation to list more than an adviser's 25 largest locations (judged by the number of employees in each office). You may if you wish provide a greater number of locations. Item 1.F.(5) (identifying information) does require that you disclose your total number of offices, but you need list only the largest 25.

Advisory affiliates

Form ADV, Part 1 Item 7 (financial industry affiliations and private fund reporting) and the Form ADV brochure (Item 10) seek information about affiliates. However, you need not treat "operating companies" as affiliates "unless your firm has a business relationship with an operating company unrelated to a fund's investment that otherwise creates a conflict of interest between your firm and the fund," states another FAQ.

Similarly, you "can omit a related person" under Section 7.A of schedule D if you can satisfy five conditions listed in another FAQ. These include that you have "no business dealings" with the person related to advisory services provided to clients and neither you or the person refers advisory clients to each other.

It's suggested under this situation to use the miscellaneous section of the form to state why certain people weren't listed as related persons and to indicate that you'd be willing to provide to the SEC a list of such people "upon request."

Here are some other takeaways from the new FAQs:

√ List firm employees who are registered reps of a B-D under Item 5.B.(2) (employees) and not Item 7.A. However, if the employee "has a separate business as an investment adviser or broker-dealer" then he should be noted under Item 7.A.

√ Be sure to use a "code or designation" for a private fund that you wish to keep confidential throughout your entire books and records for that fund.

√ You may pull a disclosure under Item 11 (disclosure information) that dates back longer than 10 years. This option isn't open to state-registered advisers. A new FAQ reminds advisers that "they may have a continuing anti-fraud obligation to disclose to clients and prospective clients information about an event that occurred more than 10 years ago."

√ "Promptly amend Item 3.B" (form of organization) should you change your fiscal year end.

√ You have three "situations" when you can remove a disclosure reporting page. They are when the DRP (1) "was filed for an advisory affiliate that is no longer associated with your firm; (2) your firm is SEC-registered or an SEC Exempt Reporting Adviser and the event or proceeding reported in the DRP is more than 10 years old, or was resolved in your firm's favor (or your advisory affiliate's favor if the DRP was filed for an affiliate); or (3) the DRP was filed in error (such as due to a clerical or date-entry mistake)."

√ Include your CCO's e-mail address with the form to receive alerts and filing reminders from the SEC.

√ You may print your Form ADV, and an FAQ explains how.

√ Check the box next to any state that you must notice file in to have the state(s) notified. The SEC reminds you that many states charge a fee. Ensure your

(Form ADV FAQs, continued on page 3)

Form ADV FAQs *(Continued from page 2)*

IARD flex-funding account contains the necessary funds to pay any fees.

√ Check that you are tackling the correct Form ADV. One question reports "a completeness check error." The SEC notes this can happen if an SEC-registered investment adviser incorrectly starts by applying "for Registration as an" IA in one or more states and fails to indicate the states. Instead, the SEC-registered adviser should select "Other-Than Annual Amendment or Annual Updating Amendment" to avoid this error. ■

This story first appeared as breaking news at www.regcompliancewatch.com on Oct. 2. ■

Stay compliant by sorting out principal trades from cross trades

The regulatory landscape's dotted with enforcement cases for violations related to cross trades and principal trades. With differing rules, missteps can be as common as a slip on icy pavement.

Let's start with defining the terms:

√ **Principal trades**: These involve an adviser acting as a "principal for its own account" by selling a security it owns to a client or buying one from a client. Advisers Act section 206 (prohibited transactions) forbids this behavior without first obtaining the client's permission prior to each principal trade.

√ **Cross trades**: The Advisers Act doesn't define this phrase. It's taken to mean when the adviser buys a security for a client from the holdings of another client. This can be done, but carefully. Violations would be pursued under section 206's broad anti-fraud provisions targeting practices that are "fraudulent, deceptive, or manipulative."

√ **Agency trades**: This involves an investment adviser who uses an affiliated broker to execute both sides of a transaction involving a client and the other side of the transaction. Advisers Act rule 206(3)-2 (agency cross transactions for advisory clients) requires a one-time written consent of the client. More compliance provisions appear below.

Overriding each of these transactions is the expectation that you would act in the client's best interest and seek to achieve best execution.

Agency trades

"It's basically to regulate churning" or excessive trading, **Richard Marshall**, a partner with **Katten** in New York, says of rule 206(3)-2. The rule doesn't come into play as often as the other two types of transactions. One reason is that an adviser that has discretionary authority to act for the buyer and seller would fall outside of the rule.

Be careful if the client is an ERISA account, Marshall warns, because it has tougher rules about such transactions. And mutual fund advisers must be aware of Investment Company Act section 17 (transactions of certain affiliated persons and underwriters) and Investment Company Act rule 17a-7 (exemption of certain purchase or sale transactions between an investment company and certain affiliated persons).

Rule 206(3)-2 also requires "full written disclosure" of the transaction, written confirmation to the client(s) after the trade, the date, an offer to learn the time of the transaction and "the source and amount of any other remuneration received." Each year, the client should receive a statement that totals the number of agency cross transactions involving him and the "total amount of all commissions and other remuneration received" by the IA related to the transactions. The client also must be informed that he can withdraw his consent to such trades at any time.

Principal trades

In 2014, **Barclays Capital** paid $15 million for violations, including of the principal trading rule (**PF Watch**, Sept. 25, 2014). Last year, OCIE conducted an exam sweep on principal trading.

Before engaging in a principal trade, an adviser would first have to disclose to the "client in writing before the

(Trading Compliance, continued on page 4)

Clayton 'confident' SEC will propose a fiduciary duty rule

One week after **SEC** Chairman **Jay Clayton** seemed tepid about moving on a fiduciary duty standard (**IA Watch**, Sept. 28, 2017), he told another group of lawmakers that he's "confident that we're going to put forth" a fiduciary duty standard.

"The next step in anything like this would be a rule proposal," Clayton told the **House Financial Services Committee** Oct. 4. "We're working on such a proposal," he added.

Clayton hopes to work with the **Labor Department** so the industry wouldn't face two different standards. "If this were easy, it would already be fixed," Clayton said. ■

Trading Compliance *(Continued from page 3)*

completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction."

Cross trades

Last year, **Aviva Investors Americas** paid $250,000 to settle an SEC enforcement action that involved cross and principal trades. The behavior triggered violations of the Advisers and the Investment Company acts. Another section 17 enforcement case resulted in a $1 million fine against **Western Asset Management** in 2014.

Whether you're engaging in a principal, cross or agency cross trade, **Scott Moss**, a partner with **Lowenstein Sandler** in New York, recommends you set up a checklist that requires four steps:

1. Answer why the trade was good for the buyer and the seller.

2. Document how the transaction was valued. This is a breeze if it's marked to market. But if it's an illiquid transaction, describe how it was fair-valued.

3. Know how you vetted the inherent conflicts. Be sure to have compliance P&Ps in these areas and check for compliance with them.

4. Note the disclosure given to clients and be sure it matches what each transaction requires.

"It's been my experience that the SEC looks at those four things," says Moss.

He also reminds you of the **Gardner Russo & Gardner** SEC no-action letter from 2006. This letter established that if an investment adviser owns 25% or more of a private fund, then any transaction involving that fund becomes a principal transaction.

The SEC Oct. 2 approved a request from **Edward D. Jones & Co.** ($204B in AUM) in St. Louis to exempt the firm from the written disclosure and consent requirements of section 206(3). The adviser agreed to abide by 10 conditions for the exemption. In doing so, Edward Jones received an exemption similar to one granted to four other firms last year as a temporary Advisers Act rule was expiring (**IA Watch**, Dec. 8, 2016). ■

CAT Concerns *(Continued from page 1)*

noted that he could appreciate that security issues are particularly acute now with respect to a data repository that contains comprehensive information on trading activity in the securities markets, especially in light of recent events. "I am therefore focused on issues of data security with respect to the CAT," he said.

The CAT—which will be one of the largest financial databases in the world—is currently being developed by plan processor **Thesys**, securities exchanges and **FINRA**. It's intended to provide the SROs and the SEC with consolidated cross-market data that is more complete, accurate, accessible and timely than the data currently available to regulators. The CAT was approved last year, but has been in the works for five years (**BD Watch**, Nov. 16, 2016).

Clayton acknowledged that the sensitive data stored at the SEC "is a target to nefarious actors because it's valuable to them because they can trade ahead of the rest of the market." He stated that he has made it clear to both Thesys and the SROs that he is focused on CAT data security and "will continue to do so."

Robust protections critical

Of course, the need for robust protections of customer data is critical. The CAT establishes data security requirements regarding connectivity and data transfer, encryption, storage, access, breach management, and personally identifiable information, Clayton noted in his Hill testimony.

Among the defenses built into the CAT, Clayton noted, are requirements for Thesys to develop a comprehensive information security program that addresses the security and confidentiality of all information within the CAT data repository and associated operational risks. The SROs, which have direct oversight of Thesys, are obligated to monitor the information security program to ensure that it is consistent with the highest industry standards for the protection of data, he added. ■

Read the rest of this story on our **BD Watch** channel at www.regcompliancewatch.com. ■

New study shows firms win big, clients lose thanks to forced arbitration clauses

The aftermath of the **Wells Fargo** account scandal produces a new revelation about the firm (**IA Watch**, Sept. 29, 2016). A new study of the bank's arbitration cases reveals the average consumer loses while the firm almost always prevails.

The **Economic Policy Institute**'s study was released as Congress considers snuffing out the **CFPB**'s rule prohibiting arbitration clauses. As we've reported, **SEC**- and **CFTC**-registered entities are not affected by the CFPB's rule (**IA Watch**, July 13, 2017).

And it doesn't appear likely that SEC commissioners

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Arbitration Winners *(Continued from page 4)*

will act to eliminate mandatory arbitration clauses in client contracts anytime soon (IA Watch, March 23, 2017).

However, the study will be used by advocates who favor eliminating mandatory arbitration clauses. Author **Heidi Shierholz** cites another report that examined "250 consumers arbitrated claims with Wells Fargo between 2009 and the first half of 2017."

To the victor …

"We already knew that consumers obtain relief regarding their claims in just 9 percent of disputes, while arbitrators grant companies relief in 93 percent of their claims. But not only do companies win the overwhelming majority of claims when consumers are forced into arbitration—they win big," wrote Shierholz.

For Wells Fargo, she computed that "the average consumer is ordered to pay the bank nearly $11,000" when they lose their arbitrated cases.

"No wonder Wells Fargo prefers forced arbitration to class action lawsuits, which return at least $440 million, after deducting all attorneys' fees and court costs, to 6.8 million consumers in an average year. Banning consumer class actions lets financial institutions keep hundreds of millions of dollars that would otherwise go back to harmed consumers—and Wells Fargo seems to have harmed huge numbers of consumers," according to Shierholz.

A larger data pool shows that "the average consumer who wins a claim in arbitration recovers $5,389 [but] this is not even close to a typical consumer outcome. Because consumers win so rarely, the average consumer ends up paying financial institutions in arbitration—a whopping $7,725," she continued.

Opponents of the CFPB rule argue it would increase consumer and credit costs. Shierholz claimed this argument is "contradicted by real-life experience." ■

First of a series

Tracking the Trusted Contact: What information is best?

It seems simple enough. Starting Feb. 5, you will have to make reasonable efforts to obtain Trusted Contact information for senior accounts. But **FINRA** leaves it to firms to decide exactly what sort of contact information should be gathered. And this isn't as simple as you may think.

Take **USAA Investment Management**.

For new accounts, the San Antonio, Texas firm has tentatively decided, online applicants will be asked whether they want to name a Trusted Contact, and must answer "yes" or "no" before they can complete the application.

Those answering "yes" will be asked to supply the contact's name, phone number, e-mail and mailing address – but not the contact's relationship with the account holder.

"We spent a lot of time thinking about the various fields we wanted to ask for," said **James Muir**, executive director, investments compliance. "Our fraud unit was very interested in having the relationship field for a number of reasons."

But the business side, said Muir, was concerned that adding too many requests in the account opening flow would disrupt the process and cause people to stop.

Data storage concerns

Storing the new data was an additional consideration. "The cost of building a database to store all this data was exorbitantly expensive," Muir said. "Our clearing firm is going to build a warehouse for this that we can utilize."

Bottom line: no relationship request, at least for now. The applicant need supply only a name and a phone number for the Trusted Contact to complete the application. The e-mail and mailing address will be optional in the electronic flow, Muir said.

By contrast, **JP Morgan Chase** has tentatively decided to request relationship information, along with name, mailing address, e-mail and phone before the person is able to move forward with the application, according to **Cara Aber**, executive director and assistant general counsel.

"That gives you an understanding of the nuances of why that person was picked as the Trusted Contact," Aber says. "It gives you a leg up … in the understanding and how comfortable you are."

Family members, once you are satisfied they have the client's best interests at heart, "are often your best resource," Aber says.

Aber said JP Morgan felt it important to have an address to notify the contact in the event the firm decides to put a temporary hold on the account. New rule 2165 requires such notice unless a firm believes the contact is engaged in the financial exploitation of the customer.

KYC and snowbirds

Experts said firms should also be sensitive to the

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Making Contacts *(Continued from page 5)*

fact customers may have seasonal versus legal addresses. That makes it all the more important to have as many ways possible to reach a Trusted Contact who knows the customer well.

"If you are a robo advisor or if you are purely online or if you are just a call center, you may not know every summer Cara goes to Colorado and every winter Cara goes to Florida," Aber said.

"I think the reason you need e-mail and phone, particularly for the Trusted Contact, is you don't know where the heck they are," she said. "The more information you get the better." "It goes back to relationship," Aber added. "It goes back to different levels of knowing your client."

While the amendments do not specify what contact information should be obtained, FINRA believes that a mailing address, phone number and e-mail address for the Trusted Contact person may be the "most useful" to members.

Jeanette Wingler, associate general at FINRA, said the amendments give firms "flexibility," and that firms should "think about what works best for them." ■

Read the rest of this story on our **BD Watch** channel at www.regcompliancewatch.com. ■

As the Ball Bounces *(Continued from page 1)*

His Pittsburgh-based investment advisory firm actually deregistered in 2012, but Blazer joined forces with the **Princeton (N.J.) Advisory Group** ($579M in AUM) after that until ordered to sever ties with the IA due to the **SEC** enforcement action against him (**IA Watch**, May 12, 2016). Princeton's CCO **Joy Sheehan** declined to comment.

Blazer didn't return an **IA Watch** phone message left at his Pennsylvania home. His attorney, **Martin Dietz**, declined to comment.

Last year, the SEC formally barred Blazer from the industry (**IA Watch**, July 28, 2016), and this summer it ordered him to pay $2 million for ripping off professional athlete clients and lying to OCIE (**IA Watch**, Aug. 10, 2017).

Exam pre-dates criminal investigation

The government admits its probe into the NCAA scandal began in 2015, long after Blazer was already ensnared in the SEC's enforcement action. Neither the SEC or the **Justice Department** would comment to **IA Watch**.

The SEC's case charged Blazer with stealing from his clients, lying to examiners and roping in his CCO to sign off on phony documents Blazer created for examiners to try and conceal his fraud. The CCO wasn't charged. ■

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