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ACA Insight

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"I have a problem with regulations that are unnecessarily complex. . . . Reducing complexity, clarity, are very important. If people know the rules, they can operate more efficiently."

Expect Clayton to Cast Critical Eye on Regulations

SEC chairman-designate **Jay Clayton** has a problem with "unnecessarily complex" regulations, believes the Dodd-Frank Act should be reviewed, thinks that enforcement cases in which he recuses himself are not likely to result in deadlocked Commission decisions, and wants the agency to promote capital formation.

Those, at least, are among the positions he took during his approximately two-and-a-half hour Senate confirmation hearing before the Banking, Housing and Urban Affairs Committee this month, in which he answered somewhat contentious questions from Democratic senators, including **Elizabeth Warren** of Massachusetts, **Robert Menendez** of New Jersey, and **Sherrod Brown** of Ohio.

continued on page 2

Electronic Communication Reviews Must Keep Up with Technology

Advisory firms need to stay up to date with technology when it comes to reviewing electronic communications. Gone are the days when email monitoring was considered cutting edge. Chief compliance officers that want to be effective today need to review communications sent by text messaging, on social media and on emerging electronic platforms, including apps.

Firms that fail to do so leave themselves open to examiner questions about their electronic communication review practices. CCOs should also be aware that the SEC

continued on page 4

Another Wrap Fee Adviser Settles with SEC Over Tradeaway Disclosures

The SEC isn't letting up in its scrutiny of dually registered advisers/broker-dealers, particularly those offering wrap fee programs that result in clients paying unexpected fees for transactions that are "traded away" to other brokers. It settled two such cases a few months back – and on March 13 settled a new one.

Stifel, Nicolaus & Company, a St. Louis-based advisory firm and broker-dealer, agreed to pay a $300,000 fine to put to rest agency allegations that the adviser failed to disclose to clients that they would need to pay transaction fees to third-party brokers.

continued on page 6

involved about the steps that will be taken, allowing the problem to be addressed.

- **Separate work email from personal email.** "We find this issue during almost every review we do with clients," said McKeveny. "If a personal email account is determined to be a location of official books and records, the employee faces the possibility that the content of his or her personal email account could be requested for review as well."
- **Let employees know about the dangers posed by instant messaging and similar services.** "Employees should take a step back and view just what information they are communicating through instant messaging," he said, observing that the information in question may not seem that sensitive when an employee is first sharing it. Further, "innocent" information "may be misconstrued by an outside party to mean more than it really does. This can open a whole other can of worms."

Another Wrap Fee Adviser

continued from page 1

Such fees would arise when sub-advisers that Stifel worked with would trade away transactions to those brokers, rather than conduct the transactions through Stifel.

Stifel, according to the SEC's administrative order instituting the settlement, failed to track or monitor which sub-advisers were trading away, how often they were doing so, or the specific costs associated with those tradeaways.

"Investment advisory representatives should be knowledgeable about how their firms, and the sub-advisers they work with, conduct these sales to make sure that they are handled in accordance with the agreements with the clients and regulatory requirements," said **Eaton & Van Winkle** partner **Paul Lieberman**.

The SEC tied its failure-to-disclose allegations to the advisory firm's alleged failure to adopt or implement written policies and procedures in regard to the trading practices of its wrap fee sub-advisers. "Without adequate policies and procedures, Stifel did not inform its clients or their financial advisers what additional costs individual clients actually paid for tradeaways, beyond the amounts clients paid for participation in the wrap fee program," the agency said.

As part of the settlement, Stifel was found to have violated Section 206(4) of the Advisers Act and its Rule 206(4)-7, the Compliance Program Rule, which requires advisers to adopt and implement written compliance policies and procedures. An attorney representing the advisory firm did not respond to a voicemail or email seeking comment.

The campaigns

The SEC has certain activities and arrangements it regularly scrutinizes, among them cherry-picking and violations of Rule 105. Settlements with advisers engaged in these activities are periodically announced, sometimes several at a time. For instance, the agency announced two cherry-picking settlements in April 2016 (*ACA Insight*, 5/2/16) and more in the months that followed. In October 2015, the SEC made public six Rule 105 settlements (*ACA Insight*, 11/2/15). That announcement followed 19 Rule 105 settlements in September 2014 (*ACA Insight*, 9/29/14) and 23 such settlements in September 2013 (*ACA Insight*, 9/23/13).

As for enforcement actions against dual registrants that sponsor wrap fee programs involving transactions that were traded away to third-party brokers, the agency settled two cases with advisers in September 2016. Those cases followed an earlier settlement involving similar charges in July 2016. The three advisers may have been targeted after the SEC's Office of Compliance Inspections and Examinations listed wrap fee programs in its 2016 Examination Priorities list. If so, the enforcement actions are likely to continue, as wrap fee programs were again listed in the 2017 Examination Priorities list.

In a number of these campaigns, such as with cherry-picking and Rule 105, the agency has made ample use of its data analytics programs. The SEC's increasing sophistication in its sifting of data has, according to the agency, allowed it to find anomalies in reviewing adviser filings, which in turn either lead to charges against specific advisers, or confirm leads against certain advisers, which again may lead to charges. Whether data analytics has provided a role in the agency's campaign looking into wrap fee programs remains to be seen.

The way it was supposed to work

Stifel, which had both retail and institutional clients, offered them an opportunity to invest in several separately managed wrap fee programs it sponsored. The programs allowed the clients to have their accounts managed on a discretionary basis by one or more third-party investment managers, acting as sub-advisers to Stifel.

The way it was supposed to work was that Stifel would charge its wrap fee advisory clients a single fee for almost everything: investment advisory services, trade execution services, custody and other standard brokerage services. In fact, the SEC noted, "one of the benefits of investing in Stifel's wrap fee programs is that wrap fee clients do not pay commissions to Stifel when Stifel acts as a broker-dealer and executes the clients' trades."

But that's what occurs when Stifel does the trades.

It turns out that in addition to having discretion over investments, the sub-advisers in these programs also had sole discretion in broker-dealer selection. The sub-adviser could choose to transact trades through Stifel, or it could choose to do so through another broker-dealer. The only proviso, according to the SEC, was that the investment manager determine that any third-party broker-dealer provide best execution. Stifel, the agency charged, did not monitor whether the sub-advisers complied with their best execution obligation.

When a sub-adviser selected Stifel as its broker-dealer, there was no problem – the clients did not pay a commission on those trades. But when a sub-adviser selected a third-party broker-dealer, "Stifel's wrap fee clients [might] incur additional trading costs, such as commissions and fees that are paid to the executing broker-dealer."

Disclosure

The SEC's big issue with Stifel was not the tradeaways, but that they allegedly were not properly disclosed, either to clients or the agency itself.

"The additional costs incurred as a result of the sub-advisers trading away are embedded in the price of the security on the periodic account statements that Stifel provides to its clients," the agency said. "Stifel does not otherwise inform its clients when they have incurred these additional trading away costs or provide its clients with the amount of the additional trading away costs."

It's not that the adviser failed to disclose that tradeaways might occur and that clients might incur additional costs as a result. According to the SEC, Stifel disclosed in its Form ADV Part 2A Appendix 1 Wrap Fee Brochures, as well as in client agreements, "that sub-advisers may trade away from Stifel and that clients may incur additional costs associated with those tradeaways."

What was not disclosed prior to the first quarter of 2015, however, was the frequency with which these tradeaways occurred and the specific costs associated with each.

Why? Because, according to the SEC's administrative order, prior to the first quarter of 2015, Stifel did not collect this information. "Consequently, Stifel did not and could not inform its financial advisers or clients about the amount of the additional trading away costs, and its financial advisers lacked information to separately take the additional costs into consideration in assessing whether use of a particular sub-adviser in the wrap fee program was, and continued to be, suitable for a particular client," the agency said.

"Trading away is okay if it results in a client's receiving best execution," said Lieberman. "There has to be collection of the trade pricing information by the advisory firm, followed by accurate disclosure to clients."

The SEC, in the settlement order, noted a number of remedial actions voluntarily taken by Stifel, as well as undertakings the adviser agreed to as part of the settlement. These might explain why the violation did not result in other sanctions, such as being censured, and why the advisory firm was not required to bring on board an independent consultant to make sure further corrective actions were taken and report back to the SEC in a certain number of days.

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Published by:
ACA Compliance Group
(301) 495-7850
(301) 495-7857 (fax)
service@acainsight.com

Editor/Publisher:
Robert Sperber
(301) 502-8718
rsperber@acainsight.com

To Subscribe:
(800) 508-4140
subscribe@acainsight.com
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Customer Service:
(800) 508-4140
service@acainsight.com

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