"The situation most chief compliance officers think about is when the CCO tells the firm what they need to do and then the firm doesn’t do it."

**Chief Compliance Officers: Know When and How to Resign**

Few chief compliance officers want to resign for any reason other than accepting a better offer at another firm. The reality, however, is that CCOs may find themselves in positions where, for compliance reasons and to protect their own career credibility, they have little choice but to consider resignation. The key is recognizing when those times arise and knowing how to extricate themselves from their errant firms safely.

It’s a tough situation, and it’s not good for the advisory firm, either. “The SEC pays
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**Associations and Firms Want SEC/DOL Coordination on Standard of Conduct**

More than 90 comments have been received by the SEC to date in response to agency chairman Jay Clayton’s June 1 call for comments in regard to standards of conduct for investment advisers and broker-dealers. Among the trends emerging from the comments received to date is that the SEC, in coordination with the Department of Labor, create a separate standard of conduct for broker-dealers.

Such a standard, which was proposed in comment letters from the Investment Company Institute, the Securities Industry and Financial Markets Association, and private sector firms including UBS and Franklin Templeton Investments, would be
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**Private Fund Adviser and Owner/CCO Settle Multiple Charges with SEC**

The SEC is long past the day of being unfamiliar with private fund advisers. It knows what to look for when it investigates and isn’t shy about enforcement actions. When it finds a situation where the owner of the advisory firm is also the chief compliance officer, don’t be surprised if it makes an example of the case.

Chief compliance officers, after all, have been repeatedly described by the agency as its “partner” in ensuring that a culture of compliance, as well as of ethics, is the norm at advisory firms. While the SEC has said it does not target CCOs, it has also said that
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attention to CCOs coming and going,” said Mayer Brown attorney Adam Kanter, adding that advisers have to make note of CCO changes on their Form ADV. “The agency does look at these things. It tracks them. If they see a pattern, or even a CCO leaving after a short time on the job, they may want to know why.”

Kanter said he saw one advisory firm where three CCOs resigned over a four-year period, prompting the SEC to investigate. “There may be good reasons for such a turnover,” he said, “such as the first CCO leaving to take another job, the second one was a temporary replacement, and the third is the current CCO, who is still there.”

Reasons to leave

“The situation most CCOs think about is when the CCO tells the firm what they need to do and then the firm doesn’t do it,” said Sidley Austin partner Hardy Callcott. “But in reality the reason to leave can be broader than that.”

It all comes down to your firm’s culture and its commitment to compliance. Without that commitment, any one of a number of situations may arise where a CCO may consider resigning. Among them are these:

• **There’s fraud going on and you tried to correct it, but management was unwilling to do so.** This creates a situation where the CCO cannot do his or her job, Kanter said. “No CCO wants to be associated with a firm that is engaged in bad conduct. That kind of thing can follow a person around, even if the CCO was not engaged in the misconduct and no action was taken against the CCO.” A related reason to leave in such a situation, he said, is to avoid having enforcement actions taken against the CCO.

• **When the CCO loses confidence that management is being honest with him or her.** “If management is consistently not telling you the truth about an initiative, that can be a problem,” said Callcott. At that point, it becomes very difficult for a CCO to perform his or her job effectively.

• **The CCO is put in a position where the firm doesn’t value compliance or provide adequate resources.** “The CCO might feel his or her ability to do the job is compromised,” Kanter said. This might be the case if the CCO gets a refusal after requesting more resources from management, although there might be other reasons for such a refusal. “There was a lot of this during the economic downturn, when compliance, since it is not a profit center, was not as much of a priority.”

Resignation timing

Just how a CCO should go about resigning depends on the circumstances surrounding his or her leaving, said Kanter. “Was it because of fraud at the firm, and the CCO plans to become a whistleblower?” If so, he said, “the CCO is probably going to want to discuss exit options with his or her legal counsel.”

Barring a situation where the CCO is in danger of becoming “tainted” by fraud going on at the firm, the best course is to provide two weeks or more of notice, the best move is to keep the parting as amicable as possible. You might even want to allow time for an “off ramp” so the firm can find a replacement before you leave, Kanter said. As with any job, if you provide less than two weeks notice, there could be career consequences as word gets out. “It’s a relatively small industry we all work in,” he said. “If the parting is amicable and not because of fraud, you can provide proper notice. A firm might also appreciate it if you wait to leave until after its latest Form ADV update is filed or its annual review is completed, depending upon the timing of your proposed exit.”

On the other hand, Kanter said, “If there is fraud, then you may simply want to get out of there ASAP.”

Protect yourself

What should a resigning CCO say in his or her resignation letter? One option would be to spell out in your letter the reasons you are leaving, including any credible belief you may have that there is fraud and that the firm is doing nothing about it, despite any compliance advice you may have given. “As an attorney represent-
ing an advisory firm, I would hate, hate to see a letter like that,” Kanter said. At the same time, he acknowledged, it might provide some protection for the departing CCO.

Such a situation, though, can hopefully be avoided. “The CCO has to do an annual compliance report and you must document what the deficiencies are, including any proposals made on corrective actions,” said Callcott. If you’ve done that, there is no need for listing the problems again in a resignation letter. Should a compliance issue arise mid-year, however, you might, depending on the facts and circumstances surrounding it, need to make clear in your resignation letter that you sought to escalate the issue to management, if only to protect yourself, he said.

Also be aware of this warning from Callcott: “If you’ve got concerns and you haven’t put them in your annual compliance report, you may have compliance problems personally.”

CCOs considering taking copies of memorandums or emails showing the compliance recommendations they made and the response from management would be wise to speak with an attorney first. “It might not be legal to take company property, such as documents showing that you uncovered potential fraud, and that the firm did nothing to correct it,” Kanter said. While CCOs and others are protected to some extent when sending files showing such recommendations to the SEC pursuant to the whistleblower program, he said, it is not clear that even those files can be taken home.

**Associations and Firms**

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quite different from the DOL Fiduciary Rule that was adopted June 9. That Rule and its related exemptions, once they go into effect, would apply a uniform fiduciary standard to both advisers and broker-dealers, as well as others, who provide retirement investment advice.

If the comments offered by the ICI, SIFMA and others that made similar suggestions are followed, there would be no uniform fiduciary rule, at least not in its present form. Rather, the SEC, working with the DOL, would create a best interest standard of care for broker-dealers, and the DOL would, in some form, basically buy into the SEC action.

“Many of those who sent in comments, particularly smaller advisers and investors, chose to respond by continuing to comment on the DOL Fiduciary Rule and its effects (generally, negative) on their business and investments,” said Drinker Biddle partner Kay Gordon. “When the standard of care for investment advisers was addressed, the commenters generally stated that the SEC should not make any changes with respect to the existing fiduciary standard under the Investment Advisers Act of 1940,” she said.

However, she said, “when a uniformity of standards was suggested, it was often discussed in the context of the uniformity that should be applicable to retirement and non-retirement accounts rather than investment advisers and broker-dealers.”

How is the DOL likely to view these comments? “The DOL’s last request for comments included whether, if the SEC promulgates its own fiduciary standards for broker-dealers that provide advice to retail investors, the DOL should develop a new streamlined exemption for brokers that comply with the SEC standards,” said Mayer Brown partner Lennine Occhino.

“DOL secretary Alexander Acosta has also indicated that he sees a need to better coordinate with the SEC in this area,” she said. “One of the big concerns expressed by the industry is that the different standards imposed on retirement and non-retirement accounts give rise to confusion and compliance challenges. So coordination between the DOL and the SEC should be helpful.”

**Associations**

The ICI, in its August 7 comment letter, said that “the SEC should take the lead in establishing and enforcing a best interest standard of conduct for broker-dealers providing recommendations to retail investors in non-discretionary accounts, across both retirement and non-retirement account.”

“The SEC should coordinate closely with DOL so that DOL explicitly recognizes the best interest standard of conduct in a new, streamlined prohibited transactions
exemption for financial services providers that are subject to an SEC-governed standard of conduct,” the association said. At the same time, it added, “the SEC should maintain the existing fiduciary duty standard for investment advisers that has served investors well for over seven decades.”

For its part, SIFMA, in a July 21 comment letter, said that “the SEC should consider a best interest standard for broker-dealers that encompasses a duty of loyalty, a duty of care, and enhanced up-front disclosures.” Including these two duties would, it said, have the effect of making the new standard “akin to, and well aligned with, the investment adviser standard under the Advisers Act.”

Private firms
Not every commenter can be expected to agree with the ICI and SIFMA, but some came close. Others took a different position.

• **BlackRock** took a somewhat different position than the associations in terms of just which firms a standard of conduct should cover. A best interest standard, it said, should apply to both investment advisers and broker-dealers. “A best interest standard applicable to investment advisers and broker-dealers adopted by the SEC should provide a solid basis for addressing both the SEC’s and the DOL’s concerns with existing market practices,” it said in an August 7 letter addressed to the DOL but sent to both the Department and the SEC. In a separate comment letter sent the same day to the SEC, it urged the agency to “adopt a uniform best interest standard that applies to all types of retail accounts, whether they are plans or IRAs or non-qualified investment accounts. . . . A uniform SEC best interest standard could advance investor choice and encourage saving and investing in a way that would optimize investment outcomes.”

• **UBS**, in a July 21 comment letter, said that “we believe that the SEC should develop a best interest standard for broker-dealers that is based on the “impartial conduct standards” articulated by the Department and further should work with the Department to ensure that the SEC or [FINRA] are the authorities responsible for creating appropriate rules and enforcement of such best interest standard (which would apply to both retirement and non-retirement brokerage accounts of broker-dealers). Investment advisers would continue to be governed by the standards of the Investment Advisers Act of 1940.”

• **Franklin Templeton Investments**, in an August 7 letter, also said that “it is important for the same standard of conduct to apply to all retail accounts for a broker-dealer.” The firm said that it “welcomes the SEC’s renewed focus in this area, in particular its willingness to work with the Department of Labor to develop an enhanced standard of conduct that forms the basis for an exemption from the DOL Fiduciary Rule.”

The **Investment Adviser Association** has not yet submitted a comment letter to the SEC in response to Clayton’s call, but plans to in the future, an association spokesperson said.

**Clayton’s call**
Clayton’s call for comments asked for the public to provide their views on 17 topics, including among them the need to address retail investor confusion, potential conflicts of interest, and market developments and technology.

While some of the commenters asked for the SEC to move expeditiously on resolving the question of a broker-dealer standard – Franklin Templeton stated that it “urge[s] the SEC and DOL to act now so that state legislators and their securities regulators do not feel compelled to step in and regulate where the federal regulators do not” – any new regulations from the SEC may still be at least months away. Clayton himself, in his public statement calling for comments, said there are a broad range of actions to consider, including:

• Maintaining the existing regulatory structure,

• Enhanced disclosures to mitigate reported investor confusion,
• Development of a best interests standard of conduct for broker-dealers; or

• A single standard of conduct combined with harmonization of other rules and regulations applicable to both advisers and broker-dealers when they provide advice to retail investors.

It would seem that the thrust of the comments from the larger industry players so far would be for the third option above, development of a best interest standard of conduct for broker-dealers. That does not mean, however, that some of the other options might also be considered.

Exemptions and the compliance date

The commenters were ahead of the game in one key way. A number of them urged the DOL to extend the January 1, 2018 applicability date of the Best Interest Contract Exemption and other exemptions. In fact, the DOL proposed doing exactly that on August 9 (ACA Insight, 8/14/17), issuing a notice of administrative action stating that it plans to delay the applicability date for three exemptions, including the Best Interest Contract Exemption, to July 2019.

Whether that proposal will become final will depend on the securities industry’s reaction and a number of other factors, as well as how the Department will take those factors into account.

One thing seems clear, however. There currently is a great deal of sturm und drang regarding the issue of a broker-dealer standard of conduct, as well as the DOL Fiduciary Rule and its related exemptions.

Given that the Trump administration is philosophically more opposed to regulations than its predecessor, the number of the DOL extensions that have already occurred preventing the Fiduciary Rule and the extensions from taking practical effect, and both the DOL’s and the SEC’s current re-thinking of their positions, whatever the final regulations and/or guidance issued are likely to be different from the Fiduciary Rule that the Department adopted June 9. 

Private Fund Adviser

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when it finds a situation where a CCO has contributed to compliance problems, it will not hesitate to do so.

Consider the agency’s recent settlement with Brian Kimball Case, and his two advisory firms, Bradway Financial and Bradway Capital Management. Case is the sole owner, managing director and CCO of both firms. In the settlement, the SEC hit Case and his firms with at least six allegations:

• Invalid registration exemption. The agency charged that Bradway Capital improperly relied on the private fund adviser exemption from registration in Rule 203(m)-1 under the Advisers Act, nor did it qualify for any other registration exemption;

• Inflated valuation. Bradway Capital’s investor statements contained “inflated values” for investments held in two of its private funds, the SEC said, although the settlement made a point of noting that neither Bradway Capital nor Bradway Financial received any fees based on the inflated valuations;

• Custody Rule non-compliance. The agency alleged that both Bradway Capital and Bradway Financial failed to comply with Advisers Act Rule 206(4)-2;

• Compliance Program Rule non-compliance. The two advisory firms also allegedly did not comply with Rule 206(4)-7;

• Misuse of fund assets. The SEC stated that the two advisory firms and Case improperly used those assets to pay their legal fees in connection with the SEC’s investigation;

• Failure to determine if fund investors were qualified clients. Bradway Financial contracted to earn a performance fee for managing a fund without first determining whether the fund’s investors were qualified clients, the agency said.

As part of the settlement, Bradway Financial and Bradway Capital agreed to retain an independent compliance consultant for at least two years, and certified in writing that they would comply with the conditions
of the compliance consultant’s work. In addition, both firms were censured, and Case was barred from acting as a chief compliance officer in the securities industry for at least three years. Finally, the three respondents, collectively, agreed to pay a $150,000 civil money penalty. An attorney representing the three did not respond to a voice mail or email seeking comment.

“While the fact that no new areas were targeted may bring comfort for some,” said Paul Hastings partner Tram Nguyen, the settlement “signals that the agency remains focused on private fund advisers, notwithstanding changes in SEC personnel.”

Here’s how those allegations flesh out, according to the SEC’s administrative order that instituted the settlement:

The registration exemption

Bradway Financial was the investment adviser to a certain fund from 2006 to 2013. Case, after consulting with a compliance consultant, in 2013 formed Bradway Capital, in part to avoid the obligation of the Custody Rule, according to the agency. “He understood that Bradway Financial would not have to comply with certain Advisers Act rules in advising a private fund, such as Rule 206(4)-2 . . . if the [fund] was advised by an exempt reporting adviser (Bradway Capital) instead of an adviser registered with the Commission (Bradway Financial),” the SEC said. “Case hoped to save on expenses by not having to obtain an annual audit for the [fund] or a surprise examination to comply with the Custody Rule.”

Bradway Capital based its registration exemption on the fact that it was an adviser to private funds with assets under management of less than $150 million. But that was not enough, according to the agency. “It was not entitled to rely on this exemption because Bradway Financial and Bradway Capital were under common control and operationally integrated.” To support its point of view, the SEC notes in the settlement order that the two firms were both owned by Case, shared the same employees, operated in the same office, and share the same technology systems.

Therefore, the agency said, “Bradway Capital was required to comply with the rules under the Advisers Act applicable to investment advisers registered or required to be registered with the Commission under Section 203(a) of the Advisers Act.”

“The devil was in the details here,” said Bell Nunnally partner Robert Long. “Although the idea of having a separate adviser that was exempt from registration may have been a good idea on paper, Bradway Capital, according to the SEC’s administrative order, was operationally integrated and under common control with Bradway Financial, and therefore Bradway Capital could not rely on 203(m)-1.”

Inflated valuation

According to the SEC, Case and Bradway Capital sent “periodic valuation statements” to fund investors. These statements, the agency said, said that they were “fair market value estimates” of the fund’s investments. But “while they occasionally employed the services of third-party valuation providers to arrive at valuations, Case – despite not having any valuation experience or training – often assigned his own estimated valuations to [the fund’s] investments.”

More specifically, the settlement order states that on June 30, 2015, Bradway Capital sent statements to the fund’s investors that showed inflated fair market value estimates in the following ways:

• Bradway Capital, in addition to investing fund dollars in private company equity and debt, also invested fund money in shares of a private equity fund, and Case and Bradway Capital received fair market valuation information from the adviser to that private equity fund. Despite this, Bradway Capital reported a fair market valuation for the private equity fund investment “that was approximately three times higher than the fair market valuation of the investment provided.”

• Bradway Capital’s fair market value estimate for a $50,000 investment in a portfolio company showed that the investment was still valued at its original cost, “but the [fund’s] annual tax reporting statement
for 2014 reflected that the investment was written off as bad debt.”

- A number of the fair market value estimates for the fund’s other investments “were based on stale information,” the agency said.

These inflated valuations were reported on multiple Forms ADV, according to the SEC.

“The case illustrates the importance of taking reasonable steps to arrive at a fair market valuation for illiquid investments,” said Long. “Notably, in this matter, the staff took enforcement action on allegedly flawed, inflated valuations even though the valuations did not generate any fees to the respondents.”

Custody and the compliance program

The SEC’s allegations involving Custody Rule violations tie into its allegations that Bradway Capital improperly took advantage of a Commission registration exemption. Since the exemption was invalid, Bradway Capital would have had to comply with Custody Rule requirements – and this, the agency said, the firm did not do.

“From 2013 to 2015, Bradway Capital had custody of [two funds’] assets but did not subject the funds to an annual audit or obtain a surprise examination to verify the assets held by Bradway Capital,” the SEC charged. In 2016, a third-party auditing firm began auditing the funds for those two years, with the completed audited financial statements to be delivered to investors in the funds upon completion.

The settlement order also notes that Bradway Financial had custody of certain other clients’ assets, “and some of those assets were not maintained by a qualified custodian.” These assets, the SEC said, included stock certificates and blank signed authorization forms from certain clients. “Despite having custody of these other client assets, Bradway Financial did not obtain surprise examinations during the time period 2011 to 2015.”

As for its failure to comply with the Compliance Program Rule, the agency alleged that Bradway Capital failed to adopt or implement written compliance policies and procedures. As for Bradway Financial, although it worked with a compliance consultant, the SEC said that it “adopted an off-the-shelf compliance manual that was not tailored to the type of business it conducted, and its compliance policies and procedures did not address registration or exemption from registration as an investment adviser. In addition, Bradway Financial...
failed to conduct annual reviews of the adequacy and effectiveness of all its compliance policies and procedures.”

The other allegations
Here’s what else the agency charged:

• **Qualified client vetting.** Not all the investors in the fund apparently were qualified clients as defined by Rule 205-3(d) under Adviser Act Section 205(e), the SEC said. “When he conducted his accredited investor review, Case did not conduct any review to determine if each investor in the [fund] also satisfied the definition of qualified client.” The accredited investor review was conducted upon the drafting of the [fund’s] operating agreement, which contained a performance fee provision. The settlement notes that, “to date, Bradway Financial, Bradway Capital and Case have not charged the [fund] any performance fee for investors who may have received a return or partial return of their principal investment and profits.”

• **Use of fund assets to pay legal fees.** Case, according to the settlement order, “negligently” relied on an indemnification provision in the fund’s operating agreement as the basis for using fund assets to pay the legal fees incurred by the Division of Enforcement staff’s investigation. “However, with respect to legal costs and expenses, the operating agreement provided that the [fund] would pay such costs ‘directly relating to the ongoing activities’ of the fund. Approximately $65,000 in legal fees that were paid with [fund] assets did not directly relate to the fund’s ongoing activities because the fees were for legal services provided to the investment advisers (and not the fund), and the governing document did not otherwise authorize [the respondents] to charge the fund for their own legal costs.” That said, the administrative order noted, Case, Bradway Financial and Bradway Capital have since repaid the fund for all of the legal fees paid by it in connection with the investigation.