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In This Issue:

The Sides of "May": When is "May" Deemed False and Misleading

By Elizabeth M. Knoblock and Patricia Flynn

For years, the word "may" has been used in financial industry disclosure documents to describe any number of things that a firm registered with the Securities and Exchange Commission ("SEC") might, could or would do, or had done upon occasion. Yet, in a handful of recent SEC enforcement actions, the regulator has taken issue with investment advisers' use of the word when making disclosures in their Forms ADV. This article examines the circumstances in which the SEC has objected to the use of "may" by investment advisers and the consequences associated with using it in a manner deemed false and misleading.

As a grammarian might explain the issue, the words "can," "may" and "will" are auxiliary, or helping, verbs. "Can" is commonly used to denote the ability to do a thing, "may" denotes possibility or permission, and "will" denotes the certainty of something occurring. However, through various enforcement actions, the SEC has now indicated that investment advisers must be especially careful when using "may" in Form ADV disclosures. In fact, the SEC has concluded that advisers' use of the word "may" in their disclosure is misleading when it suggests that an action is only a possibility if the facts demonstrate that the action has already occurred.

For example, in a settled matter, the principals[1] of Belvedere Asset Management were found to have violated Section 206(2) of the Investment Advisers Act of 1940 ("Advisers Act") by disclosing only that a conflict of interest may occur when, in fact, the conflict actually existed. According to the settlement order, the adviser initially failed to disclose to its clients any conflict of interest relating to its relationship with an affiliated mutual fund. Later, the Form ADV was amended to state that the adviser "may invest clients in registered funds advised by it, which would create conflicts of interest to the extent that Belvedere receives fees on both account and fund assets." However, the amended ADV was not offered or provided to clients even though the ADV described the change as material and an outside compliance consultant had advised the principals to make delivery of the disclosure to clients.

Subsequently, the adviser provided at least some clients with a separate disclosure related to the conflict, but stated only that it "'may' invest clients' assets in one or more of its registered funds and charge additional fees for those fund investments, which 'may' create a conflict of interest."[2] However, the SEC found this been invested in an affiliated mutual fund when the disclosure was made. The SEC concluded that this meant the conflict was actual, not potential. To settle the proceedings, the principals agreed to provide a copy of the SEC Order to any prospective clients for one year following the issuance of the Order and were ordered to cease and desist, make disgorgement plus interest and pay a penalty.

Similarly, principals[3] of of Concord Equity Group Advisors were found by settlement order to have violated the Advisers Act by failing to disclose commission-sharing arrangements and the conflicts of interest associated with such arrangements. The respondents had entered into an undisclosed arrangement with an unaffiliated broker-dealer to provide trade execution for their clients at a commission rate of $0.01 per share executed, while charging clients between $0.04 and $0.06 per share, and paying the excess commission to the adviser's affiliated broker-dealer as a "referral fee", even though no referrals were made by the adviser or its affiliated broker-dealer to the executing broker-dealer. The adviser's initial ADV, which was not amended for several years, "contained no discussion concerning the affiliated broker-dealer or the commission-sharing arrangement."[4]

Moreover, even after amending the ADV years later, the disclosure stated only that an affiliated entity "may receive referral fees for referring prospective institutions to other broker dealers including customers of registrants (sic)

About the Authors:
Elizabeth M. Knoblock is the managing member and sole owner of Elizabeth M. Knoblock, PLLC, a private law firm.
Patricia ("Trish") Flynn is Senior Vice President & Chief Compliance Officer for INTECH Investment Management, LLC.

1. In the Matter of Jan Gleisner and Keith D. Pagan, Rel. No. IA-4537 (Sept. 28, 2016); https://www.sec gov/litigation/admin/2016/ia-4537.pdf.
2. See https://www.sec.gov/rules/final/2016/ia-4509.pdf.
3. Id. at 5, ¶18.
4. Id. at 7, ¶19.

related entities;" that an affiliated broker-dealer "can process unsolicited transactions for institutional customers which may include a client" of the adviser; and that the affiliate "has yet to commence or transact any such trading," even though it had already received over a million dollars worth of "referral fees" that clients were unaware had been paid from their commissions.[5]

In addition, the ADV stated that the adviser received "no products, research or services in turn (sic)" for suggesting brokers to its clients, even though its affiliate was regularly receiving the excess commissions from the unaffiliated broker-dealer.[6] According to the Order, the use of the prospective "may" in the various ADV disclosures "is misleading because it suggested the mere possibility that Tore [the affiliated broker-dealer] would make a referral and/or be paid 'referral fees' at a later point, when in fact a commission sharing arrangement was already in place and generating income" to the affiliated entities and principals.[7] The SEC found that use of the prospective term "may" was misleading, because it suggested the mere possibility of referralarrangements at a later point even though the arrangement was already in place. This conclusion was not changed by asubsequent ADV revision, because even then, the disclosurecontinued to state only that the adviser "may have a conflict of interest regarding the recommendation of an executing broker dealer in that it may receive compensation," without disclosing that the commission sharing arrangement already existed and that payments had already been made.[8]

The ALJ was not convinced and concluded that the adviser's "disclosure that it may receive incentive, subscription, and performance based compensation from certain investment companies was inaccurate and misleading because it actually was receiving this compensation.

Similarly, Advantage Investment Management[9] settled SEC charges that it failed to disclose the existence of, and conflicts associated with, a five-year, forgivable $3 million loan from a dual registrant broker-dealer and investment adviser that provided execution, custody and reporting services to 90% of its client assets under management. At the time the loan agreement was entered into, the adviser made no disclosure of its existence. Four years later, the adviser added a disclosure regarding the possibility that certain of its advisory representatives may have received forgivable loans from the dual registrant if they had recently joined the adviser from another financial services firm and also disclosed that receipt of such loans "presents a potential conflict of interest in that an IAR has a financial incentive to recommend that a client engage with the … [adviser and the representative] for advisory services in order for the loan to be forgiven."[10] However, the ADV failed to affirmatively disclose the existence of the loan agreement funding these loans or that the conflict actually existed given that all of the adviser's representatives had already received loans and the loans were still outstanding.

As with the other cases, the adviser was found to have willfully violated Advisers Act Section 206(2). The adviser was censured, ordered to cease and desist and charged a $60,000 penalty for the false and misleading disclosure.

In addition to the settled enforcement actions discussed above, SEC Administrative Law Judges have decided three other cases involving advisers using "may" disclosure, among other things. As discussed below, two of the three actions held that the disclosure was false and misleading. Although the third case was decided in favor of the adviser, it was reversed by the SEC in a final decision.

First, a principal[11] of an investment adviser, was found to have violated the Advisers Act for, among other things, inaccurate ADV and contract disclosures regarding receipt of various forms of compensation. Initially, the ADV failed to make any disclosure of performance-based compensation and referral and advisory fees paid by offshore hedge funds. Following an SEC examination, the ADV was amended to state that the adviser "may receive incentive or subscription fees from certain investment companies"[12] and "may receive performance-based compensation from certain investment companies".12 The principal testified that he believed "that 'may' is accurate and not misleading because [the adviser] did not always receive compensation and whether[the adviser] received these fees depended on the client."[13]

5. Id. at 7-8, ¶¶20, 21 and 22.
6. Id.
7. Id. at 8, ¶22.
8. Id. at 8, ¶23.
9. In the Matter of Advantage Investment Management, LLC, Rel. No. IA-4455 (July 18, 2016); https://www.sec.gov/litigation/admin/2016/ia-4455.pdf.
10. Id. at 4, ¶11.
11. In the Matter of Larry C. Grossman and Gregory Adams, Init. Dec. Rel. No. 727 (Dec. 23, 2014); https://www.sec.gov/alj/aljdec/2014/id727bpm.pdf.
12. Id. at 19.
13. Id. at 20.

The ALJ was not convinced and concluded that the adviser's "disclosure that it may receive incentive, subscription, and performance based compensation from certain investment companies was inaccurate and misleading because it actually was receiving this compensation."[14] [emphasis in original] Quoting from the Merriam-Webster

Dictionary, the ALJ stated further: "'May' is used to 'indicate possibility or probability.'" Since the payments had already been received, the existence of compensation was a fact, not merely a possibility.[15] Given the ALJ's conclusions, a better way to disclose the payments subject to a contingency would be to state that the adviser receives incentive, subscription and performance-based compensation depending on the arrangement entered into with the client.

Another ALJ decision, Total Wealth Management,[16] held, among other things, that it is "grossly inaccurate and misleading for an investment adviser to represent that revenue sharing agreements 'may' happen, when they had in fact already happened and governed a substantial portion of client investments."[17] The adviser primarily invested client assets in private funds and had entered into revenue sharing agreements involving sharing a portion of fund advisory fees or receiving incentive, referral or consulting fees from many of the funds or fund managers based on fees charged by the funds to adviser's clients. As in previous cases, initially the adviser made no disclosure of the arrangements.After undergoing a review performed by an independent compliance consultant, the firm was advised to amend the ADV to disclose that the adviser had a conflict of interest associated with receiving fees from firms offering securities to its clients, but the consultant was fired and the recommended amendment was not implemented. Instead, the adviser amended its ADV to state that it "may have arrangements with certain Independent Managers whereby the Adviser receives a percentage of the fees charged by such Independent Managers" without mentioning any related conflicts of interest.[18]

The ALJ noted that these "disclosures were made after Total Wealth had already entered into revenue sharing agreements with numerous entities and had invested enormous amounts of client funds in these entities."[19] In addition, the adviser's argument that using the word "may" to disclose the revenue sharing and consulting agreements was appropriate, "because an investor could potentially have a portfolio consisting entirely of funds without revenue sharing agreements" was rejected by the ALJ.[20] The ALJ concluded that "this argument mischaracterizes the purpose of the disclosure. The disclosure is not intended to address whether a client's portfolio may include funds with revenue sharing agreements, but whether such revenue sharing agreements were in place at all. Because such agreements were in place, disclosing that such agreements may be in place was false and misleading; the disclosures failed to make clear there were actual, present conflicts of interest at play."[21]

As we approach the Form ADV annual amendment season, we suggest your proactively scrub your disclosure documents for any potentially misleading uses of the word. Consider avoiding words like "may," "might" or "could," when it is clear that the situation being disclosed already exists.

Finally, in contrast to the preceding cases, the ALJ decision in The Robare Group[22] resulted in support for the adviser's use of "may". As in the case against Total Wealth Management, the SEC had charged that the firm's use of "may" in connection with its disclosure of certain commission sharing arrangements with another firm was false and misleading. The adviser's ADV used "may" in several instances to explain compensation it received under a revenue sharing arrangement with an unaffiliated custodian. Fees could be paid to the adviser for client assets placed in various no load mutual funds offered by, but not affiliated with, the custodian.

The adviser's president testified that the word "may" was used, "because the original Program agreement provided that the underlying mutual funds could stop payments at any time."[23] The ALJ sided with the adviser, contending

14. Id. at 36.
15. Id. at 38.
16. In the Matter of Total Wealth Management, Inc., et al.; Init. Dec. Rel. No. 860 (Aug. 17, 2015); https://www.sec.gov/alj/aljdec/2015/id860bpm.pdf.
17. Id. at 32.
18. Id. at 15.
19. Id. at 32.
20. Id.
21. Id. at 32-33.
22. In the Matter of The Robare Group, Ltd., et al., Init. Dec. Rel. No. 806 (June 4, 2015); https://www.sec.gov/alj/aljdec/2015/id806jeg.pdf.
23. Id. at 13.

that the agreement between the adviser and the custodian informed the adviser "that the underlying mutual funds could change or suspend payments at any time," and he concluded that "[u]se of the word "may" thus accounts for the possible cessation of payments."[24]

However, the ALJ's initial decision was reversed by the SEC on November 7, 2016.[25] Contrary to the conclusion reached by the ALJ, the SEC determined that the adviser and its principals violated Advisers Act Section 206(2) by negligently failing to fully and fairly disclose the revenue sharing agreement with the unaffiliated custodian for several years and by failing to disclose adequately and completely the conflict of interest arising from the agreement even after disclosing the arrangement. According to the Final Decision, the initial disclosure made by the firm that the principals testified was intended to refer to the arrangement was wholly inadequate, because "disclosure that it may receive selling compensation in the form of 12b-1 fees in no way revealed that TRG actually had an arrangement with [Custodian], that it received fees pursuant to the arrangement, and that the arrangement presented at least a potential conflict of interest."[26] [emphasis in original] Moreover, the SEC concluded that even disclosure added later to clarify the existence of the arrangement was inadequate, because it failed to mention that not all of the unaffiliated no-load mutual fund assets on the custodian's platform" resulted in fees; therefore, the "disclosure failed to reveal that [adviser] had an economic incentive to put client assets into eligible . . . funds over other funds on the . . . platform", and without that information, clients would be unable to "properly assess the relevant conflicts."[27] As a result, respondents were ordered to cease and desist and a $50,000 penalty was imposed on each principal.

As we approach the Form ADV annual amendment season, we suggest that you proactively scrub your disclosure documents for any potentially misleading uses of the word. Consider avoiding words like "may," "might" or "could," when it is clear that the situation being disclosed already exists. Describe related conflicts of interest in a way that makes clear that the conflicts will or do exist, if not for all clients, at least for affected clients and explain what you are doing to avoid or mitigate the conflicts.

As you review your existing Form ADV, do a search for the word "may" and whenever possible, modify the sentence to eliminate the word or provide more detailed factual information. This exercise has been performed by at least one advisory firm of which we are aware. That firm concluded that the word "may" was still appropriate in about two dozen instances. However, over 50 uses of the word were eliminated from its ADV. We have provided some examples from those ADV revisions at the end of this article to assist you when reviewing your firm's ADV.

Finally, we note that although this article reviewed "may" cases brought against investment advisers, other financial industry participants, including mutual funds, hedge funds and even broker-dealers, should consider reviewing their disclosures, since "false and misleading" could apply to any mandatory disclosure. Firms seeking to avoid being the next "poster child" for "may"-related enforcement actions would be wise to reconsider how they are using this term in existing disclosure documents.

24. Id. at 38.
25. In the Matter of the Robare Group, Ltd, et al., Opinion of the Commission, Rel. No. IA-4566 (November 7, 2016); https://www.sec.gov/litigation/opinions/2016/ia-4566.pdf.
26. Id. at 10.
27. Id. at 10-11. See also, In the Matter of Royal Alliance Associates, Inc., SagePoint Financial, Inc. and FSC Securities Corporation, SEC Rel. Nos. IA-4351 and 34-77362 (March 14, 2016) (dual registrant adviser /broker-dealer affiliates found to have violated Advisers Act Section 206(2) by disclosing in their Forms ADV that they "may receive 12b-1 fees from mutual fund investments in fee-based advisory accounts", but failing to disclose anywhere that they had a conflict of interest when selecting mutual fund share classes "due to a financial incentive to place non-qualified advisory clients in higher-fee share classes over lower-fee share classes of the same mutual fund," resulting in censure, disgorgement and interest of over $2 million and a penalty of $7.5 million).

Attachment

The following are examples of ADV-related revisions

Clients ~~may~~ *will* incur certain charges imposed by custodians, brokers, and other third parties such as custodial fees, deferred sales charges, odd-lot differentials, transfer taxes, foreign exchange transaction fees, wire transfer and electronic fund fees, as well as other fees, taxes, and governmental charges
Adviser ~~may invest~~ *invests* in shares of investment companies that charge asset management fees and other fees, which are in addition to the advisory fees charged by Adviser.
Performance-fee arrangements may create an incentive for an adviser to take risks in managing assets that would not otherwise be taken in the absence of such arrangements. Similarly, ~~Adviser may have an incentive to favor~~ larger or higher fee-paying accounts *could be favored* because they ~~may~~ generate more revenue for *an adviser*.
Depending on the client's country of domicile, sometimes there ~~may be~~ *are* government or regulatory limitations on investments in certain securities, which ~~may affect~~ *affects* Adviser's ability to invest in such securities.
The trading techniques used by Adviser ~~may~~ result in a higher portfolio turnover rate and/or related trading expenses, which ~~may adversely~~ affect performance.
Global securities ~~may~~ *tend* to be volatile and ~~may~~ involve greater risks, including currency risk, adverse political or economic developments in certain countries, the relative lack of information, relatively low market liquidity and the potential lack of strict financial and accounting controls and standards.
Potential conflicts of interest ~~may~~ exist when an investment adviser manages more than one client account. Adviser ~~may buy~~ *buys* and ~~sell~~ *sells* securities of issuers, or ~~engage~~ *engages* in other investments on behalf of more than one of its clients, including affiliated accounts. *As a result*, Advisers ~~may give~~ advice and/or actions in the performance of its duties with respect to clients in any given strategy that ~~may~~ *can* differ from the advice given, or the timing or nature of actions taken, with respect to other clients that ~~may~~ invest in some of the same securities or strategy.
Adviser will not effect any principal or agency cross securities transactions for client accounts. Adviser will also not intentionally cross trades between client accounts. However, Adviser's investment process ~~may result~~ results in situations in which some of its accounts ~~may~~ sell securities when other accounts purchase the same securities at or about the same time. All such transactions are executed through unaffiliated brokerage firms.
The selection of broker-dealers used to execute orders depends on type-of-trade and past-execution performance. Adviser gives primary consideration to obtaining the most-favorable price and efficient execution. ~~Adviser may, however, pay~~ *Paying* a higher commission than would otherwise be necessary for a particular transaction *is possible* when, in Adviser's opinion, to do so would further the goal of obtaining the most-favorable available execution and ensuring the transaction as a whole represents the best qualitative and quantitative execution
Adviser has a limited number of arrangements whereby from time to time it ~~may compensate~~ *compensates*, either directly or indirectly, affiliated and/or unaffiliated persons for client referrals and/or service. Under such arrangements, Adviser generally pays a ~~percentage portion~~ of the investment advisory fee payable to Adviser by the client. This fee ~~may vary~~ *usually varies* according to each agreement. Clients referred to Adviser will not be charged more than similarly situated clients who were not referred to Adviser. Referral arrangements are entered into in accordance with Advisers Act Rule 206(4)-3.
Adviser's discretionary authority ~~may~~ *can* be subject to restrictions imposed by certain federal securities laws. Depending on the client's country of domicile, there ~~may be~~ *are* government or regulatory limitations on investments in certain securities, which ~~may affect~~ *affect* Adviser's ability to invest in such securities. In addition to investment limitations imposed by applicable regulations, certain investment companies, commingled funds, and separately managed accounts ~~may~~ have established certain restrictions on the types and quantities of securities that ~~may~~ *can* be purchased.

Below are examples of when "may" could be appropriate.

Adviser *may* allow an existing client with multiple accounts above the minimum to open another account below the minimum account size.
Laws, regulations, or contracts restrict how much of a particular security we *may* invest in on behalf of a client, and as to the timing of a purchase or sale.
Adviser does not have custody or possession of client assets. Adviser encourages all clients to carefully review the statements received from their qualified custodian and compare custodial records to the account statements provided by Adviser. Adviser's statements *may* differ from custodial statements due to accounting procedures, reporting dates, or valuation differences for certain securities.

Compliance and Legal Officer Guidelines To Prevent Non-Line Supervisory Liability

By James G. Lundy and Carrie DeLange

Introduction

The primary objective of this article is to provide guidance for compliance officers and in-house attorneys with investment management and broker-dealer firms to avoid supervisory liability related to the violative conduct of business personnel. As discussed below, important principles for firms such as – culture, (appropriate) collaboration, escalation, and documentation – are critically important. Although other publications have addressed this controversial topic, historically the majority of the discussions have appropriately focused on frustration that the Securities and Exchange Commission ("SEC") and the Financial Industry Regulatory Authority ("FINRA") even engage in these investigations. This frustration, while completely understandable, is not particularly beneficial because the SEC has been conducting investigations into the conduct of compliance and legal officers in limited and appropriate circumstances for about a quarter of a century. While the anticipated changes at the SEC may impact the Division of Enforcement's investigative techniques, the staff will continue to follow evidence where it leads them, including to the "doors" of compliance and legal departments. The goal of this piece is to provide guidance to compliance and legal personnel to be able to "slam those doors" as quickly as possible – or even better – avoid a "knock on the door" in the first place.

A Review of the Statutes and Rules for Supervisory Law

We begin with a summary of applicable supervisory laws and guidance. Many of you will be familiar with the laws and guidance described below, but a full analysis of these requirements as they apply to both investment management and brokerage firms is necessary to build towards the recommended takeaways. As we know, in addition to the SEC enforcing its supervisory regulations, for broker-dealers, FINRA also investigates and enforces its supervisory rules.[1] Further, with the increase of dual registrants and the growing complexity of the multiple business lines of larger financial services firms, it is important to understand and cross-reference the regulatory framework and guidance that has developed in this area over time.

Section 203(e)(6) of the Investment Advisers Act of 1940

The regulatory regime for the investment advisory industry is covered in the Investment Advisers Act of 1940 ("Advisers Act").

Amongst its various regulations is Section 203(e)(6), which requires that investment advisers, both entities and affiliated persons, reasonably supervise or face sanctions by the SEC. This regulation states:

> (e) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any investment adviser if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such investment adviser, or any person associated with such investment adviser, whether prior to or subsequent to becoming so associate —
>
> (6) . . . has failed reasonably to supervise, with a view to preventing violations of the provisions of statutes, rules and regulations [federal securities laws, the Commodity Exchange Act, or the rules of the Municipal Securities Rulemaking Board], another person who commits such a violation, if such other person is subject

About the Authors:

James G. Lundy is a Partner at Drinker Biddle & Reath LLP, www.drinkerbiddle.com. He can be reached at james.lundy@dbr.com.

Carrie DeLange is an Associate at Drinker Biddle & Reath LLP, www.drinkerbiddle.com. She can be reached at carrie.delange@dbr.com.

1. For futures, the Commodity Exchange Act and futures self-regulatory organization rulebooks also provide a supervisory legal framework for the futures industry. This article, however, focuses on the securities industry.

to his supervision. For the purposes of this paragraph no person shall be deemed to have failed reasonably to supervise any person, if:

(A) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect insofar as practicable, any such violation by such other person, and

(B) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.[2]

Notably absent from Section 203(e)(6) is a scienter requirement. This means that an individual can be held liable under Section 203(e)(6) even if she or he lacked knowledge.[3] Also of note, subparagraphs (A) and (B) provide for affirmative defenses, as discussed in more detail below.

Section 15(b)(4)(E) of the Securities and Exchange Act of 1934

The registration and regulation of broker-dealers is covered by Section 15 of the Securities Exchange Act of 1934 (the "Exchange Act"). Among the various provisions of Section 15 of the Exchange Act is Section 15(b)(4)(E), which requires that broker-dealers, the entities and affiliated persons, reasonably supervise or face sanctions by the SEC. This regulation states:

(4) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated—

(E) . . . has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations [federal securities laws, the Commodity Exchange Act, or the rules of the Municipal Securities Rulemaking Board], another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person, if—

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.[4]

The language of Section 15(b)(4)(e) of the Exchange Act mirrors Section 203(e)(6) of the Advisers Act. And like Section 203(e) (6), Section 15(b)(4)(e) does not require scienter.[5] Further, subparagraphs (i) and (ii) provide for affirmative defenses.

The failure to supervise case law for broker-dealers is more developed than the case law for investment advisors. To establish a failure to supervise charge, the SEC must demonstrate: 1) an underlying violation of the federal securities laws; 2) that the supervisor was associated with the person who committed the violation; 3) that the supervisor had supervisory responsibility over that person; and 4) that the supervisor failed to reasonably supervise the person committing the violation.[6] It is the third factor – supervisory responsibility – that the SEC needs to investigate and establish to charge compliance and legal officers for supervisory violations related to the conduct of non-linear business personnel. We explain this factor in more detail in the below discussion of the "Gutfreund Standard."

2. Advisers Act § 203(e)(6).
3. Wonsover v. SEC, 205 F.3d 408, 414 (D.C. 2000).
4. Exchange Act §15(b)(4)(E).
5. *See In the Matter of Gary M. Kornman, Release No. 2840 (Feb. 13, 2009) (noting that there is "no scienter requirement" for Section 15(b) violations because the sanction is remedial and designed to protect the public.)*
6. *Id.*; see also *Collins v. S.E.C.*, 736 F.3d 521, 524 (D.C. Cir. 2013) (explaining that Section 15(b)(4) (e) "create[s] liability for a supervisor when his inadequate supervision is coupled with a violation by his supervisee."); *Branigan v. Alex. Brown & Sons, Inc.*, 978 F. Supp. 547, 549 (S.D.N.Y. 1997) (same).

Supervisory Systems Requirements

Rule 206(4)-7 of the Investment Advisers Act of 1940

Advisers Act Rule 206(4)-7 was adopted in 2003. It requires certain compliance procedures and practices, which have been described as a supervisory system for investment advisers.[7] Specifically, Rule 206(4)-7 states:

> If you are an investment adviser registered or required to be registered under section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3), it shall be unlawful within the meaning of section 206 of the Act (15 U.S.C. 80b-6) for you to provide investment advice to clients unless you:
>
> (a) Policies and Procedures. Adopt and implement written policies and procedures reasonably designed to prevent violation, by you and your supervised persons, of the Act and the rules that the Commission has adopted under the Act;
>
> (b) Annual Review. Review, no less frequently than annually, the adequacy of the policies and procedures established pursuant to this section and the effectiveness of their implementation; and
>
> (c) Chief Compliance Officer. Designate an individual (who is a supervised person) responsible for administering the policies and procedures that you adopt under paragraph (a) of this section.[8]
>
> The SEC initially charged investment advisory firms with violations of Rule 206(4)-7. Soon thereafter, however, the SEC also started charging the firm's chief compliance officer ("CCO") with Rule 206(4)-7 violations.[9]

FINRA Rule 3110

Neither Section 15 of the Exchange Act nor any other provisions of the federal securities laws require that a broker-dealer have a supervisory "system." Instead, FINRA, as the primary selfregulatory organization for broker-dealers, establishes this legal requirement with FINRA Rule 3110 "Supervision." FINRA Rule 3110 requires that FINRA member firms have: 1) a supervisory system; 2) written supervisory procedures; 3) conduct annual internal inspections of its businesses; 4) conduct a reasonable transaction review and investigation when necessary; and 5) investigate the member's applicants for registration.[10] FINRA routinely examines its broker-dealer member firms for compliance with this supervisory rule and enforces any violations. While FINRA's actions against CCOs for violations of this rule are less frequent than SEC Rule 206(4)-7 CCO cases, FINRA pursues these cases as well.[11]

The Gutfreund Standard

The standard that the SEC applies to the issue of whether a compliance or legal officer can be liable for failing to supervise business personnel outside their reporting lines was first described twenty-five years ago in the SEC's case and accompanying report from In the Matter of John H. Gutfreund, et al . This action included a "Report of Investigation Pursuant to Section 21(a)" of the Exchange Act (the "21(a) Report") regarding the conduct of Donald M. Feuerstein, the chief legal officer and head of the legal department at Salomon Brothers, Inc.[12] The SEC guidance in the 21(a) Report established the "Gutfreund Standard" cited by the SEC in subsequent enforcement actions.

However, approximately one year earlier, two Commissioners in a concurring opinion had espoused a "control" standard akin to the capability to hire or fire the employee.[13] While advocating for a more narrow "control" standard remains a valid legal defense strategy, the SEC has historically applied the Gutfreund Standard as described below. Further, when given the opportunity, the Commission has pointed to the Gutfreund Standard over the "control" / "hire or fire" standard as the legal precedent in this area.[14]

In *Gutfreund*, the underlying conduct involved a false bid in excess of $3 billion in an auction for U.S. Treasury securities. Feuerstein was informed of the bid at the same time as other senior executives of Salomon. Feuerstein was present at the meetings where the supervisors named as respondents in the proceeding discussed the matter. In his capacity as a legal adviser, Feuerstein advised the respondents that the submission of the bid was a criminal act and should be reported to the government. Feuerstein urged Salomon executives on several occasions to proceed

7. Regarding Investment Companies, Rule 38a-1 under the Investment Company Act of 1940 applies. Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 22044, Investment Company Act Release No. 26299, 68 Fed. Reg. 74714 (Dec. 24, 2003).
8. Advisers Act Rule 206(4)-7.
9. *See e.g., In the Matter of Omni Inv. Advisors Inc. & Gary R. Beynon*, Release No. 3323 (Nov. 28, 2011) (charging an investment advisor firm's Chief Compliance Officer with violations of Rule 206(4)-7.
10. FINRA Manual Rule 3110.
11. *See e.g., In the Matter of Jeffrey Stinnett, Respondent* (AWC 2014039194102, February 23, 2016); *see also* DISCIPLINARY AND OTHER FINRA ACTIONS, 2010 WL 652064, at *5.
12. *In the Matter of John H. Gutfreund, et al.* 51 S.E.C. 93 (1992).
13. *In the Matter of Arthur James Huff,* 50 S.E.C. 524 (1991).
14. *In the Matter of Arthur James Huff,* 55 S.E.C. 1009 (2002).

with disclosure when he learned that the report had not been made. However, Feuerstein did not direct that an inquiry be undertaken, and he did not recommend that appropriate procedures reasonably designed to prevent and detect future misconduct be instituted, or that other limitations be placed on the trader's activities. Feuerstein also did not inform the compliance department, for which he was responsible as Salomon's chief legal officer, of the false bid.[15]

In the 21(a) Report, the SEC advised that employees of brokerage firms who have compliance or legal responsibilities do not become "supervisors" solely because they occupy those positions.[16] Instead, determining if a particular person is a "supervisor" depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability, or authority to affect the conduct of the employee whose behavior is at issue. This is referred to as the Gutfreund Standard.[17]

While the Gutfreund Standard remains controversial, the 21(a) Report actually provided guidance for compliance and legal officers as well. Specifically, the 21(a) Report advises compliance and legal officers to reasonably respond to potential violative conduct by:

- directing or monitoring an inquiry or investigation of the conduct at issue;
- making appropriate recommendations for limiting the activities of the employee or for the institution of appropriate procedures, reasonably designed to prevent and detect future misconduct; and
- verifying that his or her recommendations, or acceptable alternatives, are implemented.[18]

None of these steps are remotely controversial in 2017. Indeed, these are now accepted compliance and legal department practices to address potential violative conduct that comes to their attention.

The 21(a) Report went further, however, with guidance that remains controversial, starting with: "If such a person [compliance or legal officer] takes appropriate steps but management fails to act and that person knows or has reason to know of that failure, he or she should consider what additional steps are appropriate to address the matter."[19] In this very uncommon and extremely unfortunate circumstance, the SEC advised that the additional steps to consider may include:

- escalation to appropriate members of senior management;
- escalation to the entity's board of directors;
- disclosure to regulatory authorities; or
- resignation from the firm.[20]

The first of these steps – escalation to senior management – may come up periodically, but hopefully not regularly, as part of a firm's escalation process. Thereafter, the following three steps quickly become significantly more sensitive and controversial. If a compliance or legal officer finds that escalation to senior management does not address the issues, then he or she needs to consider consulting with outside counsel. The last two of these steps should only be considered in dire circumstances as a last resort because they are extremely controversial and involve highly sensitive and complex legal and regulatory issues. That said, for the vast majority of firms that strive for a strong culture of compliance and where management appropriately fosters an appropriate collaborative relationship with the compliance and legal departments, any issues should be resolved as early in the process as possible.

SEC Guidance

On September 30, 2013, the SEC Division of Trading and Markets issued a Frequently Asked Questions ("FAQ") release to serve as guidance regarding this controversial topic.[21] Although focused on the brokerage industry, due

to the similar language and case law interpretations of Section 15(b)(4)(E) of the Exchange Act and Section 203(e)(6) of the Advisers Act, the guidance in this FAQ can be extended to the investment management industry.

15. *Id*.
16. *Id.*
17. *Id.*
18. Id.
19. *Id.*
20. *Id.*
21. *Frequently asked Questions about Liability of Compliance and Legal Personnel at Broker-Dealers under Sections 15(b)(4) and 15(b)(6) of the Exchange Act,* available at: http://www.sec.gov/divisions/marketreg/faq-cco-supervision-093013.htm.

In the FAQ, the SEC emphasized that they have brought these types of failure to supervise actions against compliance or legal personnel "only in limited circumstances in which these individuals have been delegated, or have assumed, supervisory responsibility for particular activities or situations, and therefore have 'the requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.'"[22] In terms of determining whether an individual has the requisite degree of – "responsibility, [or] ability or authority to affect the conduct of the employee whose behavior is at issue" – the SEC's FAQ posits these considerations:

- Has the person [compliance or legal officer] clearly been given, or otherwise assumed, supervisory authority or responsibility for particular business activities or situations?
- Do the firm's policies and procedures, or other documents, identify the person as responsible for supervising, or for overseeing, one or more business persons or activities?
- Did the person have the power to affect another's conduct? Did the person, for example, have the ability to hire, reward or punish that person?
- Did the person otherwise have authority and responsibility such that he or she could have prevented the violation from continuing, even if he or she did not have the power to fire, demote or reduce the pay of the person in question?
- Did the person know that he or she was responsible for the actions of another, and that he or she could have taken effective action to fulfill that responsibility?
- Should the person nonetheless reasonably have known in light of all the facts and circumstances that he or she had the authority or responsibility within the administrative structure to exercise control to prevent the underlying violation?[23]

The FAQ further recommends processes to escalate identified instances of noncompliance to business line personnel for remediation and procedures that clearly designate responsibility to business line personnel for supervision of functions and persons. In fact, escalation and appropriate collaboration with management are themes throughout the FAQ. Regarding collaborative counseling and advice, the FAQ states:

> Compliance and legal personnel play a critical role in efforts by broker-dealers to develop and implement an effective compliance system throughout their organizations,including by providing advice and counsel to senior management. Compliance and legal personnel do not become "supervisors" solely because they provide advice to, or consult with, senior management. In fact, compliance and legal personnel play a key role in providing advice and counsel to senior management, including keeping management informed about the state of compliance at the broker-dealer, major regulatory developments, and external events that may have an impact on the broker-dealer. In this regard, compliance and legal personnel should inform direct supervisors of business line employees about conduct that raises red flags and continue to follow up in situations where misconduct may have occurred to help ensure that a proper response to an issue is implemented by business line supervisors. Compliance and legal personnel may need to escalate situations to persons of higher authority if they determine that concerns have not been addressed.[24]

By way of more recent guidance from the SEC, in a June 29, 2015 speech, former Commissioner Luis Aguilar gave his perspective on this topic:

> The vast majority of these cases involved CCOs who "wore more than one hat," and many of their activities went outside the traditional work of CCOs, such as CCOs who were also founders, sole owners, chief executive officers, chief financial officers, general counsels, chief investment officers, company presidents, partners, directors, majority owners, minority owners, and portfolio managers. Many of these cases also involved compliance personnel who affirmatively participated in the misconduct, misled regulators, or failed entirely to carry out their compliance responsibilities.[25]

Providing guidance from an enforcement perspective and following the 2015 In the Matter of SFX Financial Advisory Management Enterprises, Inc., et al. and In the Matter of Blackrock Advisors, LLC cases, at that year's

22. Id.
23. Id.
24. Id.
25. SEC Commissioner Luis A. Aguilar, *The Role of Chief Compliance Officers Must be Supported* (Jun. 29, 2015), available at https://www.sec.gov/news/statement/supporting-role-of-chief-compliance-officers.html.

National Society of Compliance Professionals National Conference Keynote Address, then Enforcement Director Andrew Ceresney stated that in the limited situations when the SEC brings actions against compliance officers they generally fall into three categories.[26] He specified these categories as: 1) compliance officers who are affirmatively involved in misconduct; 2) compliance officers who engage in efforts to obstruct or mislead the staff; and 3) compliance officers who exhibit a wholesale failure to carry out his or her responsibilities.[27] To put all of this in the proper perspective though, throughout both of their speeches and in their concluding remarks both Commissioner Aguilar and Director Ceresney expressed the SEC's full support for the compliance community.

Takeaways / Strategic Recommendations

In considering the above statutes, rules, and guidance – several strategic lessons and recommendations serve as takeaways.

First, investment management and broker-dealer firms should continue to be vigilant regarding their compliance with Rule 206(4)-7 of the Advisers Act and FINRA Rule 3110 with respect to their supervisory systems. Among the many important benefits, strong supervisory systems provide firms and individuals with affirmative defenses to SEC investigations into violations of Sections 203(e)(6) and 15(b)(4)(E) via subparagraphs 203(e)(6)(A) and 15(b)(4)(E)(i). Specifically, these supervisory systems allow firms to establish that "there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person."[28] Thus, by the plain language and interplay of these regulations, strong supervisory systems will thwart efforts by regulators to bring these types of charges.

Perhaps most importantly, firms need to foster a strong compliance culture and a culture of appropriate collaboration between managment and compliance and legal personnnel. This is hardly a novel concept in the 21st century.

Second, but perhaps most importantly, firms need to foster a strong compliance culture and a culture of appropriate collaboration between management and compliance and legal personnel. This is hardly a novel concept in the 21st century. Indeed, one of the primary themes of FINRA's 2016 Regulatory and Examination Priorities Letter was the culture of compliance.[29] A strong compliance culture and appropriate collaborative relationships allow for issues to be addressed as early as possible in the escalation process.

Third, firms should clearly delineate supervisory responsibility for business functions to business line management and the supervisory responsibilities of compliance and legal should be delineated and limited specifically to the employees in those departments. This should be documented clearly in a firm's written supervisory procedures – leaving no ambiguity – and should be included in the reviews of the written supervisory procedures and updated as needed.

Fourth, in addition to the written supervisory procedures, firms should have written firm-wide escalation policies and procedures or have them in place on a department-by-department basis across the firm, including the compliance and legal departments. These escalation policies should address when escalation will be triggered and provide the steps to be followed, including when to escalate issues to senior management. These policies and procedures should address the documentation required at the various stages of the escalation process. Escalation policies and procedures serve several purposes, including providing notice across the firm on how "red flags" of possible violative conduct will be addressed. A firm's periodic trainings should include a review of these escalation policies and procedures at least annually.

Lastly – if the circumstances arise that a compliance or legal officer is delegated or assumes supervisory responsibility and therefore ends up with "the requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue" – the compliance or legal officer needs to appropriately document his or her efforts. This cannot be recommended strongly enough. Creating contemporaneous written

26. Andrew J. Ceresney, Director, Div. of Enforcement, Secs. & Exch. Comm'n, *Keynote Address at National Society of Compliance Professionals*, National Conference (Nov. 4, 2015), available at https://www.sec.gov/news/speech/keynote-address-2015-national-society-compliance- prof-cereseney.html. (*Citing, In the Matter of SFX Financial Advisory Management Enterprises, Inc. and Eugene S. Mason, Advisers Act Release No. 4116 (June 15, 2015); In the Matter of Blackrock Advisors, LLC and Bartholomew A. Battista*, Advisers Act Release No. 4065
(Apr. 20, 2015)).
27. Andrew J. Ceresney, Director, Div. of Enforcement, Secs. & Exch. Comm'n, *Keynote Address at National Society of Compliance Professionals, National Conference* (Nov. 4, 2015).
28. Advisers Act § 203(e)(6)(A) and Exchange Act §15(b)(4)(e).
29. *FINRA 2016 Regulatory and Examination Priorities Letter*, available at: http://www.finra.org/industry/2016-regulatory-and-examination-priorities-letter.

records of the efforts to respond reasonably to "red flags" of possible violative conduct by engaging management or escalating to senior management pursuant to the firm's escalation policies and procedures is critical. Regarding this documentation, if a compliance officer ends up in this situation they should closely coordinate with the legal department. This will allow the documentation that is generated to be covered by the firm's attorney-client and attorney work product privileges. For compliance officers who are also attorneys, but work in the compliance department, be advised that the SEC and FINRA view compliance as an operational function to which these privileges do not apply. Therefore, in an abundance of caution to preserve these privileges, compliance officers should consult with the legal department. For those firms that do not have legal departments, depending on the seriousness of the issues and where they are at in the escalation process, they should consider consulting with outside counsel.

Conclusion

This topic has historically caused both frustration and fear with compliance and legal officers. Rightfully so. However, armed with a thorough understanding of the legal standards, the guidance, and these takeaways and strategic recommendations, compliance and legal officers can use appropriate planning to extricate themselves from a supervisory investigation as quickly as possible – or even better – avoid being subjected to any exposure in the first place.

What Every Compliance Officer Should Know About Best Execution

By Sophia Lee, CFA

A. Introduction to the Duty of Best Execution

The duty of best execution has become more central to the compliance programs of investment advisers and broker dealers. The Securities and Exchange Commission ("SEC"), the Financial Industry Regulatory Authority ("FINRA"), the Municipal Securities Rulemaking Board ("MSRB"), and other regulatory bodies are continuing to focus on investor protection and the best execution obligations of investment advisers and broker dealers to make sure they are using reasonable diligence to achieve the best trade executions for their customers.

The duty of best execution originates in the common law duty of loyalty owed to a principal by an agent. The Securities Exchange Act of 1934 (the "Exchange Act") made this obligation more explicit. For example, in the adopting release for Regulation National Market System, the SEC stated that the purpose of the national market system is to protect investors, provide an opportunity for investors' orders to be executed without the participation of a dealer, and to meet the needs of longer-term investors.[1] Section 6 of the Exchange Act states that the rules of an exchange shall protect investors and the public interest and Section 11A of the Exchange Act states that the linking of the markets will "contribute to best execution of [investors'] orders.[2]

Furthermore, the Investment Advisers Act and the Investment Company Act set forth the duty of best execution for advisers and funds, respectively.[3] Investment advisers' duty of best execution stems from their duty of "utmost good faith, and full and fair disclosure of all material facts" and an affirmative obligation "to employ reasonable care to avoid misleading" clients.[4] In fulfilling this duty, investment advisers need to monitor performance of their brokers, which requires an understanding of brokers' best execution obligations as well.

Every compliance officer should review his or her firm's operating model to ensure it is delivering and monitoring execution quality and meeting heightened regulatory expectations. Best execution compliance programs needto account for advances in technology, the emergence of new trading venues, execution quality analysis, and recent guidance from the regulators. Compliance officers should aim to include certain key components in their best execution compliance programs, including the generation and review of relevant metrics, trends and reports and the documentation and rationale for key decisions, either on an order-by-order basis or periodic review, as necessary. In a fragmented market structure with fifty market centers trading the same security, a broker-dealer's order routing decisions are critically important to fulfilling the best execution obligation, and buy-side firms and their traders devote significant resources to monitoring broker-dealer order handling practices.

Regulators around the globe are scrutinizing order handling and routing practices to ensure that investment advisers and broker dealers are consistently achieving and monitoring best execution of customer orders.

In this article, I will discuss the duty of best execution owed by investment advisers and that owed by broker-dealers. I will then discuss the challenges in understanding the best execution obligation, and suggestions for compliance officers to use the data available to help fulfill this duty. Lastly, I will discuss recent proposals from the regulators both in the U.S. and overseas to clarify and expand the duty of best execution.

About the Author:
Sophia Lee is General Counsel and Corporate Secretary of IEX Group, Inc. She can be reached at sophia.lee@iextrading.com.

1. 15 U.S.C. 78f; Securities Exchange Act Release No. 34-51808 (June 9, 2005), available at https://www.sec.gov/rules/final/34-51808.pdf.
2. *15 U.S.C. 78k.*
3. 17 C.F.R. 275.206(4)–7; 17 C.F.R. 270.38a-1.
4. 15 U.S.C. 80b–6.

B. Who Has a Duty to Best Execution?

Investment Advisers Have a Duty of Best Execution

An adviser must act in the clients' best interest for all clients for which it has discretion to place brokerage, and any conflicts of interest must be adequately disclosed. Under Section 206 of the Investment Advisers Act, which prohibits adviser fraud, courts have imposed on advisers a fiduciary duty that includes an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts" and an affirmative obligation "to employ reasonable care to avoid misleading" clients.[5] Courts have interpreted this provision to include the duty to seek best execution. An adviser fulfills its duty of best execution not only by obtaining the best price or the lowest commission rate, but also by determining whether the transaction represents the best qualitative execution for their clients.

Fund directors also owe fiduciary duties to oversee (at the fund level) the performance of the selected brokers (via transaction-cost analysis and other reports), analyze the trading data, discuss the data with the portfolio manager, and act on such information. These duties apply to the directors' activities in monitoring best execution as well. Section 15(c) of the Investment Company Act of 1940 ("Section 15(c)") requires fund directors to request and assess the information necessary to evaluate the terms of the advisory contract, initially and at each renewal. For advisers with discretion in placing client brokerage, the advisory agreement typically requires that they seek best execution. Failing to seek best execution may therefore allow clients contractual remedies in addition to other available remedies. As part of their fiduciary duty, directors are expected to request and evaluate appropriate best execution information when approving an initial advisory agreement or renewal. Note that Section 15(c) also imposes on advisers a duty to furnish the information directors need to evaluate the advisory contract. As a result, even if the directors do not ask for best execution information, fund management is expected to provide it, particularly any information that may indicate a conflict of interest.

Additionally, advisers to a registered investment company and fund directors are both subject to Section 36(a) of the Investment Company Act of 1940, which authorizes actions against officers, directors, advisers or principal underwriters for breaches of fiduciary duty involving personal misconduct with respect to an investment company.

In Section 28(e) of the Exchange Act, the SEC clearly stated that investment advisers have a duty to seek the most favorable execution terms reasonably available given the specific circumstances of each trade. In this regard, the SEC has recognized that qualitative factors are generally as important as quantitative factors. According to the SEC, in making its best execution determination, "a money manager should consider the full range and quality of a broker's services in placing brokerage including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness to the money manager."[6]

To ensure investment advisers are getting best execution for clients' trades, advisers must periodically evaluate the execution performance of the broker-dealers used to execute such clients' transactions. The portfolio manager, a fiduciary with respect to clients' accounts, has an obligation to ensure that trades are executed in a manner that is optimal under the particular circumstances and to achieve the best result for the client in terms of both explicit and implicit costs.

This best execution obligation comes with an independent duty to conduct analysis of the quality of the executions achieved by the brokers. Factors that should be analyzed include explicit commissions, market impact costs, opportunity costs of orders that are not filled, and whether the fill rates in the particular securities are satisfactory. Furthermore, investors need to oversee how their brokers are doing and reduce their conflicts of interest through reducing inducements and improving disclosures.

The CFA Institute has also issued Trade Management Guidelines, which focus on establishing processes, disclosures, and documentation to form a systematic, repeatable, and demonstrable approach to seeking best execution in the aggregate[7]. These best practices guidelines are becoming industry practice for advisers. They include the development of trade management procedures that help a firm identify and manage actual and potential conflicts of interest resulting from trading activities and assist in the regular review of the quality of services received from brokers. Furthermore, these guidelines recommend inclusion of an effective trade evaluation process which provides important information that can help a firm analyze trading costs and execution trends of trades with readily available comparative execution data. These guidelines also recommend that firms take into

5. Sec. & Exch. Comm'n v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194, 84 S. Ct. 275, 284, 11 L. Ed. 2d 237 (1963), citing Prosser on the Law of Torts, among other authorities..
6. See Securities Exchange Act Release No. 34- 23170 (April 28, 1986).
7. Trade Management Guidelines, CFA Institute Publications, available at http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2004.n3.4007.

consideration technology developments and market changes that may help a firm achieve higher quality execution. Therefore, firms must identify the level of a broker's trading expertise when selecting brokers for the firm's approved brokers list, which includes analyzing whether the broker seeks and obtains liquidity to minimize market impact, maximize the opportunity for price improvement, and executes a trade quickly.

Recent SEC investment adviser action

The SEC has specifically listed best execution as one of the areas that advisers and funds should consider when establishing their compliance programs under the SEC compliance rules.[8] In April 2017, In the Matter of Credit Suisse Securities (USA) LLC, the SEC found a breach of Section 206 of the Advisers Act. The SEC found that, by purchasing Class A shares when Credit Suisse's DMP clients were eligible for institutional share classes and by failing to disclose to its clients that best execution might not be sought for mutual funds with multiple available share classes, Credit Suisse breached its duty to seek best execution on behalf of its DMP clients.[9] Similarly, in January 2016, In the Matter of Everhart Financial Group, Inc., et al., the SEC stated that an investment adviser failed to seek best execution when it caused a client to purchase a more expensive share class when a less expensive class was available.[10]

Broker-Dealers Have a Duty of Best Execution

A broker-dealer's order-routing decisions are subject to the duty of best execution. This duty requires a broker seek to execute a customer's order at the most favorable terms reasonably available under the circumstances. The scope of this duty of best execution must evolve as changes occur in the market that give rise to improved executions (e.g., opportunities to trade at more advantageous prices) for customer orders, and broker-dealers' best execution procedures must be modified to consider price opportunities that become "reasonably available."

The determination of whether a broker-dealer exercised reasonable diligence to ascertain the best market for the security and execute the trade at as favorable as possible a price for the customer under prevailing market conditions involves a facts and circumstances analysis. The factors which broker-dealers should consider in meeting their duty of best execution have been set forth in FINRA Rule 5310.[11] These factors, as set forth by FINRA are:

(A) the character of the market for the security (e.g., price, volatility, relative liquidity, and pressure on available communications);

(B) the size and type of transaction;

(C) the number of markets checked;

(D) accessibility of the quotation; and

(E) the terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member.

FINRA Rule 5310 also states that a broker-dealer that routes customer orders to other broker-dealers for execution on an automated, non-discretionary basis, as well as a broker-dealer that internalizes customer order flow, must have procedures in place to ensure the member periodically conducts regular and rigorous reviews of the quality of the executions of its customers' orders if it does not conduct an order-by-order review. FINRA 5310 states that firms choosing to conduct a regular and rigorous review must conduct the reviews, at a minimum, on a quarterly basis, and more frequently, if needed.[12] Furthermore, FINRA 5310 states that, in conducting its regular and rigorous review, with respect to customer limit orders for equity securities, a broker-dealer must consider any material differences in execution quality, which includes the likelihood of execution and whether a broker-dealer is internalizing its order flow, among the various markets to which orders may be routed, and if so, modifying the member's routing arrangements or justifying why it is not modifying its routing arrangements.[13]

To assure that order flow is directed to markets providing the most beneficial terms for customers' orders, the broker-dealer must compare, among other things, the quality of the executions it is obtaining via current order

8. Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IA-2204; IC-26299 (December 17, 2003) (Adopting Release), at II.A.
9. See In the Matter of Credit Suisse Securities (USA) LLC, Securities Exchange Act Release No. 80373 (April 4, 2017), available at https://www.sec.gov/litigation/admin/2017/34-80373.pdf.
10. See In the Matter of Everhart Financial Group, Inc., Richard Scott Everhart, and Matthew James Romeo, Securities Exchange Act Release No. 76897 (January 14, 2016), available at https://www.sec.gov/litigation/admin/2016/34-76897.pdf.
11. FINRA Rule 5310 (2014), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=10455.
12. See id.; Supplementary material .09 of FINRA Rule 5310, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=10455.
13. FINRA, supra note 11.

routing and execution arrangements (including the internalization of order flow) to the quality of the executions that it could obtain from competing markets. According to FINRA, in reviewing and comparing the execution quality of its current order routing and execution arrangements to the execution quality of other markets, a broker-dealer should consider the following factors:

(1) price improvement opportunities (i.e., the difference between the execution price and the best quotes prevailing at the time the order is received by the market);

(2) differences in price disimprovement (i.e., situations in which a customer receives a worse price at execution than the best quotes prevailing at the time the order is received by the market);

(3) the likelihood of execution of limit orders;

(4) the speed of execution;

(5) the size of execution;

(6) transaction costs;

(7) customer needs and expectations; and

(8) the existence of internalization or payment for order flow arrangements.[14]

Guidance for brokers on how they should rigorously review their practices to determine whether they are obtaining best execution for their clients is available from FINRA, and these guidelines could form a foundation from which more rigorous requirements could be developed. FINRA has stated that in light of the increasingly automated nature of the markets, firms need to regularly review their systems and procedures relating to obtaining best execution for their customers' orders. Furthermore, the SEC has recognized that the scope of the duty of best execution must evolve as changes occur in the market that give rise to improved executions for customer orders. The SEC has also articulated a non-exhaustive list of factors that firms should consider as part of their best execution analysis as markets evolve: (1) the size of the order; (2) the trading characteristics of the security involved; (3) the availability of accurate information affecting choices as to the most favorable market center for execution and the availability of technological aids to process such information; and (4) the cost and difficulty associated with achieving an execution in a particular market center.[15]

Recent FINRA and SEC broker-dealer action

In 2016, FINRA fined E*Trade Securities LLC $900,000 for supervisory failures over protecting customer information and failing to conduct an adequate review of the quality of execution of its customers' orders, including failures to properly take into account the internalized order flow that was sent to its affiliated broker-dealer market maker and to consider the actual execution quality provided by the market centers that it was routing to.[16] In 2014, FINRA fined Citigroup Global Markets Inc. $1.85 million and ordered restitution of $638,000 for best execution and supervisory violations, finding that one of Citigroup's trading desks employed a pricing methodology for non-convertible preferred securities which resulted in Citigroup's pricing more than 14,800 customer transactions inferior to the NBBO for more than three years.[17] In early 2017, the SEC fined Citadel Securities LLC, one of the largest market makers in the industry, $22.6 million to settle the charge that its team that processes retail customer orders from other brokerage firms misled those customers about the way it priced trades from 2007 to 2010. It was the largest fine of its kind.[18]

C. Challenges of the Duty of Best Execution

Complying with the duty of best execution is challenging for firms because the duty of best execution is more principles-based and less prescriptive. For investment advisers, best execution is the process by which an adviser seeks the most favorable terms for a client's trade reasonably available under the circumstances. In addition, brokers must consider a variety of factors to comply with best execution. However, the regulations do not rank the factors (e.g., price, speed of execution, execution costs, likelihood of execution) that firms must consider when making routing and execution decisions.

14. FINRA, supra note 11.
15. See Securities Exchange Act Release No. 43590 (November 17, 2000), available at https://www.sec.gov/rules/final/34-43590.htm.
16. FINRA Fines E*Trade Securities LLC $900,000 for Supervisory Violations Related to Best Execution and Protection of Customer Order Information, FINRA, http://www.finra.org/newsroom/2016/finra-fines-etrade-900k-best-execution-and-protection-customer-order-information.
17. FINRA Fines Citigroup Global Markets Inc. $1.85 Million and Orders Restitution of $638,000 for Best Execution and Supervisory Violations in Non-Convertible Preferred Securities Transactions, FINRA, http://www.finra.org/newsroom/2014/finra-fines-citigroup-global-markets-inc-185-million-and-orders-restitution-638000.
18. Citadel Securities agrees $22.6m settlement with SEC, The Financial Times, https://www.ft.com/content/ee8d4ba0-d9a8-11e6-944b-e7eb37a6aa8e; see In the Matter of Citadel Securities LLC, Securities Exchange Act Release No. 79790 (January 13, 2017), available at https://www.sec.gov/litigation/admin/2017/33-10280.pdf.

Moreover, compliance officers of investment advisers often struggle to determine the calculations, metrics or methodology to measure execution quality and the order-by-order review requirements of best execution. Historically, there has been a lack of truly independent third-parties (e.g., unaffiliated with a broker-dealer) to provide analytics an order-by-order basis. This left some compliance officers to rely on the execution quality reports produced by the brokers, or execution providers themselves, who were effectively grading their own work. Others relied exclusively on Rule 605 metrics, which have not been updated to sufficiently cover the reporting of new order types, such as pegged order types, orders of over 10,000 shares, to add more granular execution time categories, nor to sufficiently distinguish between a broker-dealer's reporting and that of the ATS it operates.[19] Compliance officers of investment advisers would be prudent to seek out other publicly-available execution analyses.

Given the enhanced regulatory scrutiny around best execution, compliance officers need to ensure that their firms are requesting the relevant data from their brokers, etc., and that they are utilizing such data across various venues, including exchanges and dark pools, in addition to publicly-available data, widely-available data and published research, during their regular and rigorous review of best execution. Asset managers and mutual fund directors should vigilantly assess the potential conflicts of interest of individual brokers and should collection information sufficient to address: How many of the orders are sent by the brokers to their own dark pools? What is the composition of the participants in these dark pools? What is the manner in which a broker utilizes its own venue versus other venues with similar characteristics? Can participants opt out of interacting with certain types of order flow or counterparties? What logic is used by the broker's smart-order router?

SEC Rule 605 and Rule 606 require markets to supply monthly reports on execution quality and broker-dealers to provide quarterly reports on routing of customer orders. Although these reports could be improved, they are nonetheless helpful tools for determining how the adviser is monitoring the broker and whether the adviser is holding the broker accountable for execution results. There are now many publicly-available execution metrics such as the FINRA OTC (ATS & Non-ATS) Transparency website, and a recent White Paper by IEX titled, "A Comparison of Execution Quality across U.S. Stock Exchanges" (the "IEX White Paper").[20] Compliance officers should incorporate such broker-neutral transaction cost analysis and independent execution quality research from academics and other parties into their best execution compliance programs. FINRA Rule 5310 states "a member shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions."[21] Furthermore, FINRA Regulatory Notice 15-46[22], which is described in further detail below, states that firms should not allow access fees charged by venues to inappropriately affect routing decisions, and, in general, a firm's routing decisions should not be unduly influenced by a particular venue's fee or rebate structure. For example, public data in the IEX White Paper demonstrates that 50-60% of all volume traded on exchanges that pay rebates for adding liquidity occurs within 2 milliseconds of a quote change. This strongly suggests that customer trades on those markets are not occurring at a resultant price which is as favorable as possible (e.g., immediate buyer's/seller's remorse).[23]

D. Recent Updates from the Regulators

Recent FINRA Guidance

In November 2015, FINRA issued guidance on best execution obligations in Regulatory Notice 15-46 (FINRA 15-46) to restate the best execution obligations applicable to firms when they receive, handle, route or execute customer orders in equities, options and fixed income securities and to remind firms of the obligation to repeatedly and thoroughly examine execution quality likely to be obtained from the different markets trading a security.[24]

When Order-By-Order Analysis is Required

FINRA 15-46 clarifies FINRA Rule 5310 to state that regular and rigorous review is insufficient in several situations, including the routing of larger-sized orders and orders executed internally, and that such executions should be subject to an order-by-order analysis of best execution: "While Supplementary Material .09 to Rule 5310 allows a firm to use a regular and rigorous review of execution quality, this standard only applies to a firm's initial

19. 17 CFR 242.605.
20. Elaine Wah et al., A Comparison of Execution Quality across U.S. Stock Exchanges (21 Apr 2017), https://ssrn.com/abstract=2955297.
21. FINRA, supra note 11.
22. FINRA Notice 15-46 (November 2015), available at https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-46.pdf.
23. Wah, supra note 20.
24. FINRA, supra note 22. In parallel, the MSRB released its best execution guidance for municipal securities, which, in large part, mirrors the guidance of FINRA 15-46, which states that a broker-dealer must take into account market and technology changes that might alter its best execution analysis.

determination whether to route an order and to its review of orders routed outside of the firm. Orders that a firm determines to execute internally are subject to an order-by-order best execution analysis."[25]

FINRA 15-46 also listed additional factors to be considered by a broker-dealer when conducting its review of execution quality in any security, and clarified that such factors should apply to both Nonmarketable and Marketable Limit Orders. The new factors included: "(1) the price obtained, including the extent to which an execution results in price disimprovement (i.e., instances where orders are executed at inferior prices); (2) the extent to which an order may obtain price improvement at other venues; (3) the likelihood that an order will be partially or fully executed; (4) the speed of execution; (5) the size of execution."[26]

Routing to Multiple Venues

FINRA 15-46 makes clear that a broker-dealer that routinely routes a customer order to multiple trading centers (internal or external) should regularly review the execution quality that results from this practice. For example, the broker-dealer should evaluate the latency attendant in routing a customer order (or portion of a customer order) to multiple ATSs, a practice of routing to a particular trading center (e.g., an internal ATS) before other routing decisions are made, or repeated routing to the same ATS, and whether such practices may negatively impact fill rates or the overall quality of execution. The firm should also examine whether any of these practices may result in information leakage, and the impact of any information leakage on execution quality. FINRA states that firms should consider the risk of information leakage by routing orders to a particular venue in light of the fill rates achieved at that venue and carefully assess whether the risks outweigh the potential for an execution.

Compliance officers should consider using quantitative measures such as whether an exchange's routing practices impact fill rates or execution quality when evaluating order routing practices. Moreover, FINRA 15-46 states that a broker-dealer that limits its review of execution quality only to those markets to which it currently routes customer order flow (including the internalization of order flow) without considering competing markets would not satisfy the duty of best execution: "This obligation would include reviewing new markets and trading centers that become available as potential markets to which the firm may route orders; thus, a firm should regularly consider execution quality at venues to which it is not connected and assess whether it should connect to such venues."[27]

FINRA also notes that, if a firm accepts a directed order from a customer and has access to a trading center to which the customer requests that its order be directed, then the firm is obligated to act in accordance with the customer's instructions. If the firm is unable to route the order to the specific market in accordance with the customer's instructions, the customer must be informed of that fact and provided the opportunity to revise or cancel the order. FINRA 15-46 states that just as with a firm's regular and rigorous review, a firm has an obligation to periodically assess whether it should establish or terminate connectivity to trading centers when handling customer orders.

Payment for Order Flow

The SEC has stated that a broker or dealer must assess whether its order flow, in the aggregate, is receiving best execution and that a broker-dealer must not allow a payment or an inducement for order flow to interfere with its efforts to obtain best execution.[28]

FINRA 15-46 advises firms to "not allow access fees charged by particular venues to inappropriately affect their routing decisions, and, in general, a firm's routing decisions should not be unduly influenced by a particular venue's fee or rebate structure" and goes on to state, "Given the potential conflict between the receipt of payment for order flow, which is broadly defined under Rule 10b-10, and the duty of best execution, a firm should carefully evaluate its receipt of payment for order flow and the impact of such practices on execution quality."[29] Rule 10b-10 defines "payment for order flow" to include "discounts, rebates, or any other reductions of or credits against any fee to, or expense or other financial obligation of, the broker or dealer routing a customer order that exceeds that fee, expense or financial obligation."[30]

25. FINRA, supra note 22.
26. Id.
27. Id.
28.See Securities Exchange Act Release No. 34902 (October 27, 1994), available at https://www.sec.gov/rules/final/orderfin.txt.
29. FINRA, supra note 22.
30. 17 C.F.R. 240.10b-10(d)(8).

Recent SEC Proposal

In recent years, some of the more sophisticated institutional investors have begun to request, and their brokers have been providing, certain information about the brokers' routing of the institution's order flow. The nature and extent of the information provided, however, varies considerably across brokers. Standardizing customer-specific institutional-order-routing disclosures could enhance the ability of institutional investors to: (1) assess the potential for harmful information leakage concerning their orders; (2) assess the conflicts of interest their broker-dealers may face in handling their orders; (3) assess the performance of broker-dealers in handling their orders and achieving best execution; and (4) generally compare the order execution services of their broker-dealers. The SEC staff notes that representatives of buy-side and sell-side institutions have suggested a standardized template for institutional order routing disclosures by broker-dealers.[31]

In response, on July 13, 2016, the SEC proposed new and enhanced order handling disclosure requirements via amendments to Rule 606 of Regulation NMS (the "SEC Proposal"), which would require, for the first time, broker-dealers to disclose standardized information on their handling of large, "institutional-size" orders—both in response to individual, customer requests and on a quarterly, aggregated basis.

The SEC proposal was meant to increase transparency, improve best execution, stem information leakage, and above all, reduce conflicts of interest by requiring certain disclosures of order routing information for institutional investors and improving upon the disclosures already available to retail investors. "These proposed rules are intended to bring order handling disclosure in line with modern technology and market practice, providing valuable information to retail and institutional investors about how their orders are treated," said SEC Chair Mary Jo White. "This information should provide investors more transparency and a powerful new tool to more effectively monitor broker-dealer routing decisions, especially when combined with the additional disclosures from alternative trading systems proposed by the Commission late last year."[32]

If adopted, the SEC proposed amendments could fundamentally change how investors choose their broker-dealers and review their broker-dealers' performance. The new and enhanced disclosures could also become significant components of best execution analyses of broker-dealers and investment advisers, and examiners would likely begin to ask broker-dealers and investment advisers how they use such data in their best execution analyses.

D. Trends Outside the U.S.

Global regulators are also trending towards increased scrutiny of best execution, which might have important ramifications on the U.S. operations of international firms. For example, even if European regulations only specifically apply to operations within the European Union, broker-dealers and asset managers with substantial non-U.S. operations may choose to apply the strictest regulatory scheme to their global compliance programs for scalability as well as competitive reasons. Therefore, U.S. compliance officers at buy-side firms and broker-dealers may need to make even further enhancements to their best execution programs to meet these high regulatory standards.

Under MIFID I, firms were obligated to take all reasonable steps to achieve best possible results for their clients, while under MiFID II, which will take effect on January 3, 20108, firms will be required to take all sufficient steps. Also, MiFID I currently requires MiFID investment firms to seek best execution for customer and portfolio orders, but MiFID II will require certain institutions to consider new data points in routing decisions and in some cases, make these data points available for public consumption. MiFID II bans payment for order flow arrangements. With regard to rebates and other inducements, MiFID II provides that such inducements will be permissible if they are transferred to clients in full and that investment firms should take appropriate measures to (1) ensure that fees, commissions, non-monetary benefits or services provided or accepted are designed to enhance the quality of the relevant service to the client; and (2) do not impair compliance with the firm's duties to act honestly, fairly and professionally in the client's best interests.

MiFID II also requires order execution policies be amended to ensure that the factors used to choose trading venues are applied to more subcategories of financial instruments than the five used currently. Furthermore, asset managers will need to provide greater transparency by annually publishing the top five execution venues used for each subclass of financial instrument they trade for managed portfolios. This will require disclosure of information

31. See Letter from Dorothy M. Donohue, Deputy General Counsel, Investment Company Institute; Stuart J. Kaswell, Executive Vice President, Managed Funds Association; and Randy Snook, Executive Vice President, SIFMA, to Chair Mary Jo White, U.S. Securities and Exchange Commission (Oct. 23, 2014), http://www.sec.gov/comments/s7-02-10/s70210-428.pdf.
32. SEC Press Release 2016-140 (July 13, 2016), available at https://www.sec.gov/news/pressrelease/2016-140.html.

that is currently regarded as confidential: commercial relationships with execution brokers, a breakdown between passive and aggressive orders, conflicts of interest and execution venue fee arrangements. When combined with an expanded obligation to monitor execution quality, these new requirements will significantly increase compliance burdens. Therefore, under MiFID II, investment firms will need to formalize their best execution policies and regulators will expect enhanced focus on the best execution requirement.

Liquidnet recently conducted a survey of buy-side firms and found that a third of asset managers plan to adjust their broker lists prior to the MiFID II January deadline and that 70% are currently reviewing new brokers outside of their traditional relationships (and named liquidity as the number one requirement of buy-side firms when choosing new brokers).[33] The survey also found that 61% of asset managers recognized the need to provide more detail to their best execution policies, to ensure, according to Liquidnet, "the creation and implementation of a process that enables the trader to be in possession of as much valuable information as possible, throughout the lifecycle of a trade."[34]

Furthermore, MiFID II rules regarding commission "unbundling" are driving significant change in the commercial model of full-service broker-dealers and investment banks. Unbundling requires all research consumed by an asset manager to be paid for in explicit terms, rather than bundled in the brokerage commission, as it has been for years. Any research delivered from research providers to asset managers without an explicit price will be prohibited as an inducement to trade. This move to explicit pricing of all research and related services will prompt changes to the broker-dealer and asset management industry, where execution measures will be more readily identifiable, which will lead to more transparency around whether best execution has been provided.

E. Conclusion

As a compliance officer, will you be ready for an audit of best execution by the SEC, FINRA or another regulator? All compliance officers need to be prepared to answer these types of best execution questions:

1. Are your brokers routing your orders based on commercial relationships?

2. Are your brokers sending your orders to venues more likely to have interest from natural investors?

3. Are your brokers routing your orders to their own dark pools? If so, are your brokers conducting an order-by-order analysis of execution quality?

4. Are your brokers routing to venues with proven high execution quality?

5. Are your brokers routing to exchanges which pay the highest rebates to the brokers (which are also the venues with the longest lines of orders and the highest likelihood of adverse price movement)?

6. Are your brokers conducting an adequate regular and rigorous review of execution quality of your orders on a s security by security type of order basis, as frequently as needed?

7. Are your brokers consistently applying factors of best execution? For example, if speed of execution is a heavily-weighted factor, does the broker display the majority of passive orders on exchanges with the longest queues?

8. In this best execution review, are your brokers considering relevant factors, including whether orders were executed at inferior prices, the extent to which the order may obtain price improvement at other venues, the likelihood that the order will be partially or fully executed, the speed of execution, and transaction costs?

Given the unprecedented amount of independent execution quality data available, the harmful effects of rebates, and the conflicts of interest inherent to brokers routing to their own dark pools, compliance officers should closely examine their best execution compliance programs to ensure their best execution committee meetings are no longer simply a periodic perfunctory check-the-box meeting. The proper functions need to be represented on the committee and they should account for the risk that best execution is not met, as well as design and apply internal controls and assessment of the risk inherent in such failure. Best execution committees need to be proactive and obtain order flow and execution data, interpretation and guidance on best execution regulatory requirements and best practices, and perform independent qualitative and quantitative testing of best execution. The goal is for compliance officers to become comfortable that the best execution process is functioning as designed and to identify improvement opportunities.

33. Hayley McDowell, Third of Buy-Side to Adjust Broker Lists Ahead of MiFID II, The Trade (Sept. 5, 2017), available at https://www.thetradenews.com/Buy-side/Third-of-buy-side-to-adjust-broker-lists-ahead-of-MiFID-II.
34. Id.

The Inside Scoop on Insider Trading Prevention: Ten Ideas for Compliance Training Sessions

By Tom Hardin

> *"[XYZ] hedge fund has agreed to pay $[x] million to settle claims by U.S. securities regulators that it failed to maintain policies to prevent misuse of inside information about three months after two of its partners were hit with criminal insider trading charges."*

The above recent headline is a compliance officer's worst nightmare.

As someone charged criminally for insider trading in 2009 and sentenced in 2015, I've made it my life's mission today to assist compliance officers in the training of investment staff by creating awareness of the behaviors which led to my decision to cross the line and the life-altering penalties that resulted from going down the proverbial slippery slope. More than just "scared straight," my goal is to educate on what exactly I was thinking at the time as a young analyst -- the extremely faulty rationalizations -- and how compliance professionals today can keep their investment staff and employers from suffering the same fate.

Dirks v SEC laid out tipper-tippee liability in 1983 and insider trading has been the bread and butter of the SEC's enforcement program ever since. More recently, the regulator has invested resources into being more proactive about detecting suspicious trading. Today, the Market Abuse Unit's Analysis and Detection Center uses data analysis tools to detect suspicious patterns such as improbably successful trading across different securities over time (see August 2017's *SEC v Rivas et al*).

On the criminal side, without a federal statute defining the law, jurisprudence of insider trading law has been periodically tweaked among the various appeal decisions in federal district courts depending on which judges are on the panel. It seems what is viewed as "good law" today is "bad law" tomorrow and is enough to make a compliance officer's head spin, especially for someone without a legal background.

They must never think they are wise enough to draw the line when they think they might have MNPI...

In August 2017, the *Martoma* majority decision in the Second Circuit, while upholding Mathew Martoma's 2014 conviction, did expand the discretion enjoyed by prosecutors and SEC lawyers in these cases by pushing back on the elements of December 2014's *Newman* decision with regard to "meaningfully close personal relationship." Numerous Big Law briefs have been circulated with nuanced discussions of what it all means and my goal is to not repeat any of that but to provide some practical advice from my former analyst perspective for compliance professionals today to use in their training sessions with investment staff. I aim to avoid any discussion of the legal nuance of "gift," "knowledge of benefit," or "closeness of relationship" because, as a former investment analyst, I do not want investment staff engaged in what I did and term "isolated decision making": where an analyst or trader makes a decision on a trade either thinking that they understand the nuance of the law or rationalize that they "won't get caught."

I have had the privilege of serving as a guest speaker for forty investment managers in 2017. Below are ten insights gathered from my own experience as a former analyst as well as feedback from clients on best practices.

1) Investment staff who think they may be in possession of material non-public information (MNPI) must escalate their questions/concerns to compliance. They must never think they are wise enough to draw the line when they think they might have MNPI. I found it perverse in December 2014 when the mainstream media headlines read "Hedge Funds Cheer *Newman* Decision" implying that some firms are trying to play it close to the line. You never want your analysts to be thinking about whether their relationship to the tipper is sufficiently close

About the Author:
Tom Hardin ins the owner of Tipper X Advisors LLC. He can be reached at tom@tipperx.com

or whether the value received by the person who tipped you was significant enough to form the basis of a claim. All of these facts will be assessed in hindsight in a political and judicial environment they can't control and may be very different from today. If they have MNPI, trading in the particular security is restricted until the MNPI becomes public. Period. Regardless of what is viewed by Big Law as "bad law" or "good law" in the current month.

Compliance professionals should also reach out to outside counsel to walk through specific research fact patterns. On occasion, I receive questions in my training sessions from analysts regarding the nuance of "material" versus "immaterial" information in their research processes. Again, they need to understand that they should not be making these determinations on their own. Even just a fifteen-minute conversation between the CCO, analyst and outside counsel can establish that you are seeking an expert's opinion on a specific fact pattern of research and, because insider trading is a fraud-based claim, can prove that you did not have intent to deceive if later questioned by the regulator. **The main point is to have a clear line of escalation from the research process to compliance.**

It's important also not make an analyst feel guilty for coming to you with their concerns regarding MNPI. You do not want the analyst to close down and be disincentivized to go to you in the future. The CCO should make sure that all employees feel that they can come to him or her and I believe should sit close to the investment staff, with your office ideally near the trading floor and the door always open.

2) The current "hot areas" of enforcement for investment managers are always changing and what's in the spotlight today (political consultants) may not necessarily be the hot topic of future indictments or enforcement actions (semi-private data sets?). The market is always three steps ahead of enforcement, but that is actually to the analyst's detriment, because new things that they are doing will feel like "everyone is doing it" so it "should be fine" – think political/healthcare consultants in the recent Visium and Deerfield cases. Keep in mind that, regardless of the decisions in *Newman, Salman* or *Martoma*, there's also the SEC, which has a much lower burden of proof – requiring only a preponderance of evidence to prove insider trading. Just because someone is within the lines of what is considered current "good law" in terms of "gift" or "knowledge of benefit", he or she could still be subject to an enforcement action by the SEC. If that enforcement action is brought, the manager's assets under management are going to be threatened or disappear altogether.

Today, there are a lot of potential issues with respect to data sets and data scraping, where firms are coming into possession of semi-private data in the research process. Whether that information is obtained in breach of a duty can be a tough call. From what I've seen, compliance is frequently under pressure from analysts to permit a data source on the basis that other firms are using that source. These data sources and providers often involve numerous areas of law, including computer privacy, securities law, even Federal Aviation Administration laws (e.g., if a manager is engaging a drone operator). I would recommend that any CCO analyzing these service providers take a closer look and bring in outside experts when needed.

3) Place limits on expert networks such as limiting the number of calls per expert to a handful. After a handful, an analyst will have established a relationship with the expert, and the risk of receiving MNPI increases. Another way to limit the risks inherent to expert networks is to chaperone calls. I feel that unannounced chaperoning is good, although some will debate this. To me, if I don't know whether compliance is on the call, I am going to always be above board. Also, work with your investment staff to rank their highest risk sources of MNPI so that you know where to focus your time.

4) Investment firms need to have specific policies in place that apply to consulting firms employing political intelligence analysts. A firm's policies and procedures for engaging outside consultants should not be focused solely on expert network firms. As noted in the SEC's settlement with Deerfield Management (8/21/17):

> *Deerfield distinguished expert network firms from research firms. Deerfield imposed compliance requirements when its employees interacted with experts and expert network firms, but did not adopt similar safeguards for ealings with research firms.*

From my former seat analyzing the telecom sector, I can say with certainty that research calls with political consultants often venture into gray areas. For example, the former government employees will comment on whether they think a certain commissioner or staff will act a certain way. They love being "right," so it's up to the analyst to judge whether it's a prediction based on past *behavior* or at risk of *actual knowledge*.

On the criminal side, the prosecution has also expanded its menu of fraud statutes when targeting investment firm professionals in these cases. In addition to filing charges alleging securities fraud, prosecutors are also including charges under wire fraud and stealing property of the U.S. government (*18 U.S. Code § 641*). Consequently, while

they may not prevail in a case for securities fraud, they've hedged themselves to a degree with these other fraud statutes.

In my view, healthcare consultants are a massive risk. Some of these firms host conferences and updates in DC quite often. They are very niche specific with their experts on staff. They actively recruit former staff and have to refresh consultants often since DC changes rapidly. That means it's hard to have quality control over the integrity of the individuals these firms are bringing on as consultants (i.e. Blaszczak in the Deerfield case).

One of the other big areas of risk is clinical trials. The best practices that I have observed in my discussions with firms is a policy of not being able to talk to anyone who is a lead investigator on a drug trial. But, there's always the risk that a smaller contributor (i.e. conducting a smaller part of the trial) may not really be contributing to the analyst's mosaic but in fact has MNPI. Again, reiterate the point in training of your investment staff to escalate these questions to you and not engage in isolated decision making.

5) Analysts should be very thoughtful when wording emails. I've observed that some firms are better than others about training their employees to consider how an email would look out of context. Regulators have the benefit of hindsight when bringing investigations. We've also recently seen an increased focused of the SEC's OCIE in understanding how investment advisers use various electronic communication mediums. Even if you're not doing anything illicit, using locker room language in an email could be a red flag during a later regulatory examination. They also need to understand that if they are communicating with people who are using a casual communication style, that they are exposing themselves to risk due to the individuals communicating this way. "How would this email look in three years out of context?" should always be considered. I've also found it quite effective during training sessions for the CCO to highlight poor examples of emails and/or IMs sent from their investment staff.

...just as important is the tone at the middle

6) Compliance professionals need to be aware of who the firm's analysts talk to the most. In my presentations, I point out that you are the average of the five people with whom you surround yourself and the mistakes that I made in building my investor peer network. Compliance officers can use email archiving to ferret out the five investors each of their analysts talk to most. Cases in the past have started from one investor talking to another in a group of investors or traders, so understanding the relationships between a firm's analysts and other investors is key.

7) What is the "tone at the middle" at your firm? Regulators and investors frequently focus on – rightfully so – tone at the top. As was seen with Deerfield, however, just as important is the tone at the middle. That case involved three members of the investment staff and analysts and traders can have asomewhat tribal subculture at a firm. While a firm can have a great tone at the top, the analyst subculture can still be its undoing. The CCO should understand these subcultures, especially in larger organizations.

8) It is important to stress that every member of your firm is on the compliance team. Compliance can't be everywhere all of the time with the investment team. Your traders and analysts are responsible for being the guardian of their own integrity and being vigilant for indications that they might be succumbing to any rationalization undermining it. Also stress if they make a mistake, own it before it gets worse –the cover-up is ALWAYS worse than the crime.

On the behavior side, making investment staff aware of some of the rationalizations and psychological traps that pull people over the line – into unethical or even illegal activity – can be helpful. Examples of psychological traps include (i) small steps, (ii) reduction words and the idea of (iii) faceless victims. With me, I received MNPI from another investor and then placed four small trades where I told myself these positions were "immaterial" because of their size. The reduction word "immaterial" was my self-talk to try and minimize my illegal behavior. Also, with insider trading, a common rationalization is that it's a victimless crime. Another trap is the thought that "everyone is doing it" – the so-called false consensus effect. During training sessions, I believe a CCO should introduce the psychological traps that can ensnare even the most well-meaning employees. Although everyone may want to behave ethically, you're only ethical up to the situation and circumstances you're in at the time.

9) Each quarter, take one or two analysts aside and go through their biggest positions. Who are they talking to? How are they getting information? Not only does it get the compliance officer comfortable with the positions and have the potential to ferret out important information, it also acclimates the investment staff to speaking about their positions. During presence exams, the SEC will often speak directly with investment staff, so it is important

that analysts, staff and management are all comfortable speaking about their positions and that they're not doing it for the first time during an exam. It may be even more important now that we know one SEC regional office is conducting unannounced visits to investment managers, not giving them time to "dress up" their compliance policies or prep analysts before the questions start.

10) The prohibition on trading while in possession of MNPI effectively shuts down the possibility of using the original analysis until after the MNPI has become public. Mistakes with handling MNPI can be made in the research process. In fact, one of my past clients shared with me the story of a young analyst and his largest position in the portfolio. He had his five thesis points, airtight analysis and then received MNPI on an unchaperoned research call with an industry contact. Instead of raising his hand and going to the CCO, he chose to ignore the MNPI as he rationalized it wasn't part of his original thesis. This all came to light after an inquiry from the regulator and the analyst is now on leave from the firm. While enforcement actions will continue to be brought against the obvious bad actors, I believe it is situations like these that are most common and of highest concern. The analyst most likely did not have any intent to break the law but engaged here in "isolated decision making" and ultimately put the firm and himself in harm's way. Analysts must own up if a mistake is made so that they are protected and the firm is protected. Again, the cover up is much worse than the crime.

For the investment team, it is important to emphasize some of the nuance here in training sessions: receiving MNPI immediately prohibits further trading in the stock, even if: i) the MNPI would not in itself have led to the decision to trade, ii) even if the MNPI was irrelevant to the decision to trade, iii) even if the individual had already started to undertake the trade when he/she received MNPI and iv) even if the decision was made to trade before receiving the MNPI.

Summary

As was originally noted in *Dirks*, the job of an analyst is to "ferret out and analyze information." Through the investment research process, a thorough analyst will come into possession of MNPI multiple times in their careers. It is not time to panic, ignore, rationalize or "cover up" in these situations. A well-trained analyst will know exactly what to do.

Thank you again for the opportunity to turn past career-ending decisions into an opportunity today to add a voice to the compliance discussion.

SEC Issues No Action Letters Addressing MiFID II Conflicts

By Andra Purkalitis, Ross Goffi and Katie Pollock

With under 10 weeks until the January 3, 2018 effective date, the U.S. Securities and Exchange Commission ("SEC") has issued three no-action relief letters providing some clarity and guidance for US-based firms impacted by certain provisions of the European Markets in Financial Instruments Directive II (MiFID II). While the no-action letters are an important first step and help reduce some uncertainty, some of the relief is temporary, questions remain on how to implement the SEC guidance, and the no-action relief does not address other MiFID II provisions that impact US firms.

Each no-action letter provides unique relief for different market participants as follows:

- Registered broker-dealers and foreign broker-dealers relying on Rule 15a-6 may, on a temporary basis, accept hard dollars and/or payments from research payment accounts ("RPA's") from money managers without being required to register as investment advisers under the Advisers Act;
- Money managers who manage client accounts that must unbundle research and execution costs may continue to aggregate orders for mutual funds and other clients as long as certain conditions are met; and
- Money managers who manage client accounts that must unbundle research and execution costs may continue to rely on the existing safe harbor in Section 28(e) when paying broker/dealers for research and brokerage under specific circumstances.

Relief from the Investment Advisers Act of 1940 for Broker-Dealers Receiving Payments for Research from Investment Managers Subject to MiFID II (the "SIFMA Letter")

The SIFMA no-action letter addresses the conditions where US broker/dealers may receive payments for research services that are unbundled from execution costs under the requirements of MiFID II. The relief granted by the Division of Investment Management allows US broker/dealers to accept hard dollar payments for research services without having to register as an investment adviser until July 3, 2020 (30 months from the MiFID II implementation date of January 3, 2018) if a money manager subject to MiFID II pays for the research from its own account, from an RPA funded with its clients' money, or a combination of the two.

Industry participants sought relief due to the conflict between the unbundling requirements of MiFID II and US securities laws and because of the significant reliance by global investment managers on US broker-dealers for research services. Several banks, broker-dealers and asset managers in the US had been heavily lobbying the SEC for relief so firms could pass on research costs separately from trading and execution charges as required by MiFID II without requiring the US firms to become registered investment advisers.

Being a registered investment adviser carries with it additional fiduciary responsibilities and regulatory requirements that broker/dealers want to avoid. There were also concerns around US broker/dealers being at a competitive disadvantage from research firms outside the US if the US firms were subject to an additional layer of regulation under the Advisers Act, which could impede their ability to provide liquidity or act as a counterparty in transactions.

The 30 month window for the temporary relief was provided to give some clarity to the market while also providing the SEC additional time to assess the impact of MiFID II's unbundling provisions and to solicit input from the industry before issuing more permanent guidance or rules.

In a release coordinated with the SEC's issuance of the SIFMA No-Action Letter, the European Commission

About the Authors:
Andra Purkalitis is Partner, Head of Americas at Bovill. She can be reached at apurkalitis@bovill.com.
Ross Goffi is a Consultant at Bovill. He can be reached at rgoffi@bovill.com.
Katie Pollock is a Consultant at Bovill. She can be reached at kpollock@bovill.com.

issued an FAQ acknowledging the need for EU managers to be able to continue to access research and execution services from broker/dealers outside the EU and to take into account different methods of payment for research. They noted that the need however, for EU firms to separately identify how much of a single bundled commission payment is attributable to research.

Request for No-Action Relief for Advisers to Aggregate Client (the "ICI Letter")

The ICI no-action letter grants relief to investment advisers that want to aggregate orders for accounts with differing arrangements for paying for research. In a previous no-action letter, the SEC allowed orders to be aggregated if each participating client in the aggregated order participated at the average share price with all transaction costs shared on a pro rata basis.

The current no-action relief granted by the Division of Investment Management specifically addresses the industry's concern that MiFID II accounts included in an aggregated order where research is unbundled would result in those MiFID II clients not paying a pro rata share of all costs (i.e., research payments) associated with that aggregated order.

Under the new MiFID II no-action relief, a client order that bundles execution and research services can be aggregated with a client order that unbundles research from execution in certain circumstances. The SEC Staff stated it would not recommend enforcement action if an adviser adopts policies and procedures reasonably designed to ensure that:

- Each client in an aggregated order pays the average price for the security and the same cost of execution (measured by execution rate),
- The payment for research in connection with the aggregated order will be consistent with each applicable jurisdiction's regulatory requirements and disclosures to the client, and
- The subsequent allocation of such trade will conform to an adviser's Allocation Statement and/or the adviser's allocation procedures.

Firms will need to review their existing trade allocation and aggregation policies and review their operational processes to address the new SEC requirements.

Section 28(e) of the Securities Exchange Act of 1934 and MiFID II (the "AMG SIFMA Letter")

The Asset Management Group SIFMA no-action letter provides relief to money managers who pay for research from

MiFID II client RPA accounts, in reliance on the safe harbor of Section 28(e) of the Securities Exchange Act of 1934.

Money managers in the U.S. have historically relied on a client commission arrangement ("CCA") structure to pay a single "bundled" commission to broker-dealers for order execution. The commission is then unbundled and a portion of the commission used to acquire Section 28(e) eligible brokerage and research services. MiFID II accounts rely on RPA's, which are similar to CCAs but different in that the research is unbundled before the trade is executed and is an asset of the client and not the firm.

In the AMG SIFMA Letter, the SEC Division of Trading said it would not take action against a money manager seeking to operate in reliance on the safe harbor provisions of Section 28(e) of the Exchange Act if the manager pays for research through an RPA that conforms to the requirements under MiFID II, provided that all other applicable conditions of Section 28(e) are met and:

- The money manager makes payments to the executing broker-dealer out of client assets for research alongside payments to that executing broker-dealer for execution;
- The research payments are for research services that are eligible for the safe harbor under Section 28(e);
- The executing broker-dealer effects the securities transaction for purposes of Section 28(e); and
- The executing broker-dealer is legally obligated by contract with the money manager to pay for research through the use of an RPA in connection with a CCA.

Tech Tools to Ease Compliance Testing

By Colleen Corwell

This is the first in a two-part series of articles developed to help compliance professionals understand how technology can make it easier to manage risk in light of regulators' plans to make compliance a top focus this year. The second in the two part series will offer an objective deep dive into the technological tools and tactics firms can implement to establish a robustinternal control framework.

This year, regulators will be "blocking and tackling" compliance issues[1] head-on during examinations as one of their stated priorities for the year, including assessing the compliance controls financial firms have in place to mitigate compliance, supervisory and risk management breaches. The Financial Industry Regulatory Authority ("FINRA"), the selfregulatory organization responsible for overseeing broker-dealers and brokerage firms, announced in its 2017 Priorities Letter that it will be focusing exams this year on assessing registrants' supervisory controls.

The Securities and Exchange Commission ("SEC") is also including compliance risk management among its 2017 examinations priorities, focusing its efforts on minimizing market-wide risk. To this end, the regulator will be assessing companies' enterprise risk management programs to ensure that they cover all business units, subsidiaries, and interconnectedinfrastructures.[2]

Technology can make it easier for firms to be audit-ready. For small and large organizations alike, technology can help firms perform compliance reviews much more easily and produce evidence of the controls they have in place, at the click of a button.

Benefits of Technology-Powered Testing

- Allows firms to identify risks proactively, e.g., before they become violations;
- Less time chasing down paper documents affords compliance professionals more time to analyze testing to improve the effectiveness of their compliance program;
- Centralization of processing and test results facilitates faster response to findings that may have implications for firm operations, business or investment strategies;
- Reduces the impact of staff turnover; since testing processes are standardized and documented, institutional knowledge can be shared fluidly within the firm;
- New hires can quickly plug in, learn and participate in the review process;
- Easy to change or update policies and procedures and related testing;
- Improves the quality of testing to deliver more relevant results;
- Replacing manual processes saves time while allowing for more frequent reviews; and
- Generates automated robust, reports that can easily be produced to satisfy annual testing requirements or a regulatory request.

Depending upon the type of firm and the risks identified through the risk assessment process, there may be specific focus areas of the business that require testing on at least an annual basis.

About the Author:
Colleen Corwell is Director at Alaric Compliance Services, She can be reached at ccorwell@alaricompliance.com

1. http://www.finra.org/industry/2017-regulatory-and-examination-priorities-letter.
2. https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf.

Investment Advisors

Rule 206(4)-7 requires advisers to review their policies and procedures ("P&Ps") at least annually to determine their adequacy and effectiveness.

Although Rule 206(4)-7 and all major securities rules stipulate that reviews be conducted annually, advisers should conduct interim reviews in response to changes or developments that could impact their business, such as adding a new product, a rule change or a risk alert.

Focus Areas for Investment Advisers

(1) Portfolio management compliance, including the allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives;

(2) Trading practices, including best execution;

(3) Proprietary trading by advisers; personal trading by employees;

(4) Disclosures made to investors, clients and regulators;

(5) Safeguarding of client assets from conversion or misuse;

(6) Records retention; accuracy of books and records;

(7) Marketing of advisory services, including the use of solicitors;

(8) Appropriate valuation of client holdings and fees assessed;

(9) Privacy protection of client records and information; and

(10) Business continuity preparedness.

Investment Companies / Funds

Under Rule 38A-1 of the Investment Company Act[3], funds and investment companies are required to review their P&Ps, as well as those of their service providers, at least annually. Investment

companies and funds are subject to recurring compliance testing and reviews as regulators look to stem unlawful conduct involving fund advisors, broker-dealers and affiliates, including market timing, late trading practices as well as improper disclosures and/ or misuse of nonpublic portfolio information.[4]

Focus Areas for Investment Companies and Funds

(1) Processing and pricing of portfolio securities and fund shares;

(2) Protection of non-public information;

(3) Identification of "Affiliated Persons" to prevent market timing, self-dealing and overreaching by persons in a position to take advantage of the fund;

(4) Accuracy of disclosures made to shareholders, affiliates and regulators;

(5) Compliance with governance requirements to ensure that fund oversight is being conducted for the benefit of the fund and its shareholders.

Brokerage Firms / Broker-Dealers

Brokers must also conduct compliance testing to ensure controls are in place to prevent securities law violations. FINRA Rule 3120 requires firms to establish, maintain, and enforce written supervisory control policies and procedures ("WSPs") to effectively manage the types of business in which it engages, and to ensure compliance of all affiliated personnel with applicable securities laws and regulations. Rule 3120 also requires testing of a firm's WSPs on at least an annual basis. Under this rule, however, registrants need not verify all of their P&Ps on an annual basis. FINRA allows regulated brokerage firms and brokerdealers to use interim risk-based sampling methodologies to test a subset of their P&Ps, focusing on areas that represent the greatest risk to the firm.

3. https://www.sec.gov/rules/final/ia-2204.htm#P65_13121.
4. https://www.sec.gov/rules/final/ia-2204.htm#P170_59174.

Focus Areas for Broker-Dealers

(1) Business activities that resulted in the termination of personnel;

(2) Business activities in which the firm has had prior customer complaints;

(3) Business activities that resulted in regulatory deficiencies in the past, including:

- Books and records omissions and/or record-retention lapses;
- Dissemination of inaccurate data related to products or order types;
- Failures to deliver required disclosures or other documents to clients;

(4) Products, rules or issues identified as potential future areas of concern; and

(5) New business activities or products.

Regulated firms occasionally fail to conduct mandated reviews, sometimes over the course of many years, faulting a shortage of time, resources or qualified personnel.

Firms found at fault for failing to implement an organized and efficient testing regime as part of an actively managed compliance program may find themselves in the public eye as a consequence. In these cases, it is not uncommon for regulators to operate with 20/20 hindsight, indicating compliance breaches could have been avoided had appropriate testing processes been in place.

Common features of compliance testing software include a risk management dashboard that offers a snapshot of a firm's compliance manual, P&Ps, compliance calendar with prescheduled tasks and alerts, as well as system for distributing notifications, test assignments, reports and other output to authorized responsible parties, individually or as a defined group.

Automated compliance testing tools enable compliance officers to easily summarize and generate reports in a variety of formats to compile a range of invaluable information, including:

1. an inventory of controls that a firm has in place to mitigate compliance, supervisory and risk management breaches;

2. the status of internal compliance tests, the personnel assigned and the actions in progress;

3. an inventory of identified or known risk-weighted gaps with measurable impact on the firm;

4. effectiveness of testing performed and metrics such as frequency of tasks by employee; and

5. identification of risks associated with responsible parties, compliance controls, data and documentation.

As firms grow and become more operationally complex, compliance test management software allows firms to more easily assess the quality of internal controls in a way that was simply not possible before. By leveraging technology, firms can spend more time analyzing and improving their compliance programs, and working proactively to minimize compliance and supervisory risk. Doing so, enables firms to demonstrate they are maintaining effective compliance programs.

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"NSCP Membership promotes professional growth, development and unification of compliance professionals within the financial services industry. NSCP members have full access to a community of like-minded people, exceptional experiences, practical and compelling content, and essential tools that empower and inspire."

– NSCP Executive Director, Lisa Crossley on the Benefits of Membership

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