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NEWSLETTER

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Positive Word of Mouth Gives Firms a Leg Up on the Competition

By Mark Alcaide

Whenever we need to engage a service professional, most of us research that individual or firm online. In many cases, we will see online reviews that contain words of praise or harsh criticism of the company or an individual working for that firm. Unfortunately, it is often difficult to discern if a positive review reflects the opinion of a real client. Similarly, one never knows for sure if a critical opinion is a legitimate evaluation or if it comes from someone who has an axe to grind with the person or company.

In our business and personal lives, we have the opportunity to evaluate the sources of the information we utilize to make decisions. When someone we know badmouths a movie or praises a restaurant, we consider the source and act accordingly. Perhaps, we've relied on that person's evaluations in the past and were sorry we did. From that point on, we research our movie choices on Rotten Tomatoes and use Yelp to decide where to eat dinner. In contrast, there are people we trust and whose opinions we value. If they have had first-hand experience with a financial services firm, we are more inclined to look favorably upon their recommendation.

Although advertisements for investment advisers and broker-dealers give consumers valuable information about firms, words of praise from a trusted friend or colleague are the best introduction. Nevertheless, consumers of any service, financial or otherwise, should never rely on advertisements or positive word of mouth as the sole basis for their decision to engage a firm or individual. They should always conduct due diligence of that individual or company.

Even if a particular person has never steered you wrong, it is important to know more about his or her dealings with the individual or firm recommended. As an example, an attorney might possess considerable expertise regarding estate planning but wouldn't necessarily be the right choice for a criminal or real estate case.

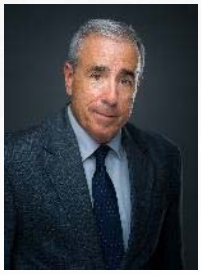
In every field, positive word of mouth is a key component of growing a business. W. Edwards Deming, an expert on business management, said, "Profit in business comes from repeat customers; customers that boast about your product and service, and that bring friends with them." Although there is nothing negative about positive word of mouth, keep in mind that testimonials can cause problems for investment advisers and broker-dealers, even if a marketing consultant tells you otherwise.

Best,

Mark Alcaide, Partner, COO

Testimonial Rule Is Alive and Well for Now

By Les Abromovitz



On June 14, 2018, the Investment Adviser Association ("IAA") published its 2018 Investment Management Compliance Testing Survey. Along with its very important findings, the survey made several recommendations for amending the Advertising Rule. The IAA has urged the SEC to remove the per se prohibition of testimonials. Karen L. Barr's letter to SEC Chairman, Walter J. Clayton, on May 10, 2017, clarified that the IAA is suggesting "at a minimum, that the specific prohibitions in the Rule not be considered per se fraudulent." Recent SEC enforcement actions demonstrate, however, that the testimonial prohibition in the Advertising Rule is alive and well.

In addition to these enforcement actions, the SEC's Office of Compliance Inspections and Examinations ("OCIE") published an advertising risk alert on September 14, 2017. Examiners observed that investment advisers had published statements from clients attesting to their services or otherwise endorsing them. RIAs used these statements on their websites and social media pages, as well as in pitch books and reprints of third party articles.

Use of social media and the Internet to violate the Testimonial Rule

On July 10, 2018, the SEC announced enforcement actions against two Registered Investment Advisers ("RIAs"), three Investment Adviser Representatives ("IARs"), and a marketing consultant. The RIAs, IARs, and the marketing consultant were accused of violating the Testimonial Rule using social media and the Internet. Many of the statements contained in those advertisements fell within the definition of testimonial.

Rule 206(4)-1(a)(1) under the Investment Advisers Act, is the subsection of the Advertising Rule, which prohibits the use of testimonials. The rule enjoins SEC-registered investment advisers from publishing, circulating or distributing any advertisement, which includes a testimonial. Although the word "testimonial" is not defined in Rule 206(4)-1, it has been interpreted as being a statement regarding a client's experience with or endorsement of an investment adviser. Generally, state-registered investment advisers are subject to a similar rule prohibiting the use of testimonials in their advertisements.

According to the SEC's orders, the RIAs, IARs, and the marketing consultant published advertisements on the Internet containing testimonials. Links to the enforcement actions are available at https://www.sec.gov/enforce/3-18586-90-s.

Role of the marketing consultant in causing the violations

All but one of the enforcement actions singled out the marketing consultant for causing the violations of the Testimonial Rule. The marketing consultant offered services to professionals such as RIAs and broker-dealers. One service was called Squeaky Clean Reputation, which the marketing consultant claimed was 100 percent compliant for RIAs. The marketing consultant made this claim, even though he had received an email from an adviser not named in the enforcement action to inform him that the Advertising Rule prohibited RIAs from publishing advertisements containing testimonials. The email included the text of the rule and a link to guidance on the SEC's website dealing with its prohibitions. At that time, the adviser requested that the consultant and his company refrain from publishing testimonials on his behalf. The marketing consultant did not remove the testimonials from the Internet for a number of months, even though the adviser made additional requests for him

to do so. After receiving these emails from the adviser, the marketing consultant did not seek any legal advice or other guidance about the Testimonial Rule's applicability to RIAs. He continued to market his firm's services to other RIAs.

Between March 2015 and March 2016, the marketing consultant collected and published Internet advertisements containing testimonials for several investment advisers. The testimonials praised their investment advice, as well as the services they rendered. These testimonials were available to the public on various websites, including YouTube, Google, Facebook, Twitter, and Yelp.

Investment advisers take the bait

On June 4, 2015, the marketing consultant entered into an agreement with a New Jersey-based investment adviser and sent emails to fifteen of their clients asking for testimonials. The testimonials were then published on the RIA's Facebook and Google webpages. Among other favorable comments, certain testimonials stated that the investment adviser was trustworthy and provided a high level of service to clients. The testimonials also stated that the adviser had helped the clients generate investment returns.

On September 21, 2015, the marketing consultant contracted with an Ohio-based investment adviser. At that time, the consultant did not notify the adviser about the compliance problems arising from testimonials. In October 2015, with the adviser's approval, the consultant sent emails soliciting testimonials from more than eighty of the IAR's clients. Four of the clients responded to the email by submitting testimonials describing their experiences working with the IAR. One of these testimonials was published on Yelp and was publicly available from October 2015 until at least January 2018. With the adviser's approval, the consultant arranged for the creation of three videos containing the testimonials. Each of the video testimonials was captioned as a "Five Star Review" and included the adviser's contact information, as well as a link to his website. Among other words of praise, the testimonials stated that the adviser was knowledgeable, and the client expected to generate investment returns as a result of working with him.

In January 2016, the consultant entered into a contract with an RIA in California and its co-owner. In March 2016, with the adviser's approval, the consultant sent emails to approximately twenty of the RIA's clients soliciting testimonials about the firm and its services. Several of the firm's clients responded by publishing testimonials on Yelp describing their experiences with the RIA. One of these testimonials stated that the RIA had enabled the client to access unique investment opportunities and had protected the client's investments from risk. These testimonials were publicly available on Yelp until at least January 2018. The RIA then purchased advertisements on Yelp contained links to the firm webpage where members of the public could view the testimonials.

Conclusion

In addition to these enforcement cases, the SEC settled an action with a different RIA that violated the Testimonial Rule without any involvement of the marketing consultant. In 2012, the RIA, which was based in Illinois, solicited testimonials to create a video for its 50th anniversary party. The RIA showed it to guests at the anniversary party and later posted the 31-minute video on its website and YouTube. All of the published testimonials discussed the firm and its IARs. The video contained statements from 27 clients regarding their experience with the firm. Certain clients stated that they had profited from the RIA's services, and the firm had given them income, security, and peace of mind. In early 2014, the RIA commissioned a shorter version of the video for use in its marketing efforts. The RIA finally removed the videos from its website and YouTube in March and April, 2017.

Aside from the compliance issues arising from this social media campaign, the results are an interesting way to evaluate the success of this marketing approach. From August 2012 through March 2017, the 50th anniversary video received at least 291 views on YouTube. The shorter version of the video, which ran for eight minutes and included many of the same client testimonials, gathered 117 views on YouTube.

Considering that existing clients may have accounted for many of those views, the social media campaign did not appear to be a resounding success.

Even if testimonials are permitted at some point, the Advertising Rule will still prohibit advertisements that are false or misleading in any way. Cherry-picking favorable comments from clients for use in advertisements is arguably misleading if they are used improperly, even if testimonials are not prohibited.

For now, RIAs utilizing testimonials are likely to be cited for compliance deficiencies by examiners. When an RIA receives a deficiency letter or is involved in an enforcement action, it is not a testimonial for the adviser's compliance program.

Les Abromovitz is a Senior Consultant with NCS Regulatory Compliance. He can be reached at labromovitz@ncsregcomp.com.

CDD Refresher

By Stephen Murphy

Swabia, an area of Germany known for its frugalness and fastidious work ethic, has a food staple that can be seen as a microcosm for their ethos: Maultaschen. As with many cultures, the Swabians put their own spin and finesse on what looks like an ordinary dumpling. What makes Maultaschen unique to the area is not just the high protein and density, but also the folklore behind it. As the story goes, the upright folks of Baden-Wurtemberg did not want to offend any higher beings by eating meat during lent, so they stuffed their contraband inside some bread where apparently deities do not look nor ask questions. Problem Solved.

Oh were AML issues that simple. If we merely avoid transparency, couldn't we all get along? For the vast majority of BDs, being used as a vehicle to launder money is difficult for several reasons, not the least of which is the industry's collective stance to guard against such activity. However, money launderers do not rest in their efforts to find ways to offer a sheen of legitimacy to their ill-gotten gains. Thus, the cat and mouse game of rules and protections implemented by regulators followed by ingenuity in trying to circumvent such rules by would-be investors.

The latest effort by the regulators is the FinCEN Customer Due Diligence Rule or "CDD." We have written about the CDD before. We have updated our client's AML Manuals with the appropriate policies and procedures to assist in compliance with the rule. Nonetheless, as we get feedback, we are seeing a little confusion regarding some of the granular detail such as which investors are exempt and what level of insight is needed.
To assist, we provide you with two areas of concern. Please keep in mind, these are condensed versions of the full guidance.

Exemptions:

Entities excluded from the definition of a customer under the USA Patriot Act are excluded from the requirements of the FinCEN CDD Rule. These include:

- A financial institution regulated by a federal functional regulator, such as:
  - o **Securities and Exchange Commission**; or
  - o Commodity Futures Trading Commission or a bank regulated by a state bank regulator;
- A department or agency of the United States, any State, or any political subdivision of any State;
- Issuers of securities registered under section 12 of the Securities Exchange Act of 1934 (SEA) or issuers required to file reports under 15(d) of that Act;
- Any entity, other than a bank, **whose common stock or analogous equity interests are listed on the NYSE Euronext and its U.S. affiliates or the separate "NASDAQ Small-Cap Issues"** (now known as NASDAQ Capital Markets) heading. **Foreign listed companies are not exempt.**
- ERISA plans, Non-Profits, and Trusts however **these are not exempt from CIP**

This is an abbreviated list and to boil it down further, family offices, venture capital, private equity, and other entities may not be exempt while pooled interests most likely are. If the exemption is not obvious, it merits the time to dig further.

Accounts versus Clients:

This applies at the account level not the client level. Each time the client opens an account that account needs to maintain documentation with regard to CDD.

Required Information:

Firms are required to gather information related to the beneficial owners and control person(s) on a Certification of Beneficial Owners ("CBO") or similar form, which contains the information required under the CDD.

The information required to be recorded on the CBO form includes:

- Account information for each individual that owns, directly or indirectly, **25 percent** or more of the equity interests of the legal entity.
- If there is no beneficial owner who has 25% or more ownership the Company will retain documentation on how they determined no such owners exist and will record "None" on the CBO form.
- The necessary account information for the individual with significant responsibility for managing the legal entity, such as a CEO, CFO, COO, Managing Member, General Partner, President, Vice President, or Treasurer.

Keep in mind, the standard avoidance tactics such as multiple layers of LLCs and multiple complex/cross shareholding structures are not an out. The rule requires Firms to know who the beneficial owners are reaching up and across the ownership structure until individuals can be named or enough evidence exists that there are no 25% holders of equity. Further, Firms need to conduct a search of the OFAC lists for all beneficial owners and control persons identified.

Ongoing Review:

Firms need procedures that describe review and identifying triggering events.

We have chosen to exist in a sector where regulators are not as forgiving or amenable to bending rules as the Swabian overlords are. As a consequence, aspiring money launderers would do well to look elsewhere to do their cleansing. From a practical application point of view, there will be investors that will push back. This is unfortunate. There are reasons why individuals would want to keep their information private. However, as pertains to the CDD rule, firms that do not comply are running serious risks of allowing their firm to be used as abettors in financial crime. The Swabians merely had to go to confession for absolution. The consequences of AML violations can be much more expensive.

Steve Murphy is a Vice President with NCS Regulatory Compliance. He can be reached at smurphy@ncsregcomp.com.

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Registration will open in September

We hope you found the content in this month's newsletter valuable. If you have any topics you would like to suggest for future editions, please let us know. You can email your feedback to newsletter@ncsregcomp.com. Also, please follow us on social media to stay well-informed of our upcoming webinars, conferences, and other important industry updates.

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