Wisconsin Department of Financial Institutions

Spring 2022
Division of Securities

Investment Adviser Newsletter

Madison Spring by Todd Klassy

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WISCONSIN ADOPTS NEW IAR CONTINUING EDUCATION RULE

New continuing education (CE) requirements for Wisconsin investment adviser representatives were adopted on February 28th with the publication in the Wisconsin Administrative Code of CR 21-057, creating Chapter DFI-Sec 11.

The new administrative rules, which require both state-registered and federal covered investment adviser representatives to complete CE on an annual basis, are effective as of January 1, 2023. This means investment adviser representatives (IARs) registered in Wisconsin will begin taking and reporting CE courses during the 2023 calendar year.

Other states adopting continuing education requirements for investment adviser representatives currently include Maryland, Michigan, Mississippi, and Vermont, with additional states expected to follow. Michigan is effective for 2023 with the other three states already effective this year.

“We're looking forward to working with the investment adviser community to implement the new continuing education requirement in Wisconsin. We expect the CE program will help IARs maintain and enhance their

IAR CE CONTINUED...

knowledge of current regulatory requirements and best practices in a profession facing increasing complexity," said Leslie Van Buskirk, Administrator of the Division of Securities Division.

Chapter DFI-Sec 11 requires every IAR to annually complete 12 CE credits to maintain their IAR registration. The 12 credits must include 6 credits of Products and Practices courses and 6 credits of Ethics and Professional Responsibility courses. Additional information can be found in last Fall's newsletter, at the Division's website, and on NASAA's website.

The Division plans to deliver a comprehensive presentation later this year on the new CE rules. In the meantime, questions regarding the Wisconsin continuing education requirements may be directed to Deb Fabritz at deborah.fabritz@dfi.wisconsin.gov or to our Examiner of the Day phone line at (608) 266-2139.

PRECIOUS METALS SCHEMES ARE ON THE RISE

Scam artists know that when stock markets are volatile, investors are afraid of losing their retirement savings. Precious metals scammers are notorious for taking advantage of investor anxiety and they use prolific advertising, including television commercials, to promote buying silver and gold during times of market volatility.

Attorney General Josh Kaul, in partnership with the Wisconsin Department of Financial Institutions (DFI), has joined the Commodity Futures Trading Commission (CFTC) and 26 other state securities regulators that are also members of the North American Securities Administrators Association (NASAA) in filing a joint civil enforcement action in the U.S. District Court for the Central District of California against Safeguard Metals, LLC and Jeffrey Santulan. The complaint alleges that from approximately October 2017 and continuing through at least July 2021, the defendants fraudulently solicited and received approximately $68 million in investor funds – the majority of which

PRECIOUS METALS CONTINUED...

was retirement savings – from at least 450 persons throughout the U.S. for the purpose of purchasing precious metals, primarily consisting of gold and silver coins.

According to the complaint, the defendants deceived customers into purchasing precious metals through false and misleading statements about the risk and safety of their investments in traditional retirement accounts. The defendants also deceived customers into purchasing silver coins at grossly inflated prices that bore no relationship to the ranges represented to customers. The defendants are accused of failing to disclose the markup charge for their precious metals bullion products and that investors could lose most of their funds once a transaction was completed. The markup that customers paid on silver coins, for example, averaged from 51 percent to over 70 percent, which was substantially more than the amounts represented in Safeguard Metals' customer agreements. In the end, nearly every customer suffered an immediate loss of their investment in precious metals purchased from Safeguard Metals.

> *In many cases, the market value of the precious metals sold to investors was substantially lower than the value of the securities and other retirement savings investors liquidated to fund their purchase.*

In many cases, the market value of the precious metals sold to investors was substantially lower than the value of the securities and other retirement savings investors liquidated to fund their purchase. In Wisconsin, 17 investors were defrauded out of $1,880,599 in the execution of this national scheme. Many Wisconsin investors liquidated their existing retirement accounts, which contained securities, to obtain funds to purchase the metals.

"In expectation of additional precious metals investment schemes, investors are advised to check the registration of all investment products and professionals, diligently research investments, and ask tough questions about the fees, markups or spreads, risks, and potential returns," said DFI Secretary-designee Cheryll Olson-Collins. "If the answers seem too good to be true or don't make sense, protect your wallet by just walking away."

In the continuing litigation against the defendants, the CFTC and state securities regulators seek the return of ill-gotten gains, civil monetary

PRECIOUS METALS CONTINUED…

penalties, restitution, permanent registration and trading bans, a permanent injunction against further violations of the Commodity Exchange Act (CEA), state regulatory laws and CFTC regulations.

In a simultaneous filing, the U.S. Securities and Exchange Commission commenced a suit against Safegard Metals LLC and Jeffrey Santulan for violations arising from the fraudulent precious metals scheme, including exorbitantly priced silver coins, and for rendering unlawful investment advice.

The CFTC has issued several customer protection Fraud Advisories and Articles, including a Precious Metals Fraud Advisory which alerts customers to precious metals fraud and lists simple ways to spot precious metals scams.

Investment advisers are encouraged to contact the Division of Securities if you suspect any of your clients were targeted by similar precious metals investment schemes. Please feel free to contact the Examiner of the Day phone line at (608)266-2139.

Press Releases: Wisconsin Department of Justice and North American Securities Administrators Association

JEFFREY SANTULAN – OWNER OF SAFEGUARD

TOP 2022 INVESTOR THREATS

Earlier this year, DFI published a press release about the top investor threats for 2022. We highlighted four main threats from a survey conducted by NASAA with state securities regulators.

Investments tied to cryptocurrencies and digital assets –

As the popularity of cryptocurrency and digital assets rise, so does the risks associated with them. Understanding these risks is an important step to take before you consider investing in such products for your clients. Crypto is highly volatile. There can be huge swings in relatively short time period. Storage and security lead to additional challenges. A lost or stolen wallet is nearly impossible to retrieve. The lack of regulation facilitates a variety of scams. New “coins” are susceptible to pump and dump schemes.

Fraudulent offerings related to promissory notes –

Promissory notes seem to be a relatively safe investment product. With stated fixed interest and principal payment terms, what could go wrong? Well, there are several things that could go haywire. Problems with promissory notes could involve fraud and deception of investors, unregistered securities and unregistered sellers. You should research the potential company and do your due diligence. All securities are registered with the SEC and/or the state in which they are sold, or are exempt from registration. While being registered doesn’t guarantee that the debt would be paid, disclosure documents at least give investors a better understanding of what is being issued.

Solicitations of money through social media and internet investment offers -

Anyone can be anyone on the internet. While social media can provide resources for investors, it also presents opportunities for fraudsters. Social media lets fraudsters contact many people at the speed of a click. It is easy to create fake profiles, emails and webpages. Be wary of unsolicited offers. Pay attention to phishing emails. If it sounds too good to be true, most likely it is. Investors need to use caution when

INVESTOR THREATS CONTINUED…

considering an investment they discovered through social media.

Financial schemes connected to self-directed individual retirement accounts –

We continue to see complaints arising from fraudulent investment schemes that utilize a self-directed IRA as a key feature. Investors should understand that the custodians of self-directed accounts have limited duties to investors. The custodians will generally not evaluate the quality or legitimacy of an investment and its promoters. An investor should thoroughly research an investment before making a decision to avoid a later discovery that the product is unregistered, illiquid, and/or fraudulent.

For information regarding additional investor threats, please refer to DFI's full press release and to NASAA's website.

DFI SETTLES WITH BLOCKFI

The Division of Securities is increasingly hearing from our state registered investment advisory firms that clients are eager to know more about – and potentially invest in – crypto related products. One corner of the crypto universe that we want to highlight is DeFi, short for decentralized finance. DeFi is a term that encompasses a number of financial services such as banking, lending, or investing that are provided by an algorithm on a blockchain.

> *Financial service firms operating in DeFi markets may not be complying with important laws that protect retail clients*

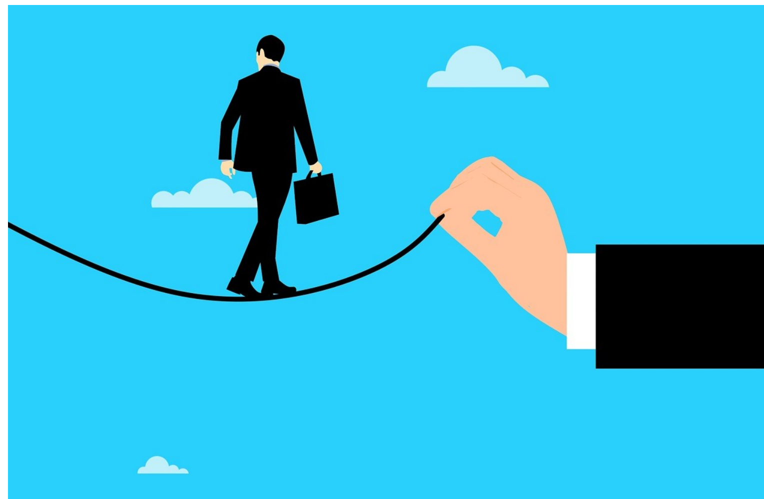
Many DeFi products and services are analogous to traditional financial services offered by banks and brokerages, but without any of the regulatory safeguards provided by registered firms and products. For example, registered firms must truthfully disclose all known material facts and explain the risks associated with their investments, while the Federal Deposit Insurance Corporation, National Credit Union Administration, and the Securities Investor Protection Corporation insure depositors and investors against certain kinds of losses.

Financial service firms operating in DeFi markets may not be

BLOCKFI CONTINUTED...

complying with important laws that protect retail clients, and investors may not have access to the information necessary to conduct due diligence and make fully informed decisions.

A large entity in the DeFi space is BlockFi, a company that sold unregistered securities in the form of interest-bearing digital asset deposit accounts. BlockFi promoted its deposit accounts with promises of high returns for investors who purchased the lending products. It took control of and pooled its investors' loaned digital assets, and exercised sole discretion over the pooled digital assets, including how to use the digital assets to generate a return and pay investors their promised interest. BlockFi failed to comply with state registration requirements and, as a result, investors were sold unregistered securities in violation of state law and deprived of critical information and disclosures necessary to understand the potential risks of these lending products.



As a result of BlockFi's actions, the company entered into an agreement with DFI, 31 other state securities regulators, and the Securities and Exchange Commission to pay a fine of $100 million dollars. Further, BlockFi immediately stopped offering their unregistered product to new customers and will seek proper registration in the future.

DeFi's products are increasingly popular due in part to flashy marketing and lofty promises. It's important that investment advisers are equipped with the tools and knowledge to help clients navigate this growing market. For more information on DeFi, visit DFI's recent Investor Alert here.

CONSIDERATIONS FOR USING SUB-ADVISERS

The Division has observed the use of sub-advisers by some investment advisers. A sub-adviser is an external manager hired by the adviser to assist with the management of a client's investment portfolio. Generally, the sub-adviser manages all or some of the client's assets in accordance with stated guidelines and objectives which are communicated by the adviser.

In this arrangement, the investment adviser is responsible for the recommendation and selection of the sub-adviser on behalf of the client and can hire and fire the sub-adviser. Investment advisers should enter into a business-to-business agreement with the sub-adviser that specifies the services, fees, and expectations between the investment adviser and sub-adviser, such as who will send client invoices. You should of course maintain a record of the agreement and monitor the activities of the sub-adviser.

The use of sub-advisers requires ongoing due diligence on behalf of the investment adviser to meet your fiduciary responsibility to your clients. Some investment advisers use due diligence questionnaires, in-person and telephone meetings, and performance reporting to ensure the sub-adviser is adhering to the guidelines, objectives, and services specified by the investment adviser and client. During examinations, the Division's examiners may ask about your firm's due diligence efforts on sub-advisers, including documentation of those efforts.

When completing your ADV, you may include assets managed by sub-advisers under your firm's assets

under management only if you have discretionary authority to hire and fire sub-advisers and reallocate assets among them. Please refer to Form ADV instructions, "Item 5.F: Calculating Your Regulatory Assets Under Management" for more information about calculating your assets under management.

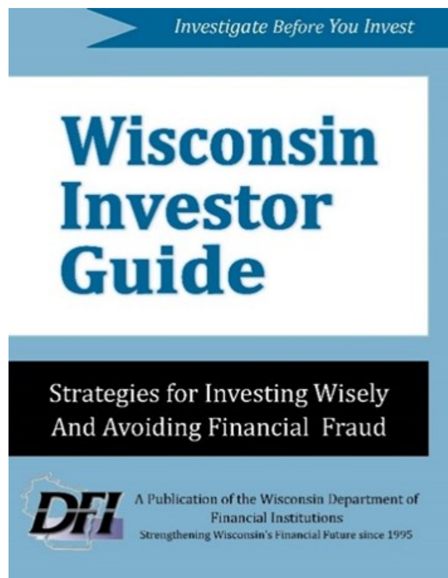
It is important to notify your clients of any sub-adviser arrangement through disclosure on Form ADV,

SUB-ADVISERS CONTINUED…

particularly in Item 4 ("Advisory Business"), and clearly describe the roles of both the investment adviser and sub-adviser. Fees should be accurately disclosed to clients so they understand how fees are allocated between their investment adviser and the sub-adviser. If you delegate management of the clients' assets to a sub-adviser, be sure your fees are warranted by the value and services you are adding to the client relationship.

NEW DFI INVESTOR EDUCATION WEBSITE

We are pleased to announce our new Investor Education website! Please consider sharing this resource with any clients who may be interested in improving their investment knowledge, or who could benefit from information on topics such as investment products, resources for older adults, or tips for avoiding investor fraud. Each page includes links to additional resources and organizations that can help answer investors' questions.



The Division's Investor Education website also includes our new Wisconsin Investor Guide, a downloadable booklet packed with topics such as differences among asset types, basic principles of investing, and how to invest for a secure retirement.

In addition to these new investor materials, NASAA (North American Securities Administrators Association) also has some great investor education resources on their website that may be helpful to clients.

WATCH FOR THESE COMMON FEE AND ADV ISSUES

The Division has reviewed the deficiencies and concerns from exams conducted in 2020 and 2021 to determine which issues are most prevalent. While the data is still being analyzed, some trends are emerging. Many of the trends are similar to those identified in our analysis of 2019 exams.

In the last few years, the two areas where we have seen the most deficiencies include the following:

1. **Contract Fee Disclosure and Fee Amendments.**

Per DFI-Sec 5.05(2)(d), an investment adviser shall not enter, extend, or renew any investment advisory contract if the contract:

(d) Fails to disclose, in substance,

1) the term of the advisory agreement,

2) the fee to be charged by the adviser,

3) the formula for computing the advisory fee,

4) the formula for computing the amount of prepaid fee to be returned in the event of the contract termination or non-performance,

5) and whether the contract grants discretionary power to the adviser.

During a routine regulatory exam, your examiner will check to see if the fee in the contract matches the fee that the client is being charged. This is accomplished by reviewing invoices and account statements and comparing the fees deducted to the fee stated in the contract. It is not unusual for examiners to find discrepancies between the stated fee and the fee actually charged.

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Even if the fee charged is lower than the fee in the contract, the examiner may conclude that is a deficiency in violation of DFI-Sec 5.05(2)(d). When the adviser agrees to charge a lower fee to a client indefinitely or over a certain period, they must document the

lower fee in the client's file and send the client a notice that their advisory fee has been lowered to the agreed amount. In the event the adviser transitions out of the business, or a beneficiary takes over a client's account, it is important to have all fee agreements clearly documented.

2. Form ADV Part 2A – Your Firm's Brochure

Per the SEC's instructions, the ADV Part 2A ("brochure") is a narrative format brochure that is to be written in plain English and is designed to promote effective communication between the firm and its clients. The brochure achieves this goal by only discussing services in which the firm engages or is reasonably likely to engage.

During exams, the Division often reviews brochures that discuss complex or esoteric investment strategies and instruments only to discover that the adviser does not actually engage in those practices. The adviser will include the burdensome language in the brochure because they think they may invest in that type of instrument in the future and want to have the language in the brochure just in case.

Typically, your examiner will ask you to remove the language that discusses practices in which you do not currently engage, or in which you have no reasonable expectation to engage in the near future. This will simplify the language and overall content of the brochure, increasing the likelihood that your clients and potential clients will review and understand its contents in the context of their relationship with you, and have a better understanding of you and your business.

Additionally, per DFI-Sec 5.04(3)(b), all firms must update their ADV 1 & 2A on an annual basis. At a minimum, most firms will need to update the number and types of clients listed in the ADV 1 as well as the regulatory assets under management. The ADV 2A will require you to update the date on your cover page as well as the disclosure of your

FEE AND ADV ISSUES CONTINUED...

assets under management in Item 4.

If you are beginning to engage in a practice that you have not yet disclosed in your brochure, you will have 30 days to file an amendment for material changes to your practice. All other changes can be made in your annual amendment.

Please evaluate whether your firm has documented changes to your clients' fees or could benefit from slimming down the language in your ADV Part 2A. Feel free to reach out to us if you would like to know how your business could better address these common deficiencies.

ENFORCEMENT NEWS

The Wisconsin Division of Securities is responsible for administering and enforcing the state's securities laws. To read our latest enforcement actions, please visit our website. Below are some highlights from recent enforcement orders:

On March 15, 2022, DFI issued a Final Order by Consent to Cease and Desist against **Stephen Byrne** (DFI Case No. S-239572 (EX)). The Order found that Byrne violated Wis. Stat. § 551.301 when he offered and sold securities (CapSource promissory notes) that were not registered or exempted from registration under Ch. 551; and he violated Wis. Stat. § 551.501(2) when he failed to disclose information regarding a prior related investor lawsuit to the Wisconsin investors.

On March 7, 2022, DFI issued a Final Order by Consent to Cease and Desist and for Restitution and Penalties against **Theresa M. Lasee** (DFI Case No. S-244188 (EX)). The Order found that Lasee violated Wis. Stat. § 551.501(2), when, in connection with the offer, sale, or purchase of a security, she made material untrue statements including that she would invest Wisconsin investor's funds by opening retirement accounts for them, and that one of the Wisconsin investors would earn bonuses for quickly transferring funds. Lasee also omitted to state material facts when she failed to inform a Wisconsin investor that she was not a registered representative of a brokerage firm, as she claimed, and that no retirement accounts were opened at the firm in that

ENFORCEMENT CONTINUED…

Wisconsin investor's name.

On December 22, 2021, DFI issued a Summary Order to Cease and Desist against **Helen Frigates** (DFI Case No. S-243832 (EX)). The Order found that Frigates violated Wis. Stat. § 551.402(1) by transacting business as an agent of a broker-dealer in Wisconsin without being registered under Ch. 551 or exempted from registration under Wis. Stat. §551.402(2); and she violated Wis. Stat. § 551.301 by offering and selling unregistered securities to a Wisconsin investor. Frigates also violated Wis. Stat. § 551.501(1-3) by implementing a scheme to conduct business, in connection with the offer and sale of securities, so as to operate a fraud and deceit upon a Wisconsin investor. Frigates claimed she worked for an investment company trading in Forex, Bitcoin and Altcoins, and could turn $5,000 into $500,000 within 3-5 months.

On December 13, 2021, DFI issued a Final Order by Consent to Cease and Desist with Penalties against **Kaboom USA, LLC, Skearch, LLC, and Philip E. Fraley** (DFI Case No. S-240381 (EX)). The Order found that they violated Wis. Stat. § 551.501(2) when in connection with the offer, sale, or purchase of a security, they omitted to state material facts to investors, including that Fraley had failed to make payments to other investors as agreed to under the promissory notes, failed to provide financial statements and information, and failed to disclose he was the subject of previous delinquent tax warrants, money judgments, foreclosures, and criminal felony charges. They also violated Wis. Stat. § 551.301 when they offered and sold securities in Wisconsin that were not registered or exempt from registration under Ch. 551.

On November 4, 2021, DFI issued a Summary Order to Cease and Desist against **Behuz Investment & Sabella Ozan** (DFI Case No. S-244039 (EX)). The Order found that Behuz Investment and Ozan violated Wis. Stat. § 551.301 when they offered and sold securities in Wisconsin without those securities being registered or exempted from registration; Behuz violated Wis. Stat. § 551.401(1) when it transacted business as a broker-dealer in Wisconsin without being registered or exempted from registration; Ozan violated Wis. Stat. § 551.402(1) when they transacted business as an agent of a broker-dealer in Wisconsin without being registered or exempted from registration. They also violated Wis. Stat. § 551.501(2) when they offered and sold securities while misrepresenting to an investor the profits that could be earned from his

More Ways to Connect with DFI

The Wisconsin Department of Financial Institutions (DFI) Facebook page provides information on DFI activities, financial literacy, investor education, scam warnings, and other timely news to help protect investors. Please check out DFI's Facebook page and share any content that you find useful. Feel free to "like" our page so that you receive future posts in your Facebook newsfeed.

In addition, to keep up with the latest from DFI, follow us on Twitter and LinkedIn.

ENFORCEMENT CONTINUED...

investment. Claiming Behuz had a superior cryptocurrency trading bot that earned high returns, they failed to disclose the lawsuits pending against their affiliate Bitmex, the illiquidity of the investment, and the risks and terms of the investment.

On September 17, 2021, DFI issued a Final Order against **Darien J. Smiley (aka Devon Reed) & Joseph J. Gibbs** (DFI Case No. S-242116 (EX)). The Order found that Smiley violated Wis.

Stat. § 551.401(1) when he transacted business in this state as a broker-dealer without being registered under Ch. 551 or exempted from registration. Gibbs violated Wis. Stat.§ 551.402(1) when he transacted business in this state as an agent of a broker-dealer without being registered as an agent or exempted from registration. Smiley and Gibbs violated Wis. Stat. § 551.301(1) when they offered and sold unregistered securities (a cryptocurrency investment contract), and violated Wis. Stat. § 551.501(3) when they engaged in an act, practice or course of business that operates or would operate as a fraud or deceit upon another person.