



Investment Adviser Newsletter

Ongoing Developments Related to COVID-19

The offices of the Wisconsin Department of Financial Institutions' Division of Securities remain open with nearly all of the staff teleworking from home to maintain continuity of operations while complying with the Governor's [Safer at Home order](#). Our examiners are continuing to process applications and conduct examinations, except that interviews are being conducted by phone instead of onsite. You can reach the examiners via their state email, by leaving a voicemail message on their office phone line, or by calling the Examiner of the Day phone line at (608) 266-2139.

We are sensitive to the challenges that the current crisis has created for our registered investment adviser community and our other constituents. On March 20th, we issued an Emergency Order to provide temporary relief for registrants affected by COVID-19. Please know that our staff will also be responsive and receptive to requests for extensions and other appropriate forms of regulatory relief.

COVID-19 Information and Resources, including the orders referenced above and a recent DFI press release concerning COVID-19-Related Investment Schemes, can be found at dfi.wi.gov.



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PAST NEWSLETTERS

Our periodic newsletter for investment advisers registered in Wisconsin is published twice per year. Past editions can be found [here](#).



BUSINESS CONTINUITY AND SUCCESSION PLANS

We hope you are staying safe and healthy during the COVID-19 public health emergency. As your firm navigates the coronavirus pandemic situation, now is a good time to review your business continuity plan to ensure it includes procedures to account for any disruptions presented by a pandemic. For instance, you have likely discovered the importance of being able to work remotely from home to comply with the Governor's Safer at Home Order.

Although the Wisconsin Uniform Securities Law does not yet include a regulatory requirement that firms have a business continuity and succession plan, this could change in the future and in any case, the Division of Securities considers it a best business practice for all firms to have a plan in place. During your last exam, the Examiner probably asked about your continuity plan and if missing, further commented on it in your exam letter.

Business continuity and succession planning is critical to your firm's ability to continue daily operations in the event of a significant disruption of your business caused by natural disasters, health issues or other unexpected events. In addition, investment advisers have a fiduciary duty to put clients' interests first - establishing a business continuity and succession plan minimizes the risk of clients experiencing an interruption in the management of their investments. Having a plan in place may also reduce the recovery time of your operations after a catastrophic event or unexpected loss of key personnel.

“Business continuity and succession planning is critical to your firm’s ability to continue daily operations in the event of a significant disruption of your business ”

For investment advisers considering retirement or close to retirement age, it is important to find a suitable successor to assume your business and its clients.

Business Continuity Continued...

It is a best business practice to establish a succession plan that details your transition from the business and ensures a smooth transition of your clients to a new adviser. The new adviser could be someone who is buying your business or a representative of your firm who may have been brought on board to take over the firm and its clients.

Whether for a planned retirement or after an unexpected event, the details of the plan will depend on the firm's business model, firm size, number of clients and other factors specific to your firm. Once your firm has a plan in place, you should periodically review and test the plan to ensure it is adequate and updated to reflect any changes in the firm's business practices or personnel assigned specific designated duties.

The North American Securities Administrators Association (NASAA) issued a Guidance on Business Continuity and Succession Planning for State Registered Investment Advisers and adopted a model rule in April 2015. The Guidance provides helpful information, case studies, and questions for state-registered advisers to consider when creating a plan for significant business interruptions or unexpected succession situations. To read the NASAA Model Rule on Business Continuity and Succession Planning and IA BCP Rule and Guidance, go [here](#).

Although it is not easy to plan for the “what ifs”, today is a good time to consider establishing a business continuity and succession plan to protect your clients and your business, if you don't already have a plan in place.



INVESTMENT ADVISER EXAM DEFICIENCIES—2019 STUDY

All Wisconsin-registered investment advisers are examined by the Division of Securities on a regular basis, currently every three years if the adviser has assets under management, and every 4-5 years for financial planners and solicitors. The exam includes an onsite interview and a review of the firm's records and procedures. After the exam, the examiner sends a letter to the adviser summarizing the exam findings, including any deficiencies or other concerns.

A deficiency arises from a violation of the Wisconsin Uniform Securities Law or administrative code, whereas a concern represents a matter that may not rise to the level of a violation but nonetheless requires the adviser's further attention. For instance, the examiner may recommend that the firm take some action that is more consistent with best practices for investment advisers.

Recently, the Division compiled data on deficiencies and concerns from exams in 2019 to discover trends in an effort to help reduce the future frequency of these deficiencies through further communication and outreach.



“27% of the exams conducted last year had no issues, 70% had 2 or less issues and 89% had 4 or less reported issues”

For purposes of the discussion in this article, deficiencies and concerns are jointly referred to as “issues.” 27% of the exams conducted last year had no issues, 70% had 2 or less issues and 89% had 4 or less reported issues. The chart on the next page shows the number of exams that had reported issues, including the 11% that had more than 4 issues revealed during the exam.

IA Exam Deficiencies Continued...

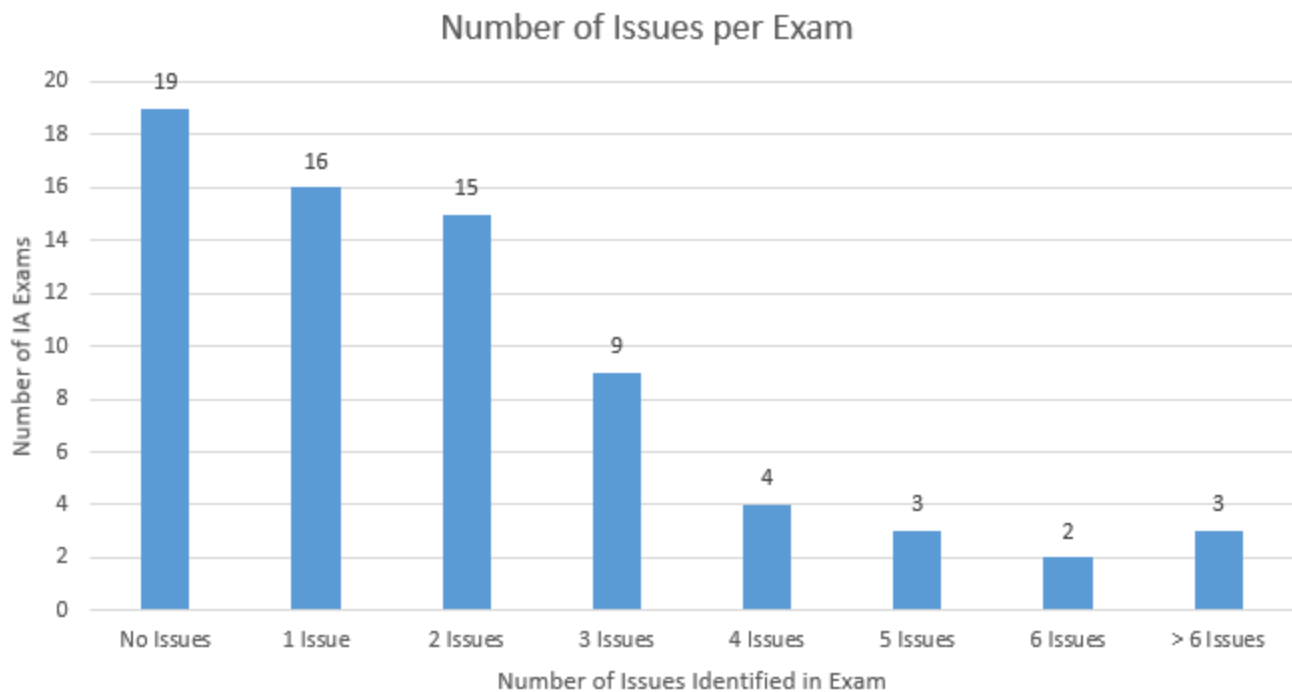


Figure 1: Bar graph showing the relationship between the number of exams conducted and number of issues found

Among the 139 total issues identified in 2019, the most common or frequent issues included:

- Failure to itemize client invoices
- Missing contract terms
- Failure to annually update/offer Form ADV
- Failure to update Form U-4
- Lack of written supervisory procedures

Invoices

Many advisers believe that they do not have custody of client funds or securities, so the custody rules do not apply to them. This is incorrect. The most common form of custody is direct fee deduction which is done by most state registered advisers. It is important for advisers to remember that if they are directly deducting advisory fees through their custodian, they are required to send (via mail or e-mail) clients invoices each time a fee is deducted from the client's account.



Investment Adviser Exam Deficiencies Continued...

Furthermore, the invoices must meet specific disclosure requirements prescribed by [DFI-Sec 5.035\(1\)\(f\) 2b](#): **“Itemization includes the formula used to calculate the fee, the amount of assets under management the fee is based on, and the time period covered by the fee.”**

In addition to the above invoicing requirements, if an adviser directly deducts fees from client accounts, they must:

- Obtain written authorization from the client to deduct advisory fees from the client’s account;
- Send the qualified custodian notice of the amount of the fee to be deducted from the client’s account; and
- Disclose that the adviser uses direct fee deduction on Form ADV.

Contracts

Under [DFI – Sec 5.05\(2\)](#), an investment adviser must not enter into an investment advisory contract that fails to incorporate certain provisions. The Division often finds that advisory contracts fail to include items such as: the term of agreement, the fee, the formulas for computing certain fees, and whether the contract grants discretionary power to the adviser.

Form ADV 2A Updates, Annual Offers and Delivery

Form ADV 2A, commonly known as the “brochure” is a narrative document that is designed to give current and potential clients an accurate picture of the adviser’s firm and its business model. Pursuant to [Rule 5.05\(8\)\(a\)](#), the Division staff frequently ask advisers to make amendments to their ADV 2A because the firm’s actual business practices, investment strategies, conflicts of interest or services provided may not be accurately reflected in the ADV 2A. Other times, fees as stated in the contract vary from what is disclosed in the ADV 2A.

Investment Adviser Exam Deficiencies Continued...

The Division also often finds that advisers fail to comply with the requirement to annually offer the ADV 2A to clients and to document the offer. The most common way to comply with the annual offer is to include an offering statement on regular invoices that are sent out to clients. The initial offer of the ADV 2A can be documented in the advisory agreement at the time the contract is signed by the client.

Form U-4 Required Updates

[Rule 5.04\(3\)\(c\)](#) requires an investment adviser representative to file updates to their form U-4 each time the information becomes materially inaccurate. The information that must be kept current includes employment history, residential address, outside business activities, criminal or regulatory actions, litigation, customer complaints, liens/judgments, etc.

Written Supervisory Procedures

Under DFI-Sec [5.05\(1\)](#), each registered investment adviser is required to produce and maintain written supervisory procedures. The procedures should be tailored to their business and designed to prevent violations of the Division's statutes and rules. The most common issue with this requirement is that advisers do not have supervisory procedures, or if they have them—they are not tailored to the adviser's business or are otherwise out of date. Advisers should review their procedures on at least an annual basis to ensure they are compliant with state rules.

“The issues listed above often exist because the advisor lacks awareness of the specific requirements”

The issues listed above often exist because the advisor lacks awareness of the specific requirements under the Wisconsin Uniform Securities Law and administrative code. Advisers should continue to consult the relevant statutes and rules for the requirements applicable to their advisory business. The administrative rules for investment advisers can be found [here](#). The current Wisconsin Uniform Securities Law can be found [here](#). The Division's Examiners are also available to answer questions regarding compliance and best practices via the Examiner-of-the-day phone line at (608) 266-2139.

DOCUMENT RETENTION: EMAIL AND TEXT MESSAGES

As technology evolves, investment advisers should keep up with how that technology intersects with document retention requirements. Nine out of ten Americans are using their mobile devices to send or receive text messages and emails. Electronic communication is a great way to keep in touch in a manner that's simple, reliable, and intuitive. However, state securities regulators require that electronic communications used for business purposes be saved for a period of time to comply with regulatory requirements.

Under the Wisconsin administrative code, [DFI – Sec 5.03\(1\)\(g\)](#), every investment adviser must retain - at its principal office - copies of all written communications and correspondence relating to investment activities of clients. As a reminder, written communication includes both emails and text messages. Under [DFI-Sec 5.03\(3\)](#), these records must be preserved for a period of not less than 5 years, the first 2 years in an easily accessible place. The record may be retained by computer if a printed copy of the record can be prepared immediately upon request.

Electronic communications should be readily available to state examiners during an examination of the firm or in response to an investigation of a customer complaint. Consider whether your firm's procedures and systems are properly retaining your business-related email records and text messages for the appropriate period of time. If they are not in compliance with 5.03, reconsider how you are organizing and archiving your electronic communications.

At firms with multiple representatives, the supervisor should be reviewing written communications in accordance with the firm's supervisory procedures to prevent and detect any violations of the Wisconsin Uniform Securities Law. If firms are unable to retain text messages, the firm's procedures should prohibit the use of text messages for business communications relating to client investment activity.

For your reference, here is a link to Section 5.03 regarding investment advisers' records: http://docs.legis.wisconsin.gov/code/admin_code/dfi/dfi_sec/5/03



POTENTIAL PROBLEMS WITH VARIABLE ANNUITIES

In reviewing the results of exams with state registered investment advisers, the Division of Securities has identified potential pitfalls with Variable Annuities (VAs). Investment advisers should consider the following before offering this unique product to clients.

Before an investment adviser representative can sell VAs they need to be properly licensed regardless of how the VA is marketed. Representatives will need the “Variable Life/Variable Annuity” line of authority from Office of the Commissioner of Insurance (OCI). To qualify, OCI states:

Residents must hold an active life license and proof of FINRA registration for Series 6 or 7 and will be required to provide a Central Registration Depository (CRD) number.

Some investment adviser representatives are also dually registered as broker-dealer agents. Those individuals need to be careful not to engage in “double dipping”. This is defined as when a financial professional sells a VA on the brokerage side to receive a commission and then manages the subaccounts on the investment adviser side to charge an asset under management fee.

Variable annuities can have many fees: brokerage commissions, AUM fees, extra riders, subaccount expense ratios, and surrender charges. The Division’s position is that depending on the particular circumstances, those fees in aggregate could be deemed an “unreasonable fee” and a violation of [DFI-Sec 5.06\(15\)](#).



Variable Annuities Continued...

Determination of whether a particular VA is suitable for a client depends not only on the unique needs of that client – time horizon, risk tolerance, age, income, net worth, etc. – but also on the type of VA itself. VAs offer an ever expanding list of share classes including A, B, C, L, O, and X shares, each with its own unique features. A benefit for one client could be a deal breaker for another.

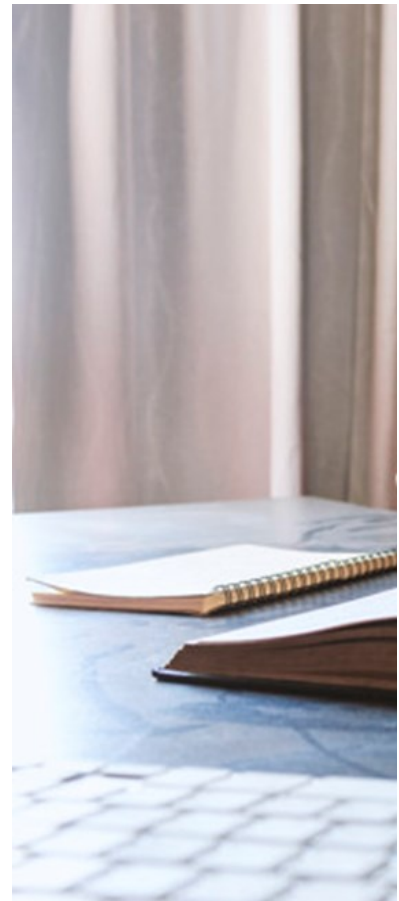
Lastly, the Division expects that advisers will take sufficient time to fully understand the products they recommend. With securities as complex as VAs, clients rely on advisers to be able to fully explain why the product is in their best interests. Absent that understanding, clients can – and often do – turn to litigation to address fiduciary duty issues.

REGULATION BEST INTEREST BASICS FOR DUAL REGISTRANTS

On June 4, 2019, the Securities and Exchange Commission (SEC) enacted Regulation Best Interest (Reg BI) as a change to the rules and regulations regarding how broker-dealers and investment advisers interact with their clients. Reg BI is designed to improve the quality of recommendations to retail clients and to reduce the potential harm that may be caused by conflicts of interest. While investment advisers (and their representatives) already have a fiduciary duty to their clients, some representatives are dually registered to sell securities through a broker-dealer. As of the writing of this newsletter, Reg BI is scheduled to be implemented on June 30, 2020.

When acting in a broker-dealer capacity, you will need to apply Reg BI to your recommendations. This means you must act in the best interest of your clients and cannot place your own interests ahead of your client's when making a recommendation. While these enhanced obligations draw inspiration from the fiduciary standard that is applied to investment advisers, they are not equivalent. Most notably, the regulation does not require broker-dealers to provide ongoing advice and monitoring after making the recommendation. Reg BI does require enhanced disclosure about the recommendation and the relationship between the client and the broker-dealer. You should follow the guidance of your broker-dealer's compliance officers regarding Reg BI compliance.

The SEC has reaffirmed the fiduciary duty of an investment adviser, which is different than the best interest standard of Reg BI. The fiduciary duty requires investment advisers to provide a duty of loyalty, a duty of care, and to act in utmost good faith. Investment advisers cannot place their own interest above the interest of the client. The investment adviser must eliminate or make full and fair disclosure of all conflicts of interest.

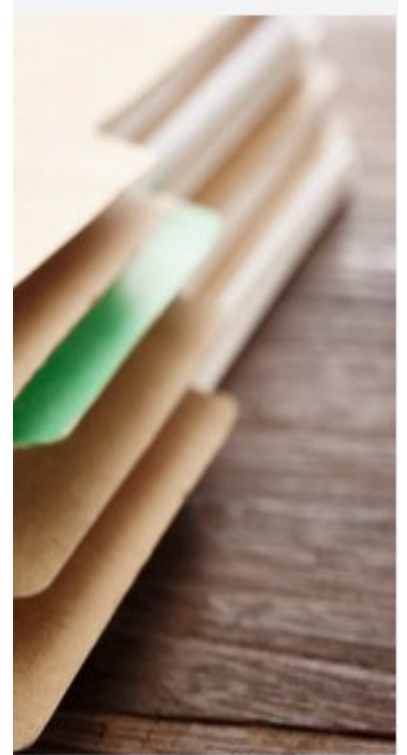


Regulation Best Interest Basics Continued...

Reg BI requires broker-dealers and federal advisers to adopt Form CRS (Client Relationship Summary). This form will be provided to retail clients at the beginning of the client relationship and will be updated as material changes occur. This form will provide clients with information comparing the services of the broker-dealer and investment adviser sides of your business, describe the standards of conduct, disclose fees and other costs, disclose conflicts of interest and disciplinary history, and provide key questions for investors to ask (called conversation starters). Form CRS shall be provided “in plain English,” avoiding legal jargon and technical terms (unless you can easily define them within the summary) while being as concise and direct as possible.

In Wisconsin, state-registered investment advisers are not currently required to adopt Form CRS. If you are registered in other states or jurisdictions you should consider contacting their state securities regulator to determine if Form CRS is required.

More information about Reg BI can be found here: <https://www.sec.gov/info/smallbus/secg/regulation-best-interest>





FUTURE CONTINUING EDUCATION REQUIREMENTS FOR INVESTMENT ADVISER REPRESENTATIVES

The Wisconsin Department of Financial Institutions' Division of Securities supports the adoption of a new continuing education requirement for registered investment adviser representatives and anticipates that compliance will be required beginning in January 2022. Under the proposed program, IARs will be required to obtain and report CE credit hours. Unlike other financial professionals (e.g., broker-dealer agents, licensed insurance salespeople, certified financial planners), IARs do not currently need to meet any CE requirements despite their significant role in the financial lives of their clients.

Comments received by NASAA from the IA community are being reviewed and evaluated against the proposed model rule to require CE for IARs. We anticipate that the NASAA membership will vote to adopt the proposed model rule later this year. Following a favorable vote, individual states, including Wisconsin, are expected to adopt the model rule for inclusion under state securities laws.

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Special Note: Since the reporting of CE hours will take place through CRD/IARD, individuals who are registered as sole proprietor investment advisers will now need to individually register as IA representatives.

Please stay tuned for future notices regarding the upcoming CE requirements.

INVESTMENT ADVISER RESOURCES AT NASAA.ORG

The North American Securities Administrators Association (NASAA) is an international organization representing the state and provincial securities regulators in the United States, Canada and Mexico.

NASAA helps coordinate the actions of its members by highlighting best practices in investor education, fraud prevention, and providing industry resources for state registered investment advisory firms. If you aren't acquainted with NASAA's recently revamped website – <https://www.nasaa.org/industry-resources/investment-advisers/> – now is a great time to take a look.

State securities regulators recognize that it can be challenging for small advisory firms to keep up with annual compliance tasks like updating Forms U4, U5, and ADV. To assist, NASAA has provided a list of reminders and recommendations when filling out those forms which can be found [here](#).

The investment adviser [FAQ site](#) is also particularly helpful. Below are some of the questions that are addressed:

- What information about a firm and its representatives is publicly available?
- What is the definition of “high net worth individual” as used in Part 1-A of Form ADV?
- How do I convert my firm from being state-registered to being SEC-registered or vice versa? When do I submit my partial ADV-W?
- How should I prepare for an audit/exam by a state securities regulator?

The above examples are questions that the Division's examiners commonly answer for state registered investment advisers. Please take some time to review NASAA's website (www.nasaa.org) to stay on top of developments and best practices in the investment advisory space.

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](#).

