State of Wisconsin
Department of Financial Institutions
Strengthening Wisconsin's Financial Future

Investment Adviser Newsletter Spring 2015

This is the sixth edition of our periodic newsletter from the Wisconsin Division of Securities to investment advisers registered in our state. We welcome your suggestions for future content. Past editions can be found at: http://wdfi.org/fi/securities/whats_new.htm

Cybersecurity Principles and Practices

The importance of cybersecurity risk management by investment advisers continues to escalate, as the Division touched on in our last newsletter. While there is no one-size-fits-all approach to cybersecurity, we have identified some principles and effective practices for firms to consider when designing and incorporating, or updating, cybersecurity-related provisions into compliance and supervisory procedures.

1. **Governance** – A cybersecurity governance framework enables firms to become aware of cybersecurity risks, estimate their severity, and decide how to manage each risk. Smaller advisers may incorporate this into their existing written supervisory procedures, required under **DFI Sec. 5.05(1)**. Some questions the governance framework should address: What risks related to cybersecurity exist? How can they be reduced, or avoided altogether? If a breach or other cybersecurity event occurs, how will you assess any damage and what recovery measures will be in place? You may consider consulting an IT professional about how comprehensive your framework should be, based on your business practices.

2. **Risk assessments** – Regular risk assessments allow firms to identify cybersecurity risks associated with firm assets and vendors, and prioritize their remediation. The firm's cybersecurity governance framework should outline the frequency and content of assessments (for example, are both external and internal threats evaluated? Asset vulnerabilities?), who is responsible for conducting assessments, and a follow up protocol for addressing any issues identified.

3. **Technical controls** – Effective use of technical controls help protect a firm's hardware, software, and data. Consider a few of the following areas:

Employee Access: Advisers should consider which employees need access to the firm's technology, whether it should be restricted to certain content, and how the identity of the employee is verified before being allowed access. If employees use passwords, how often are these changed? Are there rules on the strength of the password? How are passwords stored?

Encryption: Many firms deal with data containing sensitive information on a daily basis, and should contemplate what files and documents should be encrypted for additional security.

Testing: Technical controls should be tested on a regular basis to ensure they are being implemented properly. If an employee's high-strength password is written on a post-it note next to their computer, your best efforts to manage cybersecurity risk could be thwarted.

4. **Vendor management** – Investment advisory firms may use third party vendors for services that provide the vendor with access to sensitive firm or client information. Conducting pre-contract and on-going due diligence is vital to managing vendor risk. Procedures should be established to terminate vendor access immediately upon contract completion.

This list is non-exhaustive. Additional research and due diligence are recommended for all advisers to ensure that their firm's and clients' information and assets are protected from cybersecurity related risks.

Common Deficiency Alert - Contract Signatures and Initials

The advisory agreement or contract executed with your client is required to be in writing, with a copy retained for your records under **DFI Sec. 5.05(5)** and **DFI Sec. 5.03(j)-(k)**. Make sure clients' signatures, your signature and any required client initials are not missing to avoid a deficiency in your next exam. If the agreement is being completed by more than one person for advisory services, make sure that each client initials for specific terms and signs the signature page. To avoid initialing ambiguity, unselected terms can be marked with a dash (---) or as "Not applicable" to prevent future unauthorized alteration.

Custody Notes – Beneficial Trusts

Many investment advisers have clients who are family members. If they choose to use trusts in their estate plans, they may request that you serve as trustee and manage the trust's assets. This can trigger custody, safekeeping or net-worth requirements under Wisconsin's securities laws and rules. However, **DFI Sec. 5.035(2)(e)** reduces some of those requirements for an investment adviser who has custody solely as the result of their appointment as trustee for a beneficial trust, if all of the following conditions are met:

1. The beneficial owner of the trust must be a parent, grandparent, spouse, sibling, child, or grandchild of the adviser. These relationships include "step" relationships.
2. The adviser must provide a written statement to each beneficial owner of the beneficial trust account with a description of the custody requirements for investment advisers under **DFI 5.035(1),** and detail why the adviser will not be complying with those requirements.
3. The adviser will need to collect a signed and dated acknowledgement of receipt of the statement from each beneficial owner, and maintain copies as part of the firm's books and records until the beneficial trust account is closed or the adviser is no longer the trustee.

Estate planning can be a complex area of law – consult an attorney with any specific questions you may have about trusts' legal and financial implications.

Best Practices for Client Email Correspondence

Most of us use email on a regular basis to quickly communicate with colleagues, friends, family, and service providers. Email is also considered a correspondence record that investment advisers need to retain for five years, with the first two in an easily accessible place, per **DFI Sec. 5.03(1)(g).** Having effective retention procedures in place for your firm is a necessity, and so is making sure your client consents to receiving electronic communications from you.

Consider some of the following tips on best practices for using email with clients:

1. Get your client's consent in writing to receive emails concerning investments and advisory services. Identify what kinds of information and records will be transmitted via email and the client's designated email address. Verify that it is accurate - a single typo could send highly sensitive personal information to a complete stranger.
2. Perform your due diligence on how to protect contents of the email. Is your email platform capable of encryption? You can also consider agreeing on a password in the consent agreement for protecting documents via their security settings. Select a strong

password including letters, numbers, and symbols. Avoid beginning with a capitalized letter and placing the numbers or symbols at the end, as sophisticated cyber criminals can exploit this sequence pattern.

3. Client email accounts are more frequently being hacked or compromised. Don't accept any instructions via email to transfer funds to a third party without confirming the transaction with the client via phone or prior express authorization.
4. When retaining your emails as correspondence records, keep them organized. Getting into the habit of archiving emails in an efficient and streamlined manner now will mean a smoother examination process in the future.

As a reminder, written correspondence is a large umbrella that can include forms of messaging you might not have thought about. If you are conversing with clients through a social media platform, text messages, or an instant messenger, consider how you will retain that record before hitting "Send."

The Fiduciary Standard – More Than Just "You Before Me"

The fiduciary standard has been in the news lately, as lawmakers, regulators, and the financial industry grapple with which standards and definitions should apply to different professionals. Most often summarized as the duty to "put the client's best interest first," the fiduciary duty is more complex than most people think, and is made of several distinct duties owed by the adviser to the client. Are you familiar with the following duties owed to clients of an investment adviser?

Duty of Loyalty – This is the most widely cited aspect of the fiduciary duty. It includes acting in the client's best interest and putting it ahead of the adviser's own interest, avoiding conflicts of interest that could compromise the adviser's loyalty, not using clients' assets to benefit the adviser (soft dollars), and not engaging in self-dealing, where the adviser is a principal in a securities transaction with the client.

Duty of Care - The adviser demonstrates "due care" by acting as a reasonable or prudent person would. As an example, here are some areas where the due care standard is implemented:

Avoid misleading clients – The adviser's Form ADV Part 2 needs to be written in plain English, accurately describe the adviser's business practices, and be updated and offered in writing to clients on an annual basis. Is your ADV Part 2 easily readable and understandable to the layperson? Does it actually reflect your business?

Obtain a reasonable basis for investment advice – The adviser needs to maintain client files with written information detailing each client's net worth, annual income, other financial information, investment objectives and experience, and any other information required to determine the client's suitability and risk tolerance per **DFI Sec. 5.03(2)(c)**. The adviser should also conduct due diligence on the securities he or she recommends.

Seek best execution and control investment expenses passed on to clients - New and seasoned advisers alike should periodically evaluate the services and fees of their preferred broker-dealer for securities transactions to ensure that clients would not enjoy the same or better services from another broker-dealer with lower fees.

Emerging Issue - As the Baby Boomer population begins to age, advisers are more frequently encountering the need to consider the mental competence of their clients. Putting a plan in place which includes provisions for cognitive decline affecting financial decision-making is one way an adviser can help clients keep their assets safe.

Duty of Obedience - Advisers should adhere to the governing documents of their relationship with the client, such as the investment advisory contract. It is important that the advisory contract accurately reflect the services being provided, the fee(s) to be charged and payment schedule, and other material provisions. Advisers should follow client's instructions and guidelines on which investments are permissible, directions to execute trades with a particular brokers, and other account handling matters.

Good Faith – Advisers must act in utmost good faith and candor with clients, treating each fairly and avoiding favoritism. If clients sign the same agreement to be provided the same services, the amount of assets under management should not prioritize one over the other. For advisers with negotiable fees, any difference between the fees negotiated for two similar clients should be small.

Duty of Disclosure – Advisers should disclose all material facts to their clients to avoid misleading them with partial truths, exaggerations, and unwarranted claims. A material fact is any information a reasonable investor would want to know in order to make a decision. The ADV Part 2 covers basic disclosure areas for the investment adviser and its representatives in regards to current and prospective clients. You should ensure that yours is disclosing all of the necessary items by following the rules on reporting requirements under **DFI Sec. 5.04** and **5.05(8)(f)**.

If you have questions about whether something needs to be disclosed, please do not hesitate to contact the Division's Examiner of the Day hotline at 608-266-2139.

Is Your ADV Up to Date?

Each firm must file an updated Form ADV Parts 1 and 2 through the IARD system within 90 days of the end of its fiscal year (many firms' fiscal years end in December – if yours does, this means you should be filing your annual amendment no later than March 31 each year) under **DFI Sec. 5.04(3)(b)**. At minimum, the cover page date, number of clients, and assets under management should be updated, but you should also use this opportunity make sure the firm's actual business practices are accurately reflected to clients in the Form ADV Part 2.

If there is a material change in the information included on the firm's most recent application for registration, an amendment should be filed within 30 days of the change to comply with **DFI Sec. 5.04(3)(a)**. Additionally, if information on an investment adviser representative's Form U-4 needs to be updated due to a material change, the amendment must be made within 30 days of the event, as required by **DFI Sec. 5.04(3)(c)**. If a firm's ADV 2 or additional supplements (such a Part 2 B brochure) are amended to correct information which has become materially inaccurate, **DFI Sec. 5.05(8)(f)** requires the updated copies to be delivered to clients within 30 days of the material change or event.

Registered Individuals Can Access Their Own CRD Snapshot Online

Effective September 25, 2014, individuals who are or have been registered as broker-dealer agents or investment adviser representatives may access their own registration and licensing information by obtaining a "Snapshot" report through FINRA's website. A "Snapshot" report contains information reported on a person's record via Forms U4, U5, and U6. This reporting is more comprehensive than what is publicly available on FINRA's BrokerCheck and the SEC's Investment Adviser Public Disclosure (IAPD) systems. Prior to this release, individuals were able to access Snapshot reports only via written request to FINRA or state regulators. FINRA now provides a secure mechanism for individuals to obtain this information by completing a few simple steps online.

Click on the following link for more details:

http://www.finra.org/industry/compliance/registration/crd/p011120.

Contact an Examiner

If you have questions relating to professional registration and/or compliance, please feel free to contact our Examiner of the Day phone line at (608) 266-2139.

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