Wisconsin Department of Financial Institutions

Fall 2020
Division of Securities

DOS Investment Adviser Newsletter

Division's Remote Work Continues

Since last March, the Division has continued to work remotely, processing applications, conducting exams and conducting investigations in much the same manner as usual except with the extensive use of virtual meetings and other electronic communications. We expect that most of our state-registered investment advisers are experiencing some of the same recent changes in how they conduct business and interact with clients.

If you've experienced a remote exam since last March, you will have noticed that we collect as many documents as possible in advance and ask that you upload them to a secure website in a folder that the examiner creates specifically for your firm. On the day of the exam, the interview is conducted by phone or via Skype. Asset verification is conducted either by you sharing your screen or by us communicating directly with your custodian.

With more advisers working from home, we've recently addressed questions regarding the registration of branch offices. In Wisconsin, a branch office of an investment adviser is a location other than the main office of the adviser that is held out to the public by any means as a place where advisory business is conducted. Additional information regarding branch offices may be found here.

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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.

Remote Work Continued...

Currently, we are not looking for branch registration of temporary locations until they are determined to be permanent and are in addition to the main advisory office which does not require registration. If you have questions regarding whether you may need to register a location, please feel free to reach out to us.

As usual, we can be reached by phone or email during business hours. Our general email address is DFISecurities@wisconsin.gov and as always, you may contact the Examiner of the Day phone line at (608) 266-2139. The examiners can also be reached at their individual phone numbers and email addresses. If you need to reach a Securities division in another state, you may find the following NASAA webpage helpful: https://www.nasaa.org/contact-your-regulator/

You may also be interested in NASAA's Annual Report on State-Registered Investment Advisers, which can be found here. The 2020 Annual Report from NASAA's Investment Adviser Section provides a statistical snapshot of the state-registered investment adviser industry and the related regulatory activities of state securities regulators. Highlights of this year's report include an updated profile of state-registered investment advisers and a discussion of updates to NASAA's cybersecurity checklist.

In Remembrance of Mark Eisenmann

It is with great sadness that the Division of Securities is sharing the news that Mark Eisenmann passed away in late August after a courageous battle with a long term illness.

Mark joined the Professional Registration & Compliance Bureau in 2007 as a securities examiner and while conducting many exams during the next dozen years, became well known to our state-registered investment advisers who found that he was always readily available to listen and discuss matters brought to his attention. Mark was instrumental in leading and mentoring our examiner staff prior to his retirement last August 2019. Well-respected as a friend and colleague, he is deeply missed.

Mark's obituary can be found here.

Should I File Form CRS?

In June 2019, the Securities and Exchange Commission (SEC) adopted the Form CRS (Client Relationship Summary), also known as ADV Part 3. The SEC also adopted new rules and amendments to its forms and rules, under both the Investment Advisers Act of 1940 ("Advisers Act") and the Securities Exchange Act of 1934 ("Exchange Act").[2]

The purpose of Form CRS, which is limited to a length of 4 pages, is to provide certain information about the firm to retail investors. SEC-registered investment advisers and broker-dealers were required to begin using Form CRS by June 30, 2020, and to file it with the SEC. More information on Form CRS can be found here.

As the June 30th due date approached, Division of Securities examiners began receiving questions about whether state-registered investment advisers must also file Form CRS. States have taken different positions regarding whether they require the form but currently, most do not.

The Division does not require Form CRS when applying for or renewing state investment advisor registrations. If an investment adviser elects to voluntarily file Form CRS, there isn't an option for state-registered investment advisers to submit ADV Part 3 to IARD; however, Form CRS can be uploaded to IARD along with Part 2 of the ADV.

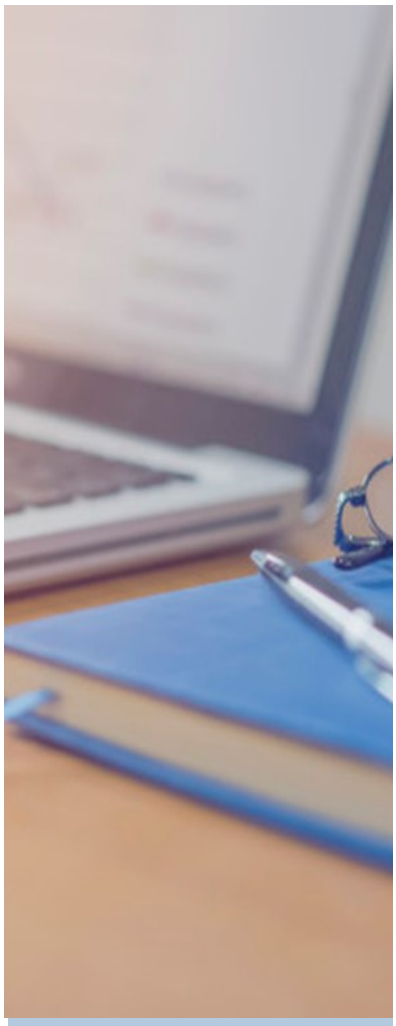
Cybersecurity Risks Continue

Many investment advisers have been increasingly leveraging technology for their business systems and to communicate with clients and business partners. Securities regulators at the state and federal level, as well as FINRA, have placed high importance on keeping data safe from digital attacks. This article will identify some cybersecurity attacks and provide tips to safeguard your business from external threats.

Ransomware is an attack where a hacker encrypts a victim's files, then demands a ransom from the victim in order to restore access to data. Ransomware is commonly delivered through a phishing attempt, where email attachments are disguised as trustworthy files. Once the files are downloaded and opened, they can take over a victim's computer and install the malicious software. The user is presented with a message explaining their files are now inaccessible and can be decrypted by sending a cryptocurrency payment to the attacker.

In another form of malware, the attacker might claim to be a law enforcement agency shutting down the computer due to the alleged presence of pirated software. The attacker will demand the payment of a "fine" in order to unlock the computer.

While it may seem unlikely that ransomware or malware attacks would target small investment advisers, attackers might view small businesses as good targets due to a matter of opportunity. Therefore, keeping your operating system patched and up-to-date is a first step in ensuring you have fewer vulnerabilities to exploit. Never install software or give away administrative privileges unless you know exactly what it is and what it does. Installing antivirus software can detect malicious software as they arrive and prevent unauthorized applications from executing. Practicing regular file backups is a way to lessen the disruption of a ransomware/malware attack. Of course, never share your passwords with anyone else.



NASAA COVID-19 Enforcement Task Force Updates

Last April 2020, the North American Securities Administrators Association (NASAA) formed a task force with the objective of identifying COVID-19 related scams targeting investors. The task force is being led by NASAA's Enforcement Section which consists of securities regulators from various states. Examiners from the Wisconsin Division of Securities Enforcement Bureau have joined the task force's efforts.

The task force primarily utilizes online investigative techniques to identify fraudulent offerings and unregistered advisory activity. By August 19, 2020, the task force had initiated actions to disrupt 220 schemes that were seeking to fraudulently profit from the pandemic.

Fraudulent activity tends to increase during times of crisis as criminals seek to take advantage of panicked investors and the newly unemployed. Fraudsters claim to have access to a once in a lifetime opportunity to invest in a cure, or they simply conduct phishing scams to intercept an unemployed person's aid money. NASAA focuses on investment related schemes that prey on investors' fears. Many schemes involve investment products that are unfamiliar to retail investors, such as cryptocurrencies, foreign currencies, and penny stocks.

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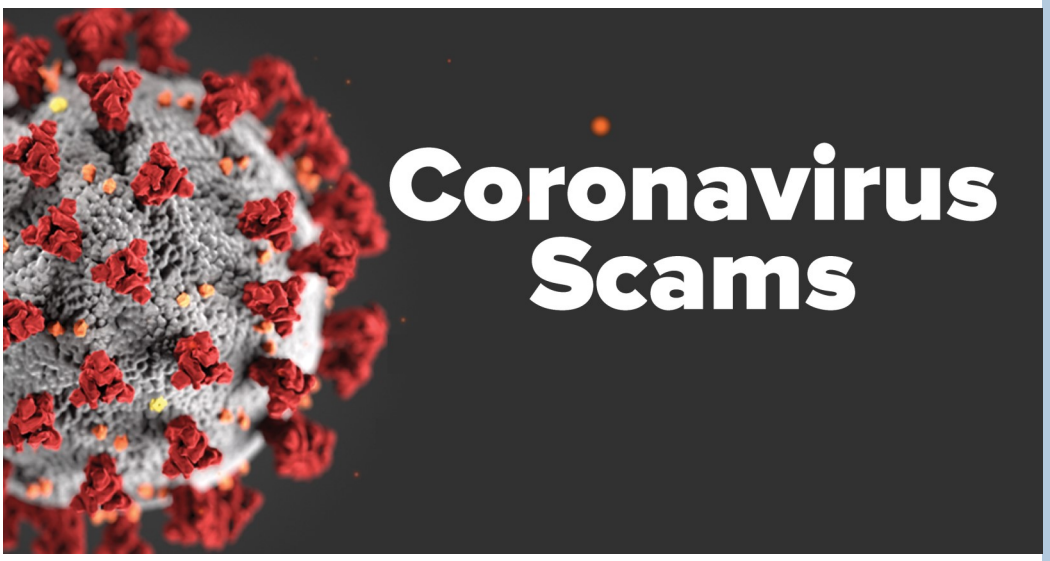
In one case, a cease and desist order was issued by the State of Alabama against an online entity called CORONAFEVERINVEST that purported to offer a trading algorithm that could protect against downturns in the markets.

NASAA COVID-19 Enforcement Task Force Updates Continued...

The website claimed that the algorithm had an "accurate analysis rate of over 99.4%" via trading cryptocurrencies. A similar scheme, "Corona Millionaire" and "Corona Billionaire" was ordered to cease and desist by the State of Ohio. The schemes were also offering victims an algorithm with "up to 83% accurate predictions".

Wisconsin's own Enforcement Bureau filed a cease and desist order against an individual who was allegedly posting online advertisements soliciting investors to invest in penny stocks related to Coronavirus. He offered to trade the securities directly in clients' accounts and split the profits with them, and offered to sell his trading strategy for $200.

NASAA provides a webpage that describes common investment related schemes. With criminal activity increasing, it is a good time for investors and their advisers to visit the page to familiarize themselves with red flags associated with investment schemes.



Financial Professionals with Diminished Capacity

The North American Securities Administrators Association (NASAA) has done extensive work on issues related to senior clients with diminished capacity. But what about diminished capacity and cognitive impairment that may affect financial professionals? NASAA recently released a report that examines how these issues may affect financial professionals.

NASAA established a working group that sought to appreciate the scope of the concerns presented by financial professionals with diminished capacity, to identify impediments to addressing the challenges of financial professionals with diminished capacity, and to provide guidance and identify possible tools and resources to the industry.

The report was based on discussions between state securities regulators with broker-dealers, investment advisers and compliance consultants to understand how the industry handles these types of issues.

The NASAA working group was interested in understanding:

- how firms identify representatives with a suspected cognitive impairment;
- challenges firms experience that prevent firms from addressing employees exhibiting symptoms of cognitive impairment or diminished capacity;
- practices or tools the firms use to address financial professionals with cognitive impairment or diminished capacity; and
- what role, if any, securities regulators may have in assisting firms with addressing financial professionals with cognitive impairment or diminished capacity.

Financial Professionals with Diminished Capacity Continued...

The report includes discussion of compliance issues, data to determine the scope of the problem and challenges for firms. In addition, the report describes how firms learned of problems, including red flags identified by the firms. The report further describes tools and practices firms use to address situations where financial professionals show signs of diminished capacity or cognitive impairment.

The working group identified the following areas for firms to consider in the context of potential cognitive impairment and the report goes into further detail in each area:

- Risk assessment
- Supervision
- Training
- Succession planning

Addressing financial professionals with diminished capacity or cognitive impairment is typically not a comfortable conversation to initiate and of course, requires sensitivity and respectfulness. However, through communication, succession planning, education and training, firms can support financial professionals to transition out of the business while protecting investors. Click here to view NASAA's full report.

Adviser Liability from Risky Alternative Investments

Investment adviser representatives have a fiduciary duty to keep the best interests of their clients front and center. This duty is wide ranging and can take many shapes throughout an engagement with a client. At account set up, it means not charging an unreasonable fee for the services provided. When building a portfolio, it means finding products that meet the specific suitability requirements of the client. When a client has a complaint, being a fiduciary means the representative takes the complaint seriously and does what is appropriate to rectify the situation.

Market volatility and continuing low interest rates can create an environment where investment adviser representatives may suggest that their clients invest in alternative investments or private placements because they appear to have appealing rates of potential investment return. By and large, clients are not pressuring advisers to sell their blue chip stocks to buy alternative arrangements such as future pension income streams. Clients do not approach their investment professionals to extoll the virtues of a Woodbridge-type Ponzi scheme!

And yet, the Division has seen registered investment adviser representatives continue to persuade clients to invest in risky, illiquid, and often fraudulent investments. If ever considering an alternative investment, advisers should conduct extensive due diligence and be on the watch for investments that are unregistered securities being sold in violation of the Wisconsin Uniform Securities Law. Do not rely on third parties who assure you that the investment is not a "security" subject to securities regulation.

While the fiduciary duty can at times feel like a vague concept, the Division enforces compliance with a range of concrete state statutes and administrative rules. The following are a sample of the administrative rules that the Division could cite when advisers put their own financial gain ahead of their clients' best interests:

DFI-Sec 5.03(2)(c) pertains to documenting the suitability of the investment for the client. Every recommendation, regardless of the type of investment, needs to be backed up and documented.

Advisor Liability from Risky Alternative Investments Continued...

DFI-Sec 5.06(4) further expands on an adviser's suitability requirements. When advisers are unable to fully explain how an investment meets the client's goals, risk tolerance, and time horizon, red flags are raised.

DFI-Sec 5.06(16) prohibits advisers from failing to disclose all material conflicts of interest, including those relating to compensation. In the Division's experience, alternative or unregistered investments are not sold to clients to further altruistic intentions. Rather, they may be sold to receive inflated compensation above what is available through standard products and advice or to encourage a client to take a risk that is not suitable for their circumstances.

Lastly, DFI-Sec 5.06(20) states the following as "prohibited conduct":

> Making, in the solicitation of clients, any untrue statement of a material fact, or omitting to state a material fact necessary in order to make the statement made, in light of the circumstances under which they are made, not misleading.

The Division understands that clients can have unreasonable expectations for investment returns. However, alternative or unregistered investments such as private placements are often not the solution, and it is up to the investment adviser to prevent clients from making risky, illiquid, and unsuitable investments. Without proper due diligence, disclosure, and documentation, advisers can be setting themselves up for future litigation or regulatory actions.

After the invested money is gone and a complaint has been filed, the Division will interview clients. In those interviews, it is not uncommon to hear from the client that, "If I would have known that, there's no way I would have invested." Failing to identify, disclose and explain risk factors, compensation arrangements, or any other material fact results in liability on the part of the investment adviser.

Are Paycheck Protection Program Loans Disclosable?

The Paycheck Protection Program (PPP) was enacted in April of 2020 as a part of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). The program ended on August 8, 2020. By that date, more than five million loans had been issued across the nation, totaling $525,012,201,124. The average loan size is $100,729. In Wisconsin, more than 77,000 loans were issued, totaling just over $2.5 billion of credit.

If you have accepted a PPP loan, you may be required to disclose that fact in your ADV 2A to your clients. Guidance issued by the SEC states that if the loan is material to your financial condition, you would need to disclose the loan to your clients. In determining materiality, you should consider whether the loan is necessary to maintain your business as a going concern, including but not limited to paying compensation, necessary overhead expenses, and other services needed to run your advisory business.

The Division of Securities has informally adopted the SEC's guidance and in response to inquiries, has recently asked advisers to determine whether the PPP loan they received is material to their financial condition. If the loan is deemed to be material, then it must be disclosed in Item 18 of the ADV 2A.

If you have any questions about determining the materiality of your PPP loan, please contact carlo.reiter@dfi.wisconsin.gov.

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.