



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

Investment Adviser Newsletter

Fall 2015

This is the seventh regular edition of our periodic newsletter from the Wisconsin Division of Securities to investment advisers registered in our state. Past editions can be found at:

http://wdfi.org/fi/securities/whats_new.htm

Watch for Renewal Season

As we enjoy the beginning of Fall and anticipate year-end, we are reminded that it will soon be time to renew your firm and individual registrations through IARD (Investment Adviser Registration Depository). Your renewal statement will be available on IARD beginning on November 16th. Renewal payments for firm, individual, and branch registrations are due on December 18th. We will be sending a separate email reminder regarding the process for 2016 registration renewals. In the meantime, here is a link to the 2016 Renewal Program Calendar: <http://www.finra.org/sites/default/files/crd-renewal-program-calendar.pdf>. If you have questions regarding your renewal process or status, please feel free to contact our Examiner of the Day phone line at (608) 266-2139.

Reporting Outside Business Activities for IA Reps

If an outside business activity takes up a substantial amount of an investment adviser representative's time or provides a substantial source of income, this must be described in Item 4 "Other Business Activities" of Form ADV Part 2B. Generally speaking, any outside business activity representing more than 10 percent of a person's time or income is considered substantial. This includes investment-related businesses and non-investment-related businesses. For example, time spent as a board member of an organization should be disclosed if that activity takes up a substantial amount of an investment adviser representative's time, even if there isn't any direct compensation.

If an investment adviser representative is actively engaged in any *investment-related* business or occupation, they must also disclose this fact in Item 4 "Other Business Activities" of Form ADV Part 2B. They must also disclose the business relationship, if any, between the

advisory business and the outside business activity. If the relationship causes a material conflict of interest with clients, the nature of the conflict shall be described and addressed.

A material conflict of interest is a situation in which a person has a private or personal interest sufficient to appear to influence the objective exercise of his or her official duties as a professional. The firm should explain why this poses a conflict of interest and what steps the firm takes to mitigate the conflict from affecting the representative's service to clients.

If the investment adviser representative receives any commissions, bonuses, mutual fund trails, or other compensation from the sale of securities with an outside business activity, this compensation shall be disclosed. Compensation that is not cash must also be explained. This practice could give the investment adviser representative incentive to recommend investment products based on the compensation received, rather than the client's needs.

When in doubt, it is better to be cautious and disclose an outside business activity rather than not disclose it.

Errors and Omissions Insurance for Investment Advisers

Error and omissions ("E&O") insurance may cover your firm for a wrongful act, error, omission, or alleged breach of fiduciary duty in rendering investment advisory services to a client. While E&O insurance is not required by the Division, consider whether you and your firm would be able to absorb the legal fees and potential settlement of a significant client claim or lawsuit. If you don't have a policy in place, you may want to consider whether this type of coverage is available and appropriate for you. If you have E&O coverage, you should periodically ensure that the policy terms and coverage are a good fit for your business.

Some insurance companies allow you to buy direct, but you may benefit from consulting with an insurance broker who is familiar with the E&O industry and can make recommendations on policy features that best fit your firm. You can ask your custodian or other advisers for references or recommendations on E&O insurance providers or brokers. [You can also check the registration status of an agency and individual agent in Wisconsin by going to the Office of the Commissioner of Insurance's ("OCI") website at www.oci.wi.gov, clicking the Agent/Agency tab, and selecting Agent/Agency Look Up.]

An investment adviser can save money on E&O coverage by joining a master policy, which combines multiple firms under one policy, instead of buying an individual policy. Generally, these policies will have a total master policy annual coverage limit. If the coverage limit is reached, other firms in the pool may not have access to protection until the next term. Investment advisers considering using a master policy should conduct in depth due diligence to

ensure they understand whether the policy is for the individual firm or for a group of firms sharing the risk and costs of coverage.

Like most other forms of insurance, more complex and comprehensive coverage generally means a higher premium. The premium may also be higher for advisers using alternative investments, who have past regulatory disclosure issues, or have less securities industry experience. There are a wide range of coverage limits, such as separate limits for an “alleged” act, aggregate acts, or for the overall master policy. Make sure you understand what coverage you’ll be receiving, or if different events will trigger different levels of coverage. Opting for a lower deductible (the amount of money you pay out of pocket before the insurance kicks in) usually means a higher annual premium cost.

How much coverage you need will depend on several factors, including but not limited to:

- The risks associated with the products and services the firm offers
- The amount of assets under management
- How much you can absorb from a loss perspective
- Your historical experience with lawsuits or claims

Make sure the policy covers your specific business activities, know the limits of liability for each claim, as well as your annual aggregate, and total aggregate for all the investment adviser representatives or other firms (if a master policy) in the program. Most professional liability insurance plans have a list of exclusions for circumstances the policy does not cover. Review the full list of exclusions when comparing plans to see what differences may exist and don’t be afraid to ask for clarification on the exclusion terms.

Two important features in an E&O policy are retroactive coverage and an extended reporting period. “Retroactive” coverage means you’ll be protect going back to your first continuous period of E&O insurance coverage. The “extended reporting period” covers you (and your heirs) after you retire, change careers, or pass away, for errors and omissions made while you were working.

Just like the circumstances and needs that change your clients’ suitability profile over time, E&O insurance isn’t something to buy and forget about until you suddenly need to check the coverage. Each year, revisit your circumstances to make sure the policy is still appropriate for your firm. For instance, if you add a product or investment strategy, it could mean you need additional coverage for the associated risks.

After you’ve purchased an E&O insurance policy, you should also proactively defend against having to file a future claim against the policy. Recommit your firm and its employees to high standards of ethics and make sure your firm is well-managed – a comprehensive code of ethics and written supervisory procedures that are actively implemented and periodically updated will create a compliance environment that reduces the likelihood of future claims made by clients.

Wisconsin's Rules for Common Deficiencies Reported by NASAA

The Division's Special Edition Investment Adviser Newsletter published in early October reported on the most common examination deficiencies encountered by states securities examiners across the United States. Below is a quick reference guide to Wisconsin's rules and regulations for those common deficiencies.

- Books and records deficiencies: Not maintaining client suitability information or not having all contracts in writing.
 - Wisconsin securities examiners are finding that firms are not maintaining written client suitability information. Firms need to maintain written client suitability information that is routinely reviewed and up to date. See [DFI Sec. 5.03\(2\)](#).
 - All contracts must be in writing and signed by all parties. Make sure any areas requiring the clients' initials are completed. See [DFI Sec. 5.05\(5\)](#).
 - For other books and records requirements, see [DFI Sec. 5.03](#).

- Contract deficiencies: Fees are not explained.
 - All fees to be charged by the adviser and the formula for computing the fee must be adequately explained in the contract. If fees are charged in advance, a formula for the refund of prepaid fees (for cases where the contract is terminated mid-billing cycle, or for non-performance) must also be included. See [DFI Sec. 5.05\(2\)\(d\)](#).
 - For other important contract requirements, see [DFI Sec. 5.05](#).

- Registration deficiencies: Inconsistencies between Form ADV Part 1 and Part 2.
 - The firm's Form ADV must be reviewed and updated annually with the investment adviser registration depository within 90 days of the end of the firm's fiscal year. See [DFI Sec. 5.04\(3\)\(a\)](#).
 - Each year, the adviser must furnish or offer in writing to furnish to each of its clients the firm's current brochure and any supplements. See [DFI Sec. 5.05\(8\)\(c\)](#).
 - An amended Form ADV must be filed when there are any material changes in the information. See [DFI Sec. 5.04\(3\)\(b\)](#).
 - When reviewing Form ADV, look for and correct any inconsistencies between Part 1 and Part 2.
 - For other registration requirements, see [DFI Sec. 5.01](#) and [DFI Sec. 5.07](#).

- Fee deficiencies: The fees being charged do not match the contract or Form ADV.
 - Fees outlined in the investment advisory contracts must match the fees reported on Form ADV.
 - Accurately calculate the fee charged to the client according to the fee agreed to in the client's written contract. Even if you negotiate and charge a lower fee with the client than the fee listed in the executed contract, the lower fee should be memorialized in writing and kept in the client's file. See [DFI Sec. 5.05\(2\)\(d\)](#)

- Custody deficiencies: Improper client invoicing for direct fee deduction.
 - Advisers who have fees directly deducted from client accounts held with a qualified custodian must obtain written authorization from the client.
 - Each time a fee is directly deducted from a client account, the adviser shall concurrently send the custodian notice of the amount of the fee to be deducted from the client's account and send the client an itemized invoice summarizing the fee.
 - Itemization on the invoice must include 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. See [DFI Sec. 5.035\(1\)\(f\)](#).

- Written supervisory procedures deficiencies: Not having adequate written supervisory procedures.
 - Another common deficiency found by Wisconsin securities examiners is that firms have not established written supervisory procedures, or the existing procedures are outdated and not being implemented by the firm. Each investment adviser shall establish written supervisory procedures relevant to the type of business, which may reasonably be expected to prevent and detect any violations of Wisconsin's statutes and rules. The procedures should also include a business continuity plan. See [DFI Sec. 5.05\(1\)](#).
 - The Division of Securities can provide firms with a checklist of items for establishing supervisory procedures. To request the checklist, contact the Division by calling the Examiner of the Day line at (608)266-2139.

To view the NASAA report, go to <http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2015/09/2015-IA-Coordinated-Examinations-Report.pdf>

Cybersecurity: What Questions to Expect on your Next Exam

Cybersecurity is top of mind across the investment advisory industry and it's no wonder why. With frequent attacks occurring nationally, smaller investment adviser firms may wonder what can be done to protect their clients and business. [A 2014 survey](#) conducted by NASAA reported that 55% of firms had no policies and procedures or training programs in place to address cybersecurity. While it's the hacking of larger companies' data that often makes the news, smaller businesses with less protection offer "low hanging fruit" for cybercriminals.

To gain more information from firms regarding cybersecurity practices, state regulators have begun to ask a series of cybersecurity questions during routine exams. Here is a sample of questions you can expect DFI Examiners to ask on your firm's next exam:

1. In the past 12 months has your firm or any employee experienced a cyber-attack?
2. How does your firm monitor its network for cyber-attack?
3. Is antivirus software installed and regularly updated on all electronic devices used to interact with clients?
4. Are strong passwords regularly changed across all electronic devices used to interact with clients?
5. Does the firm utilize encryption on devices and client files?
6. What policies and procedures does the firm have in place to address cybersecurity?
7. How does the firm stay up to date on cybersecurity issues?

These questions serve to start an important conversation with firms about security issues that cannot afford to go unaddressed. Cybersecurity practices have also been discussed in our Fall 2014 and Spring 2015 newsletters – you can find them on the [Division's website](#) under What's New.

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