


## SEC guidance on cybersecurity doesn't target RIAs but reminds of risks






Last month the SEC's Corporation Finance division urged public companies to consider the risk of a cyber attack and to disclose those risks to investors. While the SEC's [new guidance](#)  doesn't apply to advisory firms, it should prompt them to revisit the risks to the business and clients should sensitive data fall into the hands of an evil hacker.


The new guidance sends "a clear signal that this is an area that interests the SEC," says **John Reed Stark**, managing director/deputy GC with **Stroz Friedberg** in Washington. **Ben Powell**, a partner with **WilmerHale** in Washington, agrees and recommends firms ponder adding generic disclosure – so as not to provide "a road-map" to a potential Internet infiltrator.

The SEC's guidance recognizes there's "no existing disclosure requirement" referring to "cybersecurity risks and cyber incidents, [but] a number of disclosure requirements may impose an obligation on registrants to disclose such risks and incidents."

Use the guidance as an excuse to review "your whole approach to any cyber-related incident," suggests Stark. Is your IT staff up to the challenge? How would you respond? Would your recordkeeping prove adequate? Stark wouldn't be surprised if the issue of cybersecurity seeps into OCIE exams. *(Cybersecurity, continued on page 6)*

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## Benchmarks for IA compliance: Times challenge CCOs, heighten status


As the shockwaves from Dodd-Frank regulatory reforms settle, the reality steadies into increased compliance responsibilities that tax many firms yet also tend, at least for some, to bring a sense of exhilaration and greater status.


That's one of the themes emerging from **IA Watch**'s recent state-of-the-industry survey, which drew nearly 120 responses (see the table on page 3). The data show that 46% of respondents reported that they're wearing more hats than ever; 37% say they're "excited about my job and all of the challenges" and 26% indicate they're very professionally satisfied at this time.

Some may agree with the peer who wrote "too much regulation, too few resources, too little respect," while others would side with the CCO/GC who stated that "although the challenges are growing, and can be overwhelming, there's never been a better time to be a compliance officer. It's a growing field demanding more" *(RIA Benchmarks, continued on page 2)*

## Bigger firms plow into social media with vigor, displaying lessons for all RIAs

No corner of the web escapes **Vanguard**, the nation's largest advisory firm with \$1.4T in AUM. Its parent company's [Facebook page](#)  announces a new app for trading stocks and ETFs. A video on its [YouTube channel](#)  stars hip, young adults urging their peers to invest for the long haul. A [Twitter](#)  post posits that a downward economic forecast actually can be good news. And a **LinkedIn** message notes "Vanguard is the client-owned investment company that is reducing cost and complexity for all investors."

While some RIAs hop on social media like a downtown bus and others steer clear believing the SEC hasn't yet given its blessing ([IA Watch](#) , July 11, 2011), some of the largest financial firms are pioneering its use.

Nearly 30,000 people "like" **Fidelity's Facebook page** , which features a smiling father sprawled on the grass under a cloudless day, holding his baby in the air while mom looks on. The copy reads "we'd like to be part of"

*(Social Giants, continued on page 3)*

**RIA Benchmarks** (Continued from page 1)  
recognition as a professional career.”

### The state of the job

Only 8% of our survey respondents reported they feel exhausted and underpaid. A mere 1% indicated they will be leaving their job; 9% stated they would soon be looking for a new job, and only 5% wish to leave compliance altogether for another profession.

Consider the words of one CCO/GC at a large RIA: “Giving the CCO a larger role in risk [management] enhances [the] CCO’s value and makes one’s job more interesting. It also brings increased positive interaction with senior management.”

But the new regulations aggravate many. A compliance officer at a firm that manages more than \$10B in assets lamented “too much burdensome regulation. SEC and Congress have overreacted to the 2008 financial industry problems and the Madoff scandal.”

Another decried that “the tsunami that is Dodd-Frank makes it difficult” to plan. A third exhorted that she hoped “FINRA will not be our SRO!” Another compliance officer, her firm bound for state registration, questioned the wisdom of “the Switch,” opining that strapped state budgets make the SEC look wealthy.

### New regulations spurred few additions

The data reveal that 25% of respondents added compliance staff in 2011, while the bulk (65%) made no staffing changes in response to the onslaught of new regulations. Only 1% of firms cut compliance staff this year, and 6% outsourced all or more of their program.

In some cases, firms restructured their compliance departments or removed extra hats so the CCO could concentrate on compliance only. One CCO at a firm with

AUM between \$1B-\$10B noted in the past year that he has spent more money on consultants, conferences and webinars than in recent years.

### Trends with compliance budgets

Many firms don’t have a compliance line-item in their budgets, as indicated by nearly 70% of survey respondents. They would no doubt envy the president/CEO who answered that his firm spends “on whatever we wish.”

Most (67%) firms expect their 2012 compliance budget to be the same as in 2011. Nearly one-third of survey respondents haven’t yet decided what their 2012 compliance budget will be.

Of those with 2012 budgets established, 19% report an increase over 2011 and 4% a reduction. A deeper analysis shows these percentage of firms, by asset size, that expect an increase in their compliance budget in 2012:

- ✓ 25% of firms managing \$101M-\$500M in assets
- ✓ 13% of firms with \$501M-\$1B
- ✓ 27% of firms with \$1B-\$10B
- ✓ 42% of firms with \$10B+ AUM

Of those expecting a decrease in their compliance budget, the cuts ranged from 10%-20%. For those predicting a higher budget next year, the increases ranged from 5%-15%, producing an average increase of 9% and a median hike of 10%.

### Dodd-Frank behind the wheel

The regulations arising out of Dodd-Frank drive the changes in compliance, as attested to by 86% of respondents. Other triggers cited included the need to prepare for an upcoming SEC exam and the greater use of derivatives and complex products by portfolio managers.

*(RIA Benchmarks, continued on page 3)*

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## RIA Benchmarks (Continued from page 2)

Business is good for 40% of firms that reported revenues and staffing are growing. Another 13% indicated the opposite.

“Compliance staff is scrambling to ensure procedures and systems are adequate to meet all new rule requirements as well as to continue to monitor, test and improve the existing compliance program. It’s a challenge to be sure,” summed up a CCO at a billion-dollar firm.

As another compliance officer put it, this is an “extremely interesting time to be involved in the compliance field. Many things changing, some for the better, some not, but it is interesting to see how it all evolves and attempt to stay current and compliant.” ■

## Appeals court verdict sides with industry in ARS disclosure case

Count another win for the industry in a disclosure case, this time from the 2<sup>nd</sup> U.S. Court of Appeals in New York. Earlier this month the judges sided with **Merrill Lynch** and against an investor who had purchased \$125,000 worth of auction rate securities (ARS), even rejecting the SEC’s argument – which the judges had solicited.

**Colin Wilson** had the misfortune to buy the ARS via **E\*Trade** in 2007, months before the market’s collapse locked up future auctions. “He continues to hold most of these securities, which are now illiquid,” wrote Judge **Robert Katzmann** for the court.

The [decision](#) concludes that Merrill engaged in adequate disclosure, citing the prospectus for the ARS Wilson purchased and even an SEC enforcement settlement with firms, including Merrill, after the market tanked. The SEC action took issue with disclosures that ARS were safe and highly liquid investments. The agency ordered Merrill to repurchase the securities from some customers.

To aid its deliberation, the court invited the SEC to file an [amicus brief](#), which it did. While

acknowledging the need to give “at least some deference” to the agency’s view that Merrill’s disclosures were inadequate because of its “expertise and accountability,” the judges snubbed the agency’s contention that the “disclosures ... did not inform the market that, as alleged, market liquidity was entirely dependent on Merrill’s participation.”

The three-judge panel found that “Merrill’s particular disclosures sufficiently alerted investors in Merrill ARS of the likelihood that the interest rates and apparent liquidity of these ARS reflected Merrill’s own interventions in these auctions.”

## Decision has broader impact

“I think this is a big deal,” says **Thomas Gorman**, an attorney with **Dorsey and Whitney** in Washington, D.C., of the decision. It stands as the latest victory for the industry in these types of cases and suggests the “SEC’s position on some of this may be slightly out of step with the direction the courts have taken.”

Earlier this month – prior to the decision in *Colin Wilson v. BNK Asset Management Partners* – SEC Commissioner **Elisse Walter** [addressed](#) private rights of action, calling the U.S. Supreme Court’s decision earlier this year in a disclosure case involving an investment adviser (*Janus Capital Group v. First Derivative Traders*) “shockingly out of line with the realities of the marketplace” ([IA Watch](#), June 20, 2011).

The SEC’s brief notes ARS date to 1984 and grew to \$330 billion by 2008. They usually involve “long-term bonds issued by municipalities and student loan entities, as well as preferred stock issued by closed-end funds, that have variable interest rates or dividend yields periodically reset through auctions.” ■

## Social Giants (Continued from page 1)

the conversation about planning for your financial future. ‘Like’ us to see what we have to say.”

Videos of appreciative customers appear above small print reading “speakers were compensated.” Another (*Social Giants, continued on page 4*)


### How does your situation compare with your peers?

Here’s how your peers describe their current state on their job, from **IA Watch**’s latest industry survey (see the story on page 1).

I’m wearing more hats than ever.	46%
I’m excited about my job and all of the challenges.	37%
I’m very professionally satisfied at this time.	26%
I am or soon will be looking for a new job.	9%
I’m exhausted and don’t feel I’m fairly compensated.	8%
I wish to leave compliance for another field.	5%
I will leave my job.	1%

## Social Giants (Continued from page 3)


section attracts the user to “Watch this video & learn, as five money management experts from Fidelity and other firms discuss how they’re preparing for worst- and best-case scenarios on current topics like the European debt crisis, the housing market and opportunities in energy.”

Its [disclaimer](#)  warns that “Fidelity does not expressly or implicitly adopt or endorse any of the expressions, opinions or content posted by fans or any third-parties on our Facebook Fan Page.”


More than 20,000 followers await the company’s [tweets](#) . Multiple posts appear daily. On [YouTube](#) , a 30-second ad echoes the green-line branding you’ve seen in national TV spots.

### ROI elusive but gut says go

Fidelity’s VP for social media, **Hadley Stern**, says he’s still trying to measure the social media’s ROI even while pointing out consumer companies use the media to send instant messages to millions at no cost. He believes it’s better to be in the pool than outside watching the fun, and that if Fidelity didn’t have a social media presence, the user would simply find a competitor’s site.

But all may not be what it seems on the web. That **Morgan Stanley** [Facebook page](#)  didn’t originate with the firm, says **Lauren Boyman**, the company’s director of social media. They’re called “squatters,” she says, meaning the page is either generated by Facebook or others. “It’s been pretty inoffensive” so the firm hasn’t challenged the page, she adds.

A search of Twitter for Morgan Stanley turns up a teenager from Iowa that goes by that name. Boyman says the firm did recently enter the world of tweets through a page created for its global investment committee.

The firm prefers to brand its reps through social media rather than the company ([IA Watch](#) , July 18, 2011). She questions the wisdom of Fidelity’s approach even while acknowledging some reps have complained about the time it takes to update their social media sites.

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“That mentality is dangerous” because clients are using these channels, she insists. “You still should be on there just for a defensive play.”



Stern says Fidelity’s open to using the media channels to highlight its reps, too.

Some firms make modest appearances on the media. You won’t see any tweets on **Goldman Sachs’** [Twitter page](#) . A search within YouTube comes up empty, too, except for negative videos from those who aren’t enamored of the Wall Street giant.



### ‘No testimonials’ please

Contrast that with the flashy [channel](#)  hosted by Vanguard. It boasts more than 511,000 “channel views” and 630 subscribers. Perhaps in a bow to SEC rules, its guidelines read “No testimonials. Industry regulations prevent us from posting stories about how well (or poorly) people have done by investing with Vanguard or any other investment company.”

The global reach of the web is on display by **Citi-group**. It’s [Facebook wall](#)  rivals the U.N. Its Twitter page hawks pending media appearances by company officials and notes some interviews can be found on **iTunes**. Hundreds subscribe to its smartly produced [YouTube channel](#) , with its links to the firm’s blog and latest news. Content guidelines admonish that “You, and not Citi, are responsible for all User Content you submit” and a disclaimer reads “No Citi Content or comments ... should be understood or used as the sole basis of any investment or financial decision.”

It’s latest venture sports a [vibrant blog](#) . Citi shared with us a [rundown](#)  of its social media stats. A spokesman says Citi has gained “valuable insight and feedback” from customers interacting with its social media channels. He cautioned that advisers need to balance the speed of the media with regulatory compliance issues and must constantly adapt to an environment that shifts quickly.

Your online strategy from last year may no longer be relevant this year. Another lesson the spokesman passes on is to remember that users are inundated with news and information and to be very thoughtful about what you post.

When **Bank of America** announced earlier this month that in “response to customer feedback,” it was dropping its debit usage fee, more than 13,000 followers received the news via [Twitter](#) . Its LinkedIn page numbers 181,000 followers. A 2½-minute video touting the company’s commitment to peoples’ economic and social needs spins on [YouTube](#) .

*(Social Giants, continued on page 5)*




## Social Giants (Continued from page 4)


The Internet video channel lines up only behind **Google** for the most searched site on the web, notes Fidelity's Stern, in explaining a compelling reason to maintain a presence there.

Advisory staff should check with their compliance officer before venturing into the realm of social media for work use, he counsels. If the platform gives you the willies, try it personally first, Stern recommends. Boyman comforts firms by mentioning there is software available that would permit you to block staff from using certain social media features. ■

## New Massachusetts expert networking reg takes effect Dec. 1

Although the Bay State's new regulation calling for investment advisory firms to obtain written certifications from expert networking consultants only affects advisers registered in Massachusetts, it suggests best practices for others and must be added to the radar screen of those mid-sized advisers nearing registration in the state.

The [regulation](#) , which takes effect Dec. 1, follows high-profile insider trading cases stemming from the use of consultants ([IA Watch](#) , May 16, 2011). The proposal handed advisers the responsibility of getting certifications from their expert networking firms describing their confidentiality restrictions and stating the consultants will not "provide any Confidential Information to the adviser" ([IA Watch](#) , May 23, 2011).

The [final version](#) , limits the requirement to "investment consulting services," defined as those the adviser uses to decide whether to buy, sell or take no action with a client's position. It also permits electronic signatures for the certifications but advisers would have to maintain the records. ■

## No standard definition of 'independent-contractor' but look to IRS, group says

There's no standard definition to distinguish indepen-

dent contractors from "employees" and the interpretation can vary depending on what entity is making the decision. The IRS uses one test, a state workers' compensation agency can use a different test, and the courts can have their own, says **Alison Hightower**, a shareholder in the San Francisco law office of **Littler**.

The degree of employer control over the specifics of how the worker does the job daily is one of the key factors that determines how the worker should be classified, said several pros familiar with the issue. Employees generally are subject to more specific controls than are independent contractors, the idea goes.

So how specifically do registered reps fit into all this, given that they must submit to the controls their firms exert as mandated by the **SEC** and **FINRA**?

**David Bellaire**, general counsel and director of government affairs for the **Financial Services Institute**, says that under the IRS definition, reps at independent firms should be classified as independent contractors. He says that "an analysis of the industry using the behavioral, financial and relationship control factors demonstrates that registered representatives operate free from the level of control the IRS deems sufficient to warrant employee classification."

## IRS factors

The IRS has 20 factors it weighs in making the determination. Among them is the degree the worker's behavior is controlled, what business aspects of the worker's job are controlled by the payer (e.g. who buys the worker's furniture), and the type of relationship between the worker and the payer (e.g. is the worker hired with the idea that the job will continue indefinitely?).

"These registered representatives are not typically subject to limitations or restrictions, except those imposed by law or regulation, when they counsel their investing clients," Bellaire says.

He adds that even under the IRS definition of independent contractor, firms are entitled to subject reps to strong risk-management controls.

"Based on judicial and IRS precedent, the case for independent contractor status for registered representatives associated with IBDs is strong, even though federal and state securities laws require an IBD to exercise significant oversight over their registered representative workforce to ensure compliance with legal requirements," Bellaire says.

Hightower says an example of one of the factors that might indicate workers are employees is if the employer  
*(Who's a Contractor?, continued on page 6)*

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## Who's a Contractor? (Continued from page 5)

can tell them when they must work in the office versus working at home.

"You have to look at everything and just kind of weigh it," she said.

Avoid providing an independent contractor things like furniture to do the job, warns **John McGovern**, managing director at **Ascendant Compliance Management** in New York, a firm that consults on securities industry compliance issues.

### Tip: Get insurance

A California lawyer, who specializes in employment law and works at a firm that asked not to be identified, suggests that firms consider using only independent contractors that have their own insurance.

The stakes are high. The IRS says that for employees, you generally would have to withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee. But employers don't generally have to withhold or pay any taxes on payments to independent contractors.

Also, California has a new workers' compensation law that kicks in Jan. 1, that would levy a \$5,000-per-violation fine on employers who willfully misclassified employees as independent contractors. "Willfully basically means you did it," says a lawyer whose firm requested anonymity. ■

## Cybersecurity (Continued from page 1)

Your disclosure could recognize the potential risk and mention systems you have in place to mitigate them, that you have a response plan at the ready and that P&Ps protect client information, says Powell. ■

## CFTC gives safe harbor pass on initial large trader reporting

The SEC's not alone with a [large trader rule](#) (IA Watch, 11/21/11). The CFTC's [rule](#) affects those with physical commodity swaps. Last week the CFTC created a safe harbor to allow swap dealers to delay reporting provided they first e-mail the Commission and promise a date when they will be in compliance.

The safe harbor appeared because the CFTC's systems aren't entirely in place to accept the reporting. To

claim the safe harbor protection, a dealer would have to e-mail the CFTC indicating how its submission wouldn't comply with the rule's data requirements and what's being done to bring it in compliance, says the [CFTC](#). ■

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