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Three Things for Investment Advisers to Consider Regarding the Financial Choice Act of 2017

By Pamela Harper

On April 26, 2017, the Financial Choice Act of 2017 (the "2017 Act") was introduced by House Financial Services Committee Chairman Jeb Hensarling. Approved by the U.S. House of Representatives on June 8, 2017, the bill is designed to "create hope and opportunity for investors, consumers, and entrepreneurs by ending bailouts and Too Big to Fail, holding Washington and Wall Street accountable, eliminating red tape to increase access to capital and credit, and repealing provisions of the Dodd-Frank Act that make America less prosperous, less stable, and less free." Though Dodd-Frank is primarily associated with addressing regulatory controls for large financial institutions, investment advisers, particularly smaller, emerging and mid-size firms, need to be aware of the financial and compliance implications of the 2017 Act.

Drafted with the intent to reform the financial regulatory system, the 2017 Act, in an effort to foster industry accountability, enhances the level of penalties for securities law violations. These enhancements, representing in some instances, 100 percent increases, are not inconsequential. If ultimately passed, under the bill, investment advisers will be impacted in the following four areas:

1. Increased money penalties in administrative proceedings
2. Increased money penalties in civil actions
3. Enhanced provisions for the violation of any injunction or other order
4. Imposition of penalties for recidivism

About the Author

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Money Penalties in Administrative Proceedings

Under the Investment Advisers Act of 1940 (the "1940 Act"), there are currently three tiers of penalties. For each act or omission under Tier 1, the 2017 Act doubles penalties for a natural person from $5,000 to $10,000 and for any other person from $50,000 to $100,000.

For Tier 2 administrative proceeding violations, which typically relate to acts or omissions that involve fraud, deceit, manipulation or reckless disregard of a regulatory requirement, the penalties double from $50,000 to $100,000 for each act or omission by a natural person and from $250,000 to $500,000 for any other person. For Tier 3, the maximum penalty for investment advisers under the 2017 Act will be the greatest of:

- $300,000 for a natural person or $1,450,000 for any other person;
- 3 times the gross amount of gain to the person who committed the act or omission; or
- The amount of losses incurred by victims as a result of the act or omission.

Money Penalties In Civil Actions

Currently, money penalties for investment advisers in civil actions are triggered if the Securities Exchange Commission believes there is a violation of the 1940 Act or any of the rules and regulations thereunder. Under the 2017 Act, as with money penalties in administrative proceedings, the same new thresholds and dollar amounts for each tier apply in civil actions as well, thereby increasing penalties by 100 percent.

Special Provisions Relating to Violations.

The 2017 Act, as currently drafted, expands the conditions under which money penalties in civil actions are triggered. In addition to perceived violations of the Investment Advisers Act, penalties would be imposed for any violation of a Federal injunction or bar obtained or entered by the Securities Exchange Commission under the Investment Advisers Act. More specifically, each separate violation of an injunction or order would be deemed a separate offense, except in the case of a continuing failure to comply, in which case, each day of failure to comply would be deemed a separate offense. Given the penalty structure, the financial ramifications of noncompliance are substantial.

Recidivism Penalties

Under the Financial Choice Act, a new fourth tier of penalties would be imposed on investment advisers that engage in repeated violations. Recidivism has never been viewed favorably by the Securities Exchange Commission; however, if enacted, the Financial Choice Act, as currently crafted, proposes a new standard designed to deter continued misconduct. Under this new tier, the maximum penalty for each act or omission would be three times the otherwise applicable amount for administrative proceedings as well as civil actions, if, within the 5 year period preceding the act or omission, the person was criminally convicted of securities fraud or became subject to a judgement or order imposing monetary, equitable, or administrative relief in any SEC fraud-related action.

Though the Senate's response to the bill is subject to debate and there inevitably will be changes to the legislation, given the financial regulatory landscape, as a matter of best practices, investment advisers should consider the following. First, cultivate a culture of compliance in which it becomes an inherent part of the firm's DNA; one in which compliance is everyone's responsibility and not just the Chief Compliance Officer's mandate. This is a leadership issue, more than any other, and begins with senior management not only recognizing its importance but investing capital resources in the compliance function. A few elements to consider when adopting a culture of compliance include:

1. Constant training. This can take many forms, but for smaller and emerging firms, whether it is quarterly meetings, creative training sessions, timely email blasts of applicable regulatory developments, or some combination thereof, it is imperative that the entire firm view compliance as a key core value.
2. Compliance Committee. Formation of a compliance committee that meets, at least quarterly (and more frequently if necessary, given the size of the company, the complexity of its portfolio products, and its AUM), to review compliance-related matters as well as upcoming regulatory issues that may affect the firm's operations. This is meant to be proactive rather than re-active.
3. Enterprise Risk Committee. An enterprise-wide risk committee, with representatives from multiple departments, should include trading, operations, marketing, and portfolio management. It is important not to confine the risk committee to only identifying and examining portfolio risk for mitigation, but rather to assess risk from an enterprise-wide perspective. Marketing and business development are two particularly prominent areas where firms often stretch the boundaries and parameters of what is allowable. Risk lurks everywhere.
4. Take the compliance manual seriously. If the Chief Compliance Officer is the only person who has a passing familiarity with the manual, that is a problem. Senior management should never find itself in the vulnerable position of being uninformed regarding the manual's content. This is not, and never will be, an acceptable position if the SEC is ever sitting in your office.

Second, conduct a mock audit. Mock audits provide an excellent neutral, third-party review and survey of a firm's compliance ecosystem. Far better to identify and rectify a problem in advance than to have the SEC identify it for you during an audit. Though mock audits are not inexpensive exercises, they are invaluable, if done well, and solidify management's commitment to and investment in a culture of compliance.

Third, empower the Chief Compliance Officer. The CCO has one role and that is to ensure compliance with the regulatory mandates that govern the firm's operations. If the firm has a structure whereby the CCO reports to the CEO, ensure that there is real corporate parity in the relationship. To minimize potential dissonance, as an alternative, structure the position to report to the Audit Committee of the Board of Directors. This has the potential, in some instances, to mitigate, though not totally negate, the asymmetric information that Board members may receive.

Compliance, unlike portfolio management, is not revenue generating to investment managers. It is, however, one of the best revenue protection mechanisms in a firm's arsenal. Bottom line, notwithstanding all of the attention being devoted to financial deregulation, under the Financial Choice Act's regime of demanding accountability from Wall Street, compliance is still not optional. ★