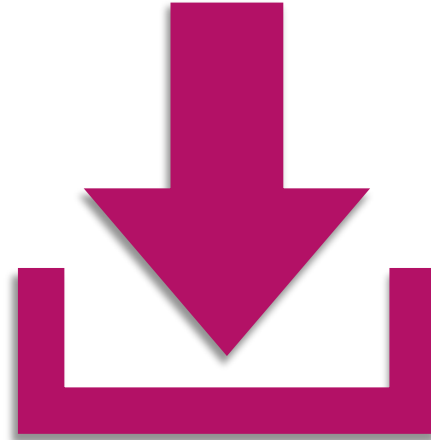




# Unethical Acts & Code of Ethic Obligations of IARs

# Download Our Slides

<https://www.ria-compliance-consultants.com/unethical-acts-iars>



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## **Effective On 1/1/25:**

U.S. Virgin Islands



# Investment Adviser Rep Continuing Education

This Course Has Already Been  
Approved by NASAA For 1  
Hour of IAR CE Under Ethics  
Category



# NASAA Disclosure

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# Content Questions & Technical Help

If you have questions about the content of this course or need technical help, please contact us via the email address below:

[ContEd@ria-compliance-consultants.com](mailto:ContEd@ria-compliance-consultants.com)

# Your Instructor



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# Course Overview

- ▶ NASAA Model Rule: Unethical Business Practices Of IARs
- ▶ SEC Code of Ethics Requirements
- ▶ Other Common Compliance Requirements
- ▶ Case Study of Questionable Conduct by an IAR



# Regulatory Resources

- ▶ NASAA Model Rule 102(a)(4)-1: Unethical Business Practices Of Investment Advisers, Investment Adviser Representatives, And Federal Covered Advisers @ <https://www.nasaa.org/wp-content/uploads/2019/05/NASAA-IA-Unethical-Business-Practices-Model-Rule.pdf>
- ▶ SEC Rule 204A-1 (Investment Adviser Codes of Ethics) @ <https://www.law.cornell.edu/cfr/text/17/275.204A-1>
- ▶ SEC Final Rule Release (Investment Adviser Codes of Ethics) @ <https://www.sec.gov/rules/2004/12/investment-adviser-codes-ethics>

# NASAA Model Rule: Unethical Business Practices Of IARs

Model Rule Has To Be Formally Adopted By State Securities Regulator

Final Version Adopted by State May Vary From NASAA Model Rule

Also Applies To IARs Of SEC Firms To Extent Conduct Is Fraudulent, Deceptive Or Otherwise Permitted By NSMIA

Fiduciary Duty – IAR Has Duty To Act Primarily For Benefit Of Clients

While Extent Of Fiduciary Duty Varies According To Nature Of Relationship, Model Rule Prohibits IARs From Engaging In Unethical Business Practices

# Specific Unethical Business Practices In Model Rule

- ✓ **Unsuitable Recommendations:** Recommending A Security Without Reasonable Grounds To Believe Suitable After Reasonable Inquiry Of Investment Objectives & Financial Situation
- ✓ **Exercising Discretion Without Authorization:** Exercising Investment Discretion Without Written Authority From Client Within 10 Business Days After Placing The First Transaction Based On Oral Discretion (Exception For Time & Price)
- ✓ **Trading Excessively:** Inducing Excessive (E.G., Size, Frequency) Trading In A Client's Account In Light Of Client's Objective & Resources
- ✓ **Unauthorized Trading:** Placing Trades In Client Account Without Authority To Do So
- ✓ **Trading On Third-Party Instructions Without Authorization:** Executing Trades Based On Instructions From A Third-Party Without Written Authorization From Client

# Specific Unethical Business Practices In Model Rule

- ✓ **Borrowing From Client:** Borrowing Money Or Securities From A Client Unless Client Is B/D, Affiliate Of The Investment Adviser Or Financial Institution (E.G., Bank, Credit Union)
- ✓ **Lending To Client:** Loaning Money to a Client Unless Investment Adviser Is A Financial Institution (e.g., Bank, Credit Union)
- ✓ **Making Misrepresentation:** Misrepresenting Qualifications, Services, Fees, Or Any Other Material Facts To Clients Or Prospective Clients
- ✓ **Providing Recommendations of Others Without Disclosure:** Providing Reports or Recommendations Prepared by Someone Other Than Adviser Without Disclosure (Exception for Published Research Reports & Statistical Analysis)
- ✓ **Charging Unreasonable Fees:** Charging Client Unreasonable Advisory Fee



# Specific Unethical Business Practices In Model Rule

- ✓ **Disclosing Conflicts Of Interest:** Failing To Disclose In Writing, Before Any Advice Is Rendered, Any Material Conflicts of Interest Including
  - Compensation Arrangements In Addition To The Fee Charged To Client
  - Charging Advisory Fee When Adviser or Its Employees Will Also Receive A Commission
- ✓ **Making Guarantees:** Guaranteeing A Client That A Specific Result Will Be Achieved (e.g., Gain, No Loss)
- ✓ **Disclosing Confidential Client Information:** Disclosing Identity, Affairs, Or Investments Of Any Client Unless Required By Law Or Consented To By Client

# Specific Unethical Business Practices In Model Rule

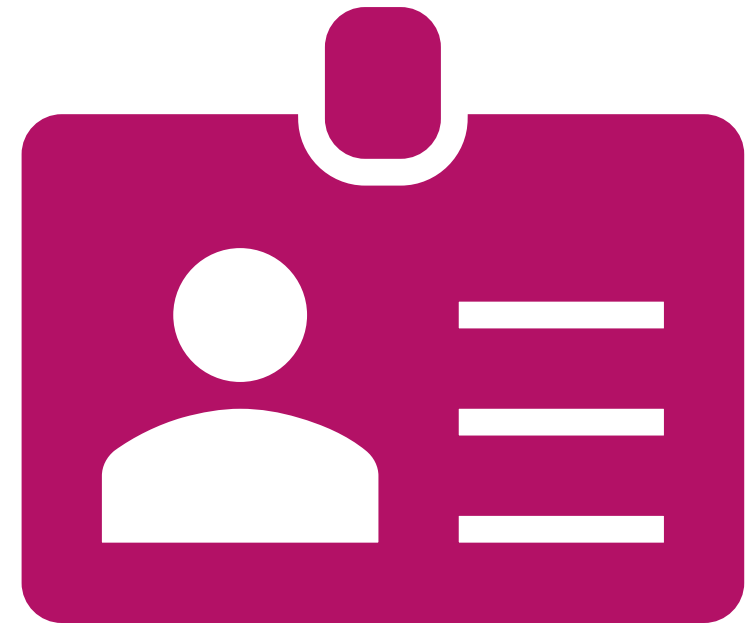
**Lack of Written Advisory Contract:** Failing To Have A Written Advisory Contract with a Client Disclosing Services, Term, Advisory Fee, Refund of Prepaid Fees, Whether Investment Discretion Is Granted and Consent for Assignment

**Inadequate Insider Trading Policies:** Failure To Develop, Maintain and Enforce Written Policies To Prevent The Misuse Of Material Nonpublic Information

# Specific Unethical Business Practices In Model Rule

## Utilizing Client's Login Credentials:

- Accessing A Client's Account By Using The Client's Own Unique Identifying Information (e.g., Username & Password)
- Not Intended To Apply To Data Aggregation Software Where: (A) Adviser Does Not Know, Or Have Access To, Client's Password; (B) There Is Agreement Between Data Aggregation Software Company And Custodian/Online Account Platform Which Permits This "Back-Door" Access; And (C) Data Is Read-Only (i.e., Adviser Can Only View The Information And Cannot Effectuate Any Changes To Client's Underlying Account)



# SEC Code of Ethics Requirement

Requires SEC Firm to Adopt Standard of Business Conduct for Supervised Persons

Doesn't Specify the Standard

Must Comply With Fiduciary Duty & Federal Law

Should Maintain And Enforce Policies And Procedures To Prevent The Misuse Of Material Nonpublic Information

Establishes Minimum Standard – Firm Can Choose Higher Standard

Each Supervised Person Must Acknowledge In Writing Receipt of Code of Ethics & Subsequent Amendments



## Applicability of Code of Ethics to State-Registered Firms

Many States Require A Code Of Ethics Similar To SEC Requirements

Both State and SEC Registered Investment Advisers and IARs Are Subject To Federal Insider Trading Laws

# Protect Material Non-Public Information

An Investment Adviser Must Prevent Misuse of Material Nonpublic Info Pursuant To Both GLBA & Fiduciary Duty

Securities Recommendations and Client Holdings & Transactions

- Adviser's Duty of Requires Safeguarding Client Info
  - Doesn't Preclude Adviser From Providing Necessary Info To Persons Providing Services to Adviser or Account
- Market Timing Examples:
  - Can't Share Fund Holdings with Select Market Timers
  - Portfolio Manager Can't Trade For Personal Account On Non-Public Info About Fund

Insider Trading Prohibition

- Do Not Trade on Inside Information
- Do Not Share Inside Information With Others

# Who Is An Access Person for Personal Securities Transactions?

Access to Non-Public Info Regarding Client Transactions or Holdings, or

Involved in Making Recommendations or Access to Such Recommendations

If Providing Investment Advice Is Primary Business, All Directors, Officers & Partners Presumed Access Persons

# Personal Securities Transaction Reportable Securities

- Any Securities Listed on National Exchange
- Excludes (i) Direct Obligations of US Govt, (ii) Bankers' Acceptances, CDs, Commercial Paper and High-Quality Short-Term Debt Instruments, (iii) Shares Of Money Market Funds, (iv) Shares Of Open-End Funds, and (v) Shares of Open-End UITs
- Includes Reportable Security In Which Access Person Has/Had Direct or Beneficial Ownership (Presumption Is That This Includes Members of Access Person's Immediate Family Sharing Same Household)




# PST Reporting

**Pre-Approval:** Access Person Required To Obtain Pre-Approval To Invest In Initial Public Offering or Limited Offerings (i.e., Private Placements)



**Holdings Report:** Required to Report Securities Holdings Initially (Within 10 Days Of Affiliation) and Each 12 Month Period (As Selected By Adviser)



**Quarterly Transaction Report:** Required to Report Securities Transactions Each Quarter (Within 30 Days of Quarter End)

# PST Reporting Exclusions

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Securities Held in Accounts That Access Person Has No Direct Influence or Control

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Transactions Effected Pursuant to Automatic Investment Plan

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Quarterly Transaction Report If Duplicates Info in Confirmations/Statements Received Within 30 Days of Quarter End

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If Small Firm Has Only One Access Person, Not Required to Submit Report As Long As Firm Maintain Records of Holdings & Transactions

## Examples of Firm Specific Policies for Personal Securities Trading by Access Persons

- Pre-Approval – Require Pre-Approval for Purchasing/Selling All or Certain Securities
- Restricted List – Prohibiting Purchasing/Selling Certain Securities
- Black Out Period – Certain Period of Times When Access Person Can Purchase Or Sell A Security
- Prohibitions on Short-Term Trading
- Reminder Limited Investment Opportunities Must Be First Given to Clients Before Access Persons Can Take
- Requirement to Use Certain Broker-Dealers/Qualified Custodians for Personal Accounts of Access Persons With Data Downloads
- Requirement for Broker-Dealer/Qualified Custodian to Send Duplicate Confirmation/Account Statement to Investment Adviser Firm
- Review Whether New Employee Responsible For Securities Analysis or Research Doesn't Have Securities Holdings in Conflict with Responsibilities

# Possible Issues With Your PST Report

Was The PST Timely Reported?

Was The PST In Accordance With Firm's Pre-Approval/Restricted List And Black Out Periods (If Applicable)?

Does The PST Appear To Be Based Upon Inside Information?

Is There Front-Running Trades Before Client Trades Are Executed?

Is There Cherry-Picking of Profitable Block Trades By Allocating To Access Person?

Are The Personal Securities Transaction Part Of Pump & Dump Scheme?



# Other Common Compliance Requirements for IARs

## Outside Business Activities:

- Most Firms Require Written Disclosure And Approval Of Any Outside Business Activities By Supervised Person

## Gift Policy:

- Most Firms Require Disclosure To Compliance Of Any Gifts Received or Given By Supervised Person
- In Order To Avoid or Mitigate the Conflict of Interest, There May Be A Restriction On The Value Of Gifts From Third-Parties or Gifts Given To Staff of Institutional Clients

# Other Common Compliance Requirements for IARs

## Meals, Entertainment & Trips

- Most Firms Require Disclosure And/Or Approval In Order For Supervised Persons To Accept Meals, Entertainment & Trips From Third-Parties Who Provide Services To Client or Client's Assets
- In Order To Avoid Or Mitigate The Conflict Of Interest, There May Be Restrictions On Value Or Purpose Of Meal, Entertainment Event or Trip

## Off-Channel Communications

- SEC Requires Any Communication Regarding Investment Advice, Investment Decisions, Trading or Disbursement From Client Account To Be Maintained As Part Of Firm's Books & Records
- Many Firms (i) Prohibit Any Communication Internally or Externally Via Text or Messaging Apps, (ii) Limit Communication Via Text or Messaging Apps To Personal (Non-Advisory Issues), or (iii) Require The Use Approved Applications That Allow For Surveillance & Archiving Of Such Communications
- To Extent Supervised Person's Firm Has Such A Policy, Supervised Person Needs To Comply With Such Restrictions and Move Any Applicable Communications To Approved Channel

## Case Study of Questionable Conduct by IAR

### Background Facts

Ivan Milken is an investment manager for ABC Capital Advisors, LLC (“ABC Capital Advisors”).

For his personal account, Ivan Milken has been investing in crypto. He’s set up a personal account at Coinbase and has traded in Solana, Cardano and Polygon. He hasn’t disclosed this personal account or the transactions within the Coinbase account to the Compliance Department of ABC Capital Advisors. The client accounts managed by Ivan do not include crypto holdings.

Ivan and Ken Skillings, the chief financial officer of Energy Conglomeration, which is a client of ABC Capital Advisors, recently went to the Monte Carlo Grand Prix on a client appreciation trip paid by ABC Capital Advisors. During this client appreciation trip, Ivan mentioned to Ken the incredible performance of his personal Coinbase account.

After the trip, Ken sent (via WhatsApp) Ivan a thank you note for a great trip. Ken asks if Ivan has any suggestions about good crypto plays. Ivan responds via WhatsApp with several examples of personal trades that Ivan has made in the last month. Ken thanks him again and tells him that they should do dinner once he returns from his due diligence trip on XYZ Incorporated, which is a small company that trades on the NASDAQ and might be acquired by Energy Conglomeration. WhatsApp isn’t an approved communication platform for ABC Capital Advisors; however, Ivan doesn’t report this communication because it didn’t involve a recommendation or trade for the account managed by ABC Capital Advisors.

Ivan looked at XYZ Incorporated. He determined that although it was performing poorly, the company’s assets were undervalued by the market. Ivan concluded that a bigger operator like Energy Conglomeration could turn this company around. He purchased (through his adult daughter’s account) 500,000 shares at approximately \$2.20 a share. Ivan didn’t report this transaction to the Compliance Department of ABC Capital Advisors.





# Case Study of Questionable Conduct by IAR

**Please identify (i) any red flags, (ii) possible compliance issues and (iii) next steps or remedial measures.**

# Case Study Red Flags

- ▶ **Undisclosed Personal Trading:** Ivan has a personal account at Coinbase where he trades in cryptocurrencies, and this account has not been disclosed to ABC Capital Advisors' Compliance Department.
- ▶ **Luxury Trip for a Fiduciary:** Giving a luxury trip to one of the key decision makers of the client is a red flag.
- ▶ **Client Interaction Outside Approved Channels:** Ivan and Ken communicated via WhatsApp, which is not an approved communication platform for ABC Capital Advisors.
- ▶ **Sharing Personal Investment Information:** During a client appreciation trip, Ivan discussed the performance of his personal Coinbase account with Ken, the CFO of the client.
- ▶ **Unreported Communication:** Ivan did not report the WhatsApp communication to the Compliance Department.
- ▶ **Possession of Inside Information:** Ivan did not report receipt of potentially inside information about XYZ to CCO.
- ▶ **Personal Investment in XYZ Incorporated:** Ivan purchased a significant number of shares in a company that a client CFO is considering for acquisition.



# Case Study

## Possible Compliance Issues

- ▶ **Failure to Disclose Personal Trading:** Ivan's undisclosed personal trading could be a violation of firm policy and possibly SEC regulations regarding personal trading disclosures.
- ▶ **Unapproved Communication Channels:** The use of WhatsApp for client communication is not approved, potentially violating SEC rules requiring the archiving and monitoring of communications related to the business.
- ▶ **Insider Trading:** Ivan's possession of inside information without disclosure to the CCO and purchase of shares in XYZ Incorporated based such information may constitute insider trading.

# Case Study

## Next Steps or Remedial Measures

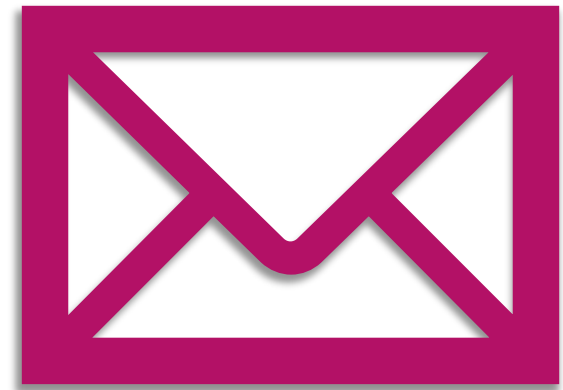
- ▶ **Immediate Disclosure:** Ivan should immediately disclose his personal Coinbase account and transactions to the Compliance Department.
- ▶ **Review of Communication Policy:** ABC Capital Advisors should review and possibly update its communication policies to clarify approved channels and the need to report all client communications, regardless of the subject matter.
- ▶ **Conflict of Interest Assessment:** The firm should review the circumstances surrounding the client appreciation trip and Ivan's conversation with Ken to assess whether a conflict of interest occurred and if disclosure is necessary.
- ▶ **Internal Review for Insider Trading:** An internal review should be conducted to determine if Ivan's purchase of XYZ Incorporated shares constitutes insider trading. If so, appropriate legal steps should be taken, including possible reporting to regulatory authorities.
- ▶ **Training and Policy Update:** Given the multiple red flags and potential compliance issues, ABC Capital Advisors should consider additional compliance training for its employees and possibly update its policies on personal trading, communication, and conflicts of interest.



# Questions

Please submit any question online or email with any questions about the content of this course.

[ContEd@ria-compliance-consultants.com](mailto:ContEd@ria-compliance-consultants.com)



Thank You

