CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC.

ANONYMOUS CASE HISTORIES
NUMBER 29693

This is a summary of a Settlement Agreement entered into at the October 2015 hearings of the Disciplinary and Ethics Commission ("the Commission") of Certified Financial Planner Board of Standards, Inc. ("CFP Board"). The conduct at issue in this case occurred after January 1, 2009. The Rules in effect at that time under the *Rules of Conduct* were Rules 1.1 through 6.5.

I. Issue Presented

Whether a CFP® professional ("Respondent") violated CFP Board's *Standards of Professional Conduct* when he failed to make disclosures regarding his ownership of an investment advisory firm.

II. Findings of Fact

Respondent was the subject of a 2014 Securities and Exchange Commission ("SEC") Cease and Desist Order and a 2015 Financial Industry Regulatory Authority, Inc. ("FINRA") Letter of Acceptance Waiver and Consent ("AWC"). Respondent was terminated by Firm in July 2013 for failing to disclose the nature and extent of his relationship with an investment advisory firm ("IA").

Respondent was employed with Firm from March 2007 until July 2013. Respondent is a former broker and had not been associated with a broker-dealer since August 2013. Although Respondent's brokerage license had expired, he remained subject to FINRA's jurisdiction for two years following his termination because his conduct commenced prior to the termination of his registration. Respondent's 2014 SEC Cease and Desist Order and 2015 FINRA AWC all derived from Respondent's 2013 Firm Termination.

Formation of WM and Association with Firm

Respondent, JH and JT, collectively "the Principals," provided brokerage and advisory services as both registered representatives and investment advisor representatives of Firm and operated under the name WM. Respondent, along with the other Principals, is a co-founder and managing partner of WM, a wealth management firm formed in March 2007.

Prior to his association with Firm, JH began utilizing a proprietary algorithmic trading model for Exchange Traded Funds referred to as the "IA Process", but the firm JH was associated with would not allow him to manage large institutional portfolios using the process. The Principals sought to market the IA Process to retail and institutional clients. They were interested in creating a hybrid model money management firm that would enable them to process both commission-based business as registered representatives and fee-based business as investment advisor representatives through the formation of a registered investment adviser firm ("RIA").

In 2007, the Principals requested permission from Firm to register WM as a separate RIA in order to incorporate the IA Process into their business. Firm denied the Principals' request. Nevertheless, the Principals associated themselves with Firm and established WM as a branch office of Firm.

Formation, Management and Control of IA

Six months after WM's formation, several institutional entities expressed interest in investing through the IA Process. The Principals again requested that Firm grant them approval to register WM as a RIA. Firm again refused. Alternatively, the Principals sought Firm's approval to form a separate RIA that they would own, but would be staffed by unaffiliated investment advisory personnel. Firm did not object to the creation of a separate RIA, but it prohibited the Principals from having any ownership interest in the RIA. The Principals also requested permission for their wives to hold ownership interest in IA, which Firm also denied.

Thereafter, in August 2008, the Principals formed and registered IA by selecting three nominees who assumed a 26.67% ownership interest, respectively, to act as majority members with the understanding that should Firm ultimately allow the Principals to own IA, the nominees would transfer their ownership interest to the Principals. The three nominees did not provide any capital for IA and did not participate in the day-to-day operations of the company.

IA became the owner of the IA Process and leased office space from WM, which owned the building where both entities conducted business. MO was appointed Chief Executive Officer ("CEO") and Chief Compliance Officer ("CCO") of IA. MO is also a member and owner of IA and has been associated with IA as an IAR since September 2008.

The Principals provided all the initial capital for IA, and engaged in other financial dealings with IA and its members that evidenced their control over the firm. From August 2008 through 2013, the relevant period, the Principals controlled IA by actively participating in its operations and directing its management and policies. They participated in all of the important personnel decisions, attended board meetings, and served on committees such as investment, and sales and marketing. The Principals also determined how company assets were marketed and regularly corresponded via email with IA's staff.

One example of the Principals' control of IA concerns the formation of IA, which was capitalized with a $170,000 loan from each Principal over the first year and a half. From August 2009 through November 2009, the Principals arranged for two third-party investors to acquire ownership interests in IA. To this end, the Principals directed each of the three nominee owners to transfer a percentage of their ownership interest to each of their respective spouses. Subsequently, the nominees voluntarily participated in two transactions with the Principals' spouses to enable IA to pay down a portion of its debt to the Principals. In 2009 and 2010, the nominees transferred small percentages of their interest in IA to the Principals' spouses for no compensation. On the day of the transfer, the Principals' spouses sold their newly-acquired interests in IA to the two third-party investors. These two transactions provided each Principal's spouse with $135,000, which operated as a partial repayment on the balance of each Principal's $170,000 loan to IA.

Another example of the Principals' control over IA is the written license agreement executed between WM and IA under which IA agreed to license the IA Process to WM for the Principals' use with their clients. Although the agreement called for the payment of a 5% royalty or licensing fee, IA did not require payment of the fee from WM.

Respondent's counsel, MK, contended that Firm was fully aware of the formation of IA and its organizational structure that included the use of nominee owners. MK also contended that Firm continued to suggest that while the Principals could not directly own IA, it was continuing to pursue an infrastructure that would allow for direct ownership in the future. MK stated that, "[T]his arrangement continued, with [Firm]'s full knowledge and support, until [Firm] shifted gears in 2013 and determined that the arrangement was no longer sustainable, thus leading to the Termination."

Inaccurate Disclosures on Compliance Questionnaires, to Firm and to Clients

For the years 2009 through 2011, Respondent and the other Principals failed to accurately complete annual compliance questionnaires when they failed to disclose IA as an outside business activity. When the Principals finally disclosed their involvement with IA in June 2012, they mischaracterized their relationship as being "outside consultants" who gave "periodic non-investment related consulting" for "less than 10" hours per month.

Thus, Respondent and the other Principals failed to adequately disclose their involvement in IA to Firm. Although Firm knew of the Principals' interest in obtaining ownership interest in IA, the Principals did not notify Firm of their active participation in the establishment, management and control of IA.

In advising some of their advisory clients to invest with IA, the Principals failed to disclose their control of IA and conflicts of interest associated with its capitalization and the Principals' potential receipt of profits from IA. IA failed to disclose to its clients that the Principals controlled the firm. Specifically, during the relevant period, each of IA's Form ADV failed to disclose the Principals as control persons and failed to accurately describe the extent of the Principals' participation in its day-to-day operations.

2014 SEC Cease and Desist Order

The SEC issued a cease and desist order to Respondent and the other Principals in July 2014, in which it determined that:

- The Principals exerted control over IA because of their (a) financial dealings with IA and its members; and (b) active participation in IA's operations and decision-making;

- The Principals breached their fiduciary duty to their clients who invested with IA by failing to disclose: (a) material facts concerning the extent of their ability to direct IA's management and policies; (b) existing and potential conflicts when advising clients to invest with IA, particularly regarding the Principals' loan to IA; and (c) that they continued to seek approval to obtain ownership interests in IA which, if obtained, would entitle them to share in any profits derived from the clients' payment of advisory fees to IA;

- IA, through MO, made false and misleading disclosures in its Forms ADV (in response to item 10) regarding its relationship with the Principals and breached its fiduciary duty to clients because it: (a) did not accurately disclose the extent of the Principals' ability to direct IA's management and policies; and (b) misrepresented that the Principals provided non-investment related consulting when, in fact, one of the Principals provided investment-related advice through his participation on IA's investment committee;

As a result, IA and the Principals willfully violated Section 206(2) of the Investment Advisers Act of 1940 ("Advisers Act") and IA and MO willfully violated Section 207 of the Advisers Act.

The Principals were ordered to provide a copy of the Order, within 30 days, to each of their advisor clients that had invested in IA from October 2009 through the date of the Order, July 2014. The Principals were also ordered to certify in writing their compliance with the above undertaking. The SEC Order also directed that IA provide a copy of the Order to each of its existing advisory clients as of July 2014 and certify in writing compliance with the above undertaking.

The SEC deemed it appropriate and in the public interest to impose the following sanctions pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 203(e), 203(f) and 203(k) of the Advisers Act:

- Respondent, IA and the other Principals were ordered to cease and desist from committing or causing any violations and any future violations of Section 206(2) of the Advisers Act;

- IA and MO were ordered to cease and desist from committing or causing any violations and any future violations of Section 207 of the Advisers Act;

- Respondent, IA and the Other Principals were censured; and

- Within 10 days of the entry of the Order, Respondent and the other Principals were ordered to pay a $60,000 civil money penalty, respectively, to the US Treasury. MO was ordered to pay $35,000 to the US Treasury, $20,000 to be paid within 10 days of the entry of the Order and $15,000 to be paid within 180 days.

2015 FINRA AWC

In February 2015, Respondent entered into an AWC with FINRA in which he consented, without admitting or denying the findings, to having violated certain NASD and FINRA Rules for the period August 2008 through July 2013.

FINRA found that Respondent and the other Principals violated NASD Rule 3030 (for conduct prior to December 15, 2010) and FINRA Rule 3270 (for conduct on or after December 15, 2010) by establishing, funding, and actively participating in the management and control of IA without disclosing or accurately disclosing those outside activities to Wells Fargo from August 2008 through July 2013. As a result, Respondent and the other Principals also violated NASD Rule 2110 (for conduct prior to December 15, 2008) and FINRA Rule 2010 (for conduct on or after December 15, 2008).

FINRA also found that the nominee interests sold to the third-party investors were securities in the form of investment contracts and Respondent and the other Principals failed to disclose their participation in those private securities transactions to Firm, thereby violating NASD Rule 3040 and FINRA Rule 2010.

FINRA further found that by claiming, on their compliance questionnaires, not to have any undisclosed activities and by inaccurately describing those activities on their outside activity disclosure forms, Respondent and the other Principals provided inaccurate information on compliance questionnaires and disclosures to their firm, in violation of FINRA Rule 2010.

Respondent consented to an 18-month suspension from association with any FINRA member firm in any capacity and a $20,000 fine.

Article 13.1 of the *Disciplinary Rules and Procedures* ("*Disciplinary Rules*") provides that a letter or other writing from a governmental or industry self-regulatory authority to the effect that a Respondent has been the subject of an order of professional discipline by such authority shall conclusively establish the existence of such professional discipline for purposes of disciplinary proceedings and shall be conclusive proof of the basis for such discipline by the Respondent. As defined in Article 13.4 of the *Disciplinary Rules*, professional discipline "shall include the suspension, bar or revocation as disciplinary measure by any governmental agency, industry self-regulatory organization or professional association."

The SEC is a governmental agency. FINRA is an industry self-regulatory organization. The Cease and Desist Order and Censure and the AWC are orders of professional discipline by the SEC and FINRA, and Respondent is the subject of those orders. Therefore, the SEC Cease and Desist Order and the FINRA AWC conclusively establish the existence of such disciplines for purposes of this disciplinary proceeding and are conclusive proof of the basis for such disciplines by the Respondent.

III. Grounds for Discipline

First Ground for Discipline

Pursuant to Article 3(A) of the *Disciplinary Rules*, there are grounds to discipline Respondent for acts or omissions that violate Rule 1.4 of the *Rules of Conduct*, which provides that a certificant shall at all times place the interest of the client ahead of his or her own. When the certificant provides financial planning or material elements of financial planning, the certificant owes to the client the duty of care of a fiduciary as defined by CFP Board.

The Commission found that Respondent, a certificant, breached his fiduciary duty to the clients, in violation of Rule 1.4 of the *Rules of Conduct*, by failing to disclose to his clients who invested with IA: (a) material facts concerning the extent of his and the other Principals' ability to direct IA's management and policies; (b) existing and potential conflicts when advising clients to invest with IA, particularly regarding the Principals' loan to IA; and (c) that he and the Principals continued to seek approval from Firm to obtain ownership interests in IA which, if obtained, would entitle them to share in any profits derived from the clients' payment of advisory fees to IA (henceforth, these three failures to disclose shall be referred to as "Respondent's Three Failures to Disclose").

Second Ground for Discipline

Pursuant to Article 3(A) of the *Disciplinary Rules*, there are grounds to discipline Respondent for acts or omissions that violate Rule 2.1 of the *Rules of Conduct*, which provides that a certificant shall not communicate, directly or indirectly, to clients or prospective clients any false or misleading information directly or indirectly related to the certificant's professional qualifications or services…A certificant shall not fail to disclose or otherwise omit facts where that disclosure is necessary to avoid misleading clients. The Commission found that Respondent's Three Failures to Disclose violated Rule 2.1 of the *Rules of Conduct*.

Third Ground for Discipline

Pursuant to Article 3(A) of the *Disciplinary Rules*, there are grounds to discipline Respondent for acts or omissions that violate Rule 2.2(B) of the *Rules of Conduct*, which provides that a certificant shall disclose to a prospective client or client a general summary of likely conflicts of interest between the client and the certificant, the certificant's employer or any affiliates or third parties, including, but not limited to, information about any familial, contractual or agency relationship of the certificant or the certificant's employer that has a potential to materially affect the relationship. The Commission found that Respondent's Three Failures to Disclose violated Rule 2.2(B) of the *Rules of Conduct*.

Fourth Ground for Discipline

Pursuant to Article 3(A) of the *Disciplinary Rules*, there are grounds to discipline Respondent for acts or omissions that violate Rule 4.1 of the *Rules of Conduct*, which provides that a certificant shall treat prospective clients and clients fairly and provide professional services with integrity and objectivity. The Commission found that Respondent's Three Failures to Disclose violated Rule 4.1 of the *Rules of Conduct*.

Fifth Ground for Discipline

Pursuant to Article 3(A) of the *Disciplinary Rules*, there are grounds to discipline Respondent for acts or omissions that violate Rule 4.3 of the *Rules of Conduct*, which provides that a certificant shall be in compliance with applicable regulatory requirements governing professional services provided to the client.

The Commission found that Respondent willfully violated Section 206(2) of the Advisers Act when he breached his fiduciary duty to his clients who invested with IA by failing to disclose material facts, existing and potential conflicts of interests and the fact that he could be entitled to share in any profits derived from the clients' payment of advisory fees to IA, thereby violating of Rule 4.3 of the *Rules of Conduct* (henceforth, this shall be referred to as the "SEC Rule Violation").

The Commission also found that Respondent, a certificant, violated NASD Rules 3030 and 2110, and FINRA Rules 3040, 3270 and 2010 when he: a) participated in outside business activities by establishing, funding and actively participating in the management and control of IA without disclosing, or adequately disclosing, those outside activities to Firm; b) participated in private securities transactions by arranging for two third-party investors to acquire ownership interests in IA from the nominees without disclosing those transactions to Firm; and c) made inaccurate disclosures on his annual compliance certification questionnaires for 2009-2011 by failing to disclose IA as an outside business activity on the questionnaires, thereby violating Rule 4.3 of the *Rules of Conduct (*henceforth, this shall be referred to as the "NASD/FINRA Rules Violation").

Sixth Ground for Discipline

Pursuant to Article 3(A) of the *Disciplinary Rules*, there are grounds to discipline Respondent for acts or omissions that violate Rule 4.4 of the *Rules of Conduct*, which provides that a certificant shall exercise reasonable and prudent professional judgment in providing professional services to clients. The Commission found that Respondent's Three Failures to Disclose violated Rule 4.4 of the *Rules of Conduct*.

Seventh Ground for Discipline

Pursuant to Article 3(A) of the *Disciplinary Rules*, there are grounds to discipline Respondent for acts or omissions that violate Rule 5.1 of the *Rules of Conduct*, which provides that a certificant who is an employee/agent shall perform professional services with dedication to the lawful objectives of the employer/principal and in accordance with CFP Board's *Code of Ethics*. The Commission found that Respondent's SEC Rule Violation and NASD/FINRA Rules Violation violated Rule 5.1 of the *Rules of Conduct*.

Eighth Ground for Discipline

Pursuant to Article 3(D) of the *Disciplinary Rules*, there are grounds to discipline Respondent for acts that are the proper basis for professional discipline. The acts set forth in the AWC and the SEC Order are the proper basis for professional discipline, and the AWC and the SEC Order constitute professional discipline. Therefore, the AWC and the SEC Order are conclusive proof that grounds exist to discipline Respondent for acts that are proper bases for professional discipline.

IV. <u>Discipline Imposed</u>

The Commission found grounds for discipline under Articles 3(a) and 3(d). Based on the terms of the Settlement Agreement, the Commission issued to one-year Suspension of his CFP® certification pursuant to Article 4.3 of the *Disciplinary Rules*.

In reaching its decision, The Commission identified the following mitigating factors:

1. Respondent indicated that Firm lacked the infrastructure to support dually registered advisors;
2. Respondent disclosed to CFP Board that he was under investigation by the SEC and the FINRA; and
3. Respondent had been a CFP® professional for 33 years and maintained a clean disciplinary history.

The Commission identified in aggravation that:

1. The SEC ordered Respondent to cease and desist from any future violations of the securities law related to disclosing his participation with IA;
2. Respondent entered into an AWC with the FINRA in 2015; and
3. The record contained evidence indicating Respondent and his partners took steps to conceal the ownership of IA.

The Commission consulted *Sanctions Guidelines* 5 (Breach of Fiduciary Duty), 12 (Employer Policies Violation), 14(b) (Failure to Disclose to Clients), 20(d) (Misrepresentation to Clients and Prospective Clients), 30 (Securities Law Violation) and 34 (Professional Discipline Involving Suspension for More than 3 Months). The Commission also consulted Anonymous Case Histories 26226, 24809, 27835, 26853 and 29214.