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Why Documenting Actions Are So Important – Another Reminder

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This article examines why it is important to keep accurate, timely records to comply with marketing rules.

The author of this article is Cathy Brand, CEO ***Sales Road Maps Online Ltd.®*** *– someone who has written in these* ***pages before about*** *compliance and strategy issues when it comes to the financial world. The usual editorial disclaimers apply to views of guest contributors. Jump into the conversation! Email tom.burroughes@wealthbriefing.com*

The **US Securities & Exchange Commission** is on the warpath for violations of record-keeping rules. In 2022, the US SEC imposed heavy fines on banks for cases of communications with customers via unauthorized channels including chat rooms and applications such as WhatsApp. Sixteen financial institutions including Goldman Sachs, Bank of America, Citigroup and Morgan Stanley paid a total of $1.8 billion in fines. UBS and Credit Suisse also had to pay $200 million each in fines due to communications with customers about business matters via chat programs and Whatsapp, in violation of the banks' documentation and record-keeping obligations.

Now the SEC is investigating the unauthorized communications practices of certain hedge fund managers, brokerage firms, asset managers and private equity firms.

We clarify the importance of record-keeping for a robust marketing compliance program and why communication with clients via unauthorized channels can lead to potential distribution risks.

What's wrong with communicating with clients on WhatsApp?

Communicating with customers via chat rooms or WhatsApp violates a firm's documentation and record-keeping requirements. Record-keeping is one of the most important and vital pillars of a robust compliance program. Without compliance records, an AIFM/asset manager's general compliance program is useless.

For general compliance programs, the adage, "Didn't Document It, Didn't Do it" is appropriate. Any good chief compliance officer knows that the value of the company's compliance program is always demonstrated by sound compliance books and records to prove at all times to regulators and clients that the company complies with all its regulatory obligations.

Let's investigate how this "unauthorized communication" phenomenon is applied specifically to a firm's marketing compliance program.

How important is record-keeping to an AIFM/asset manager's marketing compliance program?

It is absolutely mission critical

Conducting "marketing" of funds in any jurisdiction constitutes a regulated activity and is subject to compliance with local marketing regulations. You need to check these rules in advance of any AIF [alternative investment fund] marketing activity in any jurisdiction.

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Allowing sales teams to communicate with potential clients about the AIFM/asset manager's funds, either in a sales or after-sales client servicing capacity, could translate as potential violations of local fund marketing regulations and licensing rules.

With respect to marketing compliance programs, the industry adage about record-keeping is applied two-fold:

I. "Didn't document it, didn't do it" (Prove you did comply): Without records on compliance files to prove a firm's compliance with a local country's fund marketing regulations as part of cross-border AIF marketing campaigns, there is no evidentiary proof that the firm has complied with the country's fund marketing regulations. In any jurisdiction where you are marketing your AIF, you have to comply broadly with two-track compliance:

(i.) Fund registration/notification requirements: Did you register/notify your fund before marketing it in that jurisdiction? Record-keeping is key to proving compliance with this fund requirement where required. You may need to provide this information to potential investors as part of RFPs.

(ii.) Licensing requirements: Have you registered for a license to market the fund in that jurisdiction and/or appointed a licensed distributor for your fund before it is marketed in that jurisdiction (where required)? You may need to provide this information to potential investors as part of RFPs.

(iii.) Case study: South Korea – Compliance with the AIF private placement regime in South Korea requires registration of one's AIF with South Korea's regulator (FSS) along with the appointment of a "Licensed Fund Distributor" (LFD) in order for the distributor to privately place your AIF to Qualified Professional Investors (QPIs). In this example, it is critical to keep robust in-house records and documentation to prove that you complied with South Korea's private placement regulations if you want to fundraise in your AIF on a private placement basis from investors in South Korea. Additionally, the South Korean private placement regime requires the appointed LFD to conduct all "private placement marketing" and after-sale client servicing of AIFs that have been approved for private placement in South Korea.

In this case, documented records on the file proving your compliance with South Korea's laws mean that you are compliant with their private placement regime for fundraising in AIFs from Korean investors. Yet allowing unauthorized (WhatsApp) communication (conducted by anyone within the AIFM, i.e., sales teams) with Korean clients after compliance with Korea's fund marketing rules contradicts your compliance records and in itself is likely a violation of South Korea's regulations.

II. "Didn't document it, did do it" (Prove you didn't market where you say you're not marketing): Some AIFMs/asset managers use the argument, "We're not "marketing" AIFs in a particular jurisdiction (say, France for example) and therefore we're not subject to France's fund marketing rules." So the regulator may ask, "How did you – the AIFM – obtain that French institutional investor in your AIF?" Without records, you'll be hard-pressed to definitively demonstrate that you didn't do something (solicit your fund).

(i.) Sale practice: reverse solicitation – "Reverse solicitation" is a sales practice whereby the potential investor contacts the fund manager (AIFM/asset manager) and requests information on the fund manager's fund (or financial services) on an unsolicited basis. This sales practice was intended by the regulators to be an example of a carve-out to local regulations on solicitation of financial products or services so long as the contact with the investor was genuinely unsolicited by the fund manager.

(ii.) "Marketing" is a rebuttable presumption (Prove you didn't do it): If you accept investor subscriptions to your fund/AIF from countries where you say "We're not 'marketing' in that jurisdiction so we don't have to follow their rules," then you had better have robust evidentiary compliance records to prove it. Regulators generally apply the "rebuttable presumption test": Marketing compliance means that you have to prove to the regulators you did not conduct solicitation activities in their jurisdiction. The default position of the regulators is that you are marketing in their jurisdiction unless you can prove otherwise. That's especially important if you take tickets from investors in their jurisdiction.

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(iii.) Case study: France – Our longstanding France Counsel describes an example of what can go wrong when you cannot prove "you didn't do it": A French institutional investor reached out to a US-based hedge fund manager to request information about the US AIFM's Cayman Islands hedge fund, under a seemingly legitimate case of "reverse enquiry" (aka reverse solicitation or in France, "solicitation passive"). The French institution invested in the US AIFM's Cayman hedge fund. The US AIFM did not document any evidence in their compliance files to prove that the French institution reached out to them on an unsolicited basis. That means that they could not confirm that the "initiative test" was met.

The French institution suffered losses from their investment in the US AIFM's Cayman hedge fund and initiated litigation against the AIFM in the French Court, claiming that the US AIFM breached France's AIF marketing regulations by marketing the Cayman hedge fund to them in breach of France's fund marketing regulations and licensing rules. What ensued was a lengthy and expensive court case lasting around five years.

What's your downside risk for non-compliance with record-keeping for your marketing compliance program?

The following key distribution risks apply if you fail to document if you "Did Do It" and/or "Didn't Do It" with respect to cross-border marketing compliance.

Investor rescission rights risk:

1. Sanctions Risk;
2. Reputation Risk; and
3. Business Franchise Risk.

With respect to the France case study: Who has time or legal fees budget to fight a lawsuit in a court in France (outside your home jurisdiction) lasting five years? If the US AIFM had filed documentation showing that the request for information was a legitimate reverse enquiry from the French institution, this could have potentially helped their case.

Summary: It is absolutely mission critical to create and maintain robust in-house records for your marketing compliance platform to prove:

-- you did comply with country marketing regulations where you intend to fundraise in your AIF (and)
-- you did not solicit funds in any country where you say you're not marketing but have clients from that country.

Your internal marketing compliance books and records should prove that you "Did Do it" and also where you "Didn't Do it," where relevant.

Sanctions by the regulators and lengthy lawsuits are just not worth it when robust marketing compliance books and records are so easy to create and maintain.

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