DORSEY PF 2017 SYMPOSIUM

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## Session 5: Private Fund Adviser Regulation and Enforcement

2:15- 3:15PM

**Moderator:** Genna Garver, *Of Counsel, Chair Investment Management Group, Dorsey & Whitney LLP*

**Panelists:**
Paul Glenn, *Special Counsel, Investment Adviser Association*
Tom Gorman*, Partner, Dorsey & Whitney LLP*
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Mitzie Pierre, *Chief Compliance Officer, US and Canada, IFM Investors*

# COUNTDOWN TO THE NEW FORM ADV: ARE YOU READY?

2017 DORSEY & WHITNEY LLP ANNUAL PRIVATE FUND SYMPOSIUM

SESSION 5 – PRIVATE FUND ADVISER REGULATION AND ENFORCEMENT

# FORM ADV GETS AN OVERHAUL

- August 2016, the SEC adopted amendments to the Investment Adviser Act of 1940 (the "Advisers Act") and Form ADV. (See SEC Release No. IA-4509, August 25, 2016, the "Adopting Release").
- Objective for these amendments were to:
  1. Fill certain data gaps,
  2. Enhance current reporting to improve the depth and quality of information collected by the SEC, and
  3. Facilitate risk monitoring objectives of the SEC.
- The changes to the Advisers Act and Form ADV included not only technical and clarifying changes, but also require additional information regarding:
  1. Separately managed accounts ("SMAs"), and
  2. Codification of the "umbrella registration" method for private fund adviser registration.
- The amendments also change the Advisers Act books and records Rule 204-2, now requiring advisers to make and keep supporting documentation demonstrating performance calculations and rates of return in any written communications circulated or distributed by the adviser.
- The General Instructions, Glossary and almost every Item of Part 1A and its related sections of Schedule D in the Form ADV will change.

# SEPARATELY MANAGED ACCOUNTS (“SMAs”)

- New Item 5(K) of Part 1A and its corresponding section of Schedule D will require additional information on an aggregate basis regarding the types of assets held and the use of derivatives and borrowing in SMAs, such as: the approximate percentage of SMA regulatory assets under management (“RAUM” invested in 12 different asset categories.
- Advisers can use own internal methodologies and conventions to determine how to categorize assets, so long as consistent and does not double count assets.
- On an annual basis, advisers with at least $10 billion RAUM attributable to SMAs must provide such information as of mid-year and end of year.
- Advisers with less than $10 billion in RAUM attributable to SMAs must only provide such information as of end of year.

# SEPARATELY MANAGED ACCOUNTS ("SMAs")

- Item 5.K. instructs advisers to report regulatory assets under management attributable to clients "other than those listed in Item 5.D(3)(d)-(f)."
- For purposes of answering Item 5.K and Schedule D, Section 5.K, advisers to private funds that report information about parallel managed accounts to those private funds on Form PF should treat those parallel managed accounts as SMAs.
- Parallel managed account (which is defined in the Form PF Glossary) clients that are not registered investment companies, business development companies, or pooled investment vehicles are not reported in Item 5.D(3)(d)-(f).
- Therefore, parallel managed accounts should be considered SMA clients for purposes of answering Item 5.K and Schedule D, Section 5.K.

# SEPARATELY MANAGED ACCOUNTS ("SMAs")

- New Section 5.K(2) of Schedule D requires information regarding SMAs' use of borrowing and derivatives.
- Advisers with at least $500 million in SMA RAUM will be required to annually report the amount of SMA RAUM and the dollar amount of borrowings that correspond to 3 levels of gross notional exposures (i.e., less than 10%, 10-149% and 150% or more) as of the date the adviser used to calculate its RAUM for purposes of the adviser's annual updating amendment.
- Advisers with at least $10 billion in SMA RAUM must annually report that same information as of the date that is six months before that date.
- Advisers with at least $10 billion in SMA RAUM also must annually report, for both periods, average derivatives exposures across six categories of derivatives.

# ADDITIONAL INFORMATION ABOUT INVESTMENT ADVISERS

Social Media Presence

- Item 1.I. requires disclosure of whether the adviser has one or more accounts on social media platforms, such as Twitter, Facebook or LinkedIn, and the address of each of the adviser's social media pages.
- The required reporting is limited to accounts on social media platforms where the adviser controls the content and to accounts on publicly available social media platforms.
- Advisers will not be required to report the address of their employee social media accounts even in the situations where the adviser controls the contents of the employee accounts.

Physical Office Locations

- Item 1.F.(1) and Section 1.F. of Schedule D will now require disclosure of the 25 largest offices in terms of the number employees as of the end of the most recent fiscal year.
- New Item 1.F.(5) also requires disclosure of the total number of offices at which the adviser conducts investment advisory business as of the end of the most recently completed fiscal year.
- In addition, advisers must disclose each office's CRD branch number (if applicable) and the number of employees who perform advisory functions from each office, identify from a list of securities-related activities the business activities conducted from each office, and describe any other investment-related business conducted from each office.

# ADDITIONAL INFORMATION ABOUT INVESTMENT ADVISERS

Item 7 includes a number of additional technical and clarifying changes regarding financial affiliates, fund of funds and distribution of audited financial statements, among other items.

- Question 21 of Schedule D, Section 7.B.(1) has been clarified to ask if the private fund has ever relied on Securities Act Regulation D.
- Advisers must now provide the fund's Form D filing number in Question 22 if a Form D was ever filed, regardless of whether the fund currently relies on the Regulation D's safe harbor.
- New Question 15(b) of Schedule D, Section 7.B.(1) requires disclosure regarding "qualified client" status of private fund investors.
  - Note: Exempt reporting advisers ("ERAs") who are not subject to the Advisers Act prohibitions on performance-based compensation may respond "No" to this new question according to the Adopting Release.

# OUTSOURCED CHIEF COMPLIANCE OFFICERS

To enable the SEC to identify all advisers relying on a particular compliance service provider and to address potential risks associated with that service provider, the amendments include increased disclosure requirements regarding outsourced Chief Compliance Officer's ("CCO").

- New Item 1.J.(2) requires advisers to disclose whether the adviser's Chief Compliance Officer is compensated or employed by any person other than the adviser or a related person.
- If the CCO is compensated by someone else, the new Item 1.J.(2) requires the adviser to provide the CCO's name and IRS Employer Identification Number (if any).
- The revised item does not require disclosure of an adviser's third party compliance consultant unless such person is designated as the CCO.

# REGULATORY ASSETS UNDER MANAGEMENT

- In hopes of obtaining more precise data for use in SEC rulemaking on incentive-based compensation and stress testing arising from ongoing Dodd-Frank Act implementation, SEC has amended Item 1.O to require advisers with assets of $1 billion or more to report their assets within 3 ranges:
  - (i) $1 billion to less than $10 billion;
  - (ii) $10 billion to less than $50 billion; and
  - (iii) $50 billion or more.
- Form ADV instruction for Item 1.O, "assets" refers to the adviser's total assets, not the assets managed on behalf of clients.
- Non-proprietary assets, such as client assets under management, should be excluded when responding to Item 1.O, regardless of whether they appear on an adviser's balance sheet.

# REPORTING THE NUMBER AND TYPE OF CLIENTS

- In addition to the new SMA requirements discussed above, the amendments include numerous changes and additional disclosure in Item 5, such as:
  - the approximate amount of advisory clients not included in the adviser's RAUM,
  - whether the adviser elects to report client assets in Part 2A of Form ADV differently from RAUM reported in Part 1A, and
  - more information regarding wrap fee programs.
- Advisers will also need to provide the approximate amount of an adviser's total RAUM attributable to non-U.S person clients to give the staff a better idea of the adviser's relationship with non-U.S. clients for risk assessment purposes.
- To address disclosure of client-specific information and related competition concerns, advisers with fewer than five clients in a particular category may indicate that fact rather than report the actual number of clients in the particular category for Item 5.D.
- For purposes of Item 5.D, "pooled investment vehicles" include but are not limited to private funds, which are defined in the Form ADV Glossary. Whether a fund (other than an investment company or business development company) should be considered to be a "pooled investment vehicle" will depend on its particular facts and circumstances.

# UMBRELLA REGISTRATION

- The amendments to Form ADV better accommodate the method of filing a single umbrella registration as established in a 2012 SEC staff no-action letter for multiple private fund advisers under common control with the filing adviser; provided they conduct a single advisory business and satisfy other conditions set forth in letter.
- The Adopting Release states that for purposes of umbrella registration, the SEC considers the following factors as indicia of a single advisory business:
  - commonality of advisory services and clients;
  - a consistent application of the Advisers Act and the rules thereunder to all advisers in the business; and
  - a unified compliance program.
- The Adopting Release confirms the requirement to determine asset-based eligibility for umbrella registration on an entity-by-entity, rather than consolidated, basis.
  - Thus, the filing adviser and each relying adviser must individually have sufficient RAUM to qualify for SEC registration or qualify for an exemption from Advisers Act section 203A's prohibition (permitting an adviser to register with the SEC that would otherwise be prohibited if the adviser is in a control relationship with a registered adviser and has the same principal office and place of business as the registered adviser).

# UMBRELLA REGISTRATION

- To alleviate some of the confusion created by filing an umbrella registration on current Form ADV, new Schedule R will require the following information for each relying adviser:
  - identifying information;
  - basis for SEC registration;
  - form of organization, and
  - control persons.
- A new question to Schedule D will also require advisers to identify the filing advisers and relying advisers that manage or sponsor private funds.
- The amendments do not expand "Umbrella Registration" to ERAs because ERAs are not required to comply with all of the conditions for umbrella registration (such as, maintaining written compliance policies and procedures and Codes of Ethics).
  - However, the Frequently Asked Questions that permits certain exempt reporting advisers to file a single Form ADV on behalf of multiple special purpose entities has not been withdrawn.

# ADVISER REGISTRATION UNDER THE "120-DAY RULE" JUSTIFICATION

- An adviser relying on Rule 203A-2(c) to register with the SEC because it expects to be eligible for SEC registration within 120 days of filing its initial Form ADV filing but does not currently manage any assets will need to make use of a placeholder in responding to Schedule D, Section 5.K.
- For purposes of providing year-end information, advisers should respond with "100%" in the "Other" category and indicate in the Miscellaneous section of Schedule D that the firm does not have any responsive data to report as it is relying on Rule 203A-2(c) as the basis of its registration.
- If the adviser is required to report mid-year information on Schedule D, Sections 5.K(1) and 5.K(2) but did not manage assets for SMA clients as of the mid-year date, the adviser can take the same approach.
- As noted in Schedule D, Section 5.K., each column should add up to 100%.

# PERFORMANCE ADVERTISING BOOKS AND RECORDS

- The amendments also include changes to the Advisers Act books and records rule 204-2(a)(7) and (16).
- Advisers that are registered or required to be registered with the SEC must maintain additional materials related to the calculation and distribution of performance information.
- In addition, the amended rule will require advisers to also maintain originals of all written communications received and copies of written communications sent by the adviser relating to the performance or rate of return of any or all managed accounts or securities recommendations.
- Rule 204-2(a)(16), as amended, requires advisers to maintain such records for performance claims in communications that are distributed or circulated to any person.
- The SEC declined to provide exclusion for one-on-one communications that are customized responses from investors or communications with sophisticated investors or clients.

# COMMON COMPLIANCE ISSUES FOR INVESTMENT ADVISERS

2017 DORSEY & WHITNEY LLP ANNUAL PRIVATE FUND SYMPOSIUM

SESSION 5 – PRIVATE FUND ADVISER REGULATION AND ENFORCEMENT

# COMMON COMPLIANCE ISSUES FOR INVESTMENT ADVISERS

- February 2017 – SEC's Office of Compliance Inspections and Examinations ("OCIE") published a Risk Alert listing the 5 most frequent compliance topics identified on investment adviser examinations within the past 2 years.
- The 5 compliance topics include deficiencies or weaknesses under the Investment Advisers Act of 1940, as amended (the "Advisers Act") and violations relating to: :
  - Compliance Rule (Rule 206(4)-7);
  - Required regulatory filings;
  - Custody Rule (Rule 206(4)-2);
  - Code of Ethics Rule (Rule 204A-1); and
  - Required Books and Records Rule (Rule 204-2)
- Violations relating to these 5 areas overlap with those violations successfully pursued by the SEC in 2016 and that remain in the SEC's crosshairs for 2017.

# SEC'S CONTINUED FOCUS ON ADVISER COMPLIANCE VIOLATIONS

- January 2017 – OCIE announced its 2017 Examination Priorities to aid advisers in evaluating their own compliance programs in the identified areas of priority and make necessary changes and enhancements.
- The 2017 Examination Priorities demonstrate the SEC's continuing focus on a wide range of issues from traditional areas such as market-wide risks to new forms of technology, such as automated investment advice.
- In the February 7 Risk Alert, OCIE also encouraged advisers to review their compliance programs and practices in light of the topics previously noted in the 2017 Examination Priorities.
- As part of their review, advisers should consider the examples provided in this presentations as typical deficiencies and weaknesses emphasized by OCIE in these publications and that remain a frequent problem.

# 1. COMPLIANCE RULE VIOLATIONS

- Typical examples of Compliance Rule deficiencies identified by the staff include failing to tailor compliance manuals to individualized business practices—an issue previously identified in a November 9, 2015 OCIE risk alert.
- Similarly, the staff noted that certain manuals were no longer current, containing out-of-date information about the firm that had become obsolete.
- The staff also found that certain advisers did not review their compliance policies and procedures on an annual basis.
- Those registrants that did complete an annual review did not fully consider the adequacy or effectiveness of those policies and procedures.
- Notwithstanding these shortcomings, the staff also found that many advisers were simply not following their policies and procedures—even if they were current and would have otherwise been operating effectively.

# 2. REGULATORY FILINGS VIOLATIONS

- The staff highlighted a series of deficiencies regarding advisers' obligation to accurately complete and timely submit their regulatory filings, including:
  - Inaccurate Form ADV disclosures,
  - Untimely Form ADV amendments,
  - Incomplete Form PF filings, and
  - Incorrect Form D filings.

# 3. CUSTODY RULE VIOLATIONS

- As initially discussed in a March 4, 2013 risk alert, compliance with the Custody Rule remains a common issue.
- The staff observed violations of the Custody Rule stemming from situations in which advisers did not recognize that their online access to client accounts—including the ability to withdraw funds and securities—fell within the definition of custody.
- Correspondingly, certain advisers did not provide independent CPAs performing "surprise" examinations with complete lists of accounts over which the advisers had custody.
- Similar deficiencies included the advisers' failure to procure their accountants with the information necessary to timely file correct Form ADV-Es.
- Other instances suggested that surprise examinations were being conducted at the same time each year, eliminating any element of surprise and defeating the purpose of the examination altogether.

# 4. CODE OF ETHICS RULE VIOLATIONS

- Representative violations of the Code of Ethics Rule centered on the advisers' failure to satisfactorily provide information about the advisers' codes of ethics.
- Among other things, the staff observed that advisers:
  - Failed to comprehensively identify their "access persons,"
  - Neglected to timely disclose information pertaining to holdings and transactions reports, and
  - Failed to properly describe their codes of ethics in Form ADV filings.

# 5. REQUIRED BOOKS AND RECORDS RULE VIOLATIONS

- The staff emphasized a series of common books and records violations, including:
  - The failure to maintain all required books and records,
  - Inaccurate or incomplete books and records, and
  - Inconsistent recordkeeping resulting in contradictory information held in separate sets of records.

# COMPLIANCE VIOLATION CONSEQUENCES AND NEXT STEPS

- The examinations reviewed by OCIE containing the common violations outlined in this presentation resulted in a range of outcomes, the most severe being referrals to the SEC's Division of Enforcement for further investigation.
- With these 5 key topics in mind—and in light of the SEC's continued focus in these areas—advisers should review their compliance programs and practices to ensure that any existing and potential deficiencies are detected, and that proper remedial actions are taken.

# RESOURCES

- SEC OCIE Risk Alert (February 2017): https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf
- SEC OCIE 2017 Examination Priorities (January 2017): https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf
- SEC OCIE Risk Alert (November 2015): https://www.sec.gov/ocie/announcement/ocie-2015-risk-alert-cco-outsourcing.pdf
- SEC OCIE Risk Alert (March 2013): https://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf

# IMPORTANT COMPLIANCE DATES

- The first time most advisers will need to file on the new Form ADV will be for their annual updating amendments in 1Q 2018.
- However, initial Form ADV filers and those filing amendments to an existing Form ADV must begin using the new Form ADV on or after October 1, 2017.
  - For "other-than-annual" amendments after October 1, 2017 but before 1Q 2018, SEC has indicated in its August 2017 Information Update that advisers that do not have enough data to response to new amended items in Item 5 and related Schedule D sections of Form ADV may respond with the placeholder "0" and provide explanatory information in the Miscellaneous section of Schedule D.
- The amendments to the books and records rule 204-2 will apply to communications circulated or distributed after October 1, 2017.
  - However, advisers that circulate or distribute communications after October 1, 2017 that include performance information, including information on performance that predates October 1, 2017, will be required to maintain records supporting those performance claims.

# RESOURCES

- 2017 SEC Division of Investment Management Information Update: https://www.sec.gov/divisions/investment/imannouncements/im-info-2017-06.pdf
- SEC FAQs on Form ADV and IARD, Reporting to the SEC and an Exempt Reporting Adviser: https://www.sec.gov/divisions/investment/iard/iardfaq.shtml
- Dorsey &Whitney LLP, "Countdown to New Form ADV – Are you Ready?": https://www.dorsey.com/newsresources/publications/client-alerts/2017/09/countdown-to-new-form-adv?forward=06b34105-5f8a-4366-8638-4b7ee5fa3dd2
- 2016 SEC Adopting Release: SEC Release No. IA-4509, August 25, 2016,
- Dorsey & Whitney LLP, "Form ADV Gets an Overhaul": https://www.dorsey.com/newsresources/publications/client-alerts/2016/08/form-adv-gets-an-overhaul
- 2012 SEC FAQs Regarding Certain ERA Form ADV Filings: https://www.sec.gov/divisions/investment/iard/iardfaq.shtml#exemptreportingadviser.
- 2012 SEC No-Action Letter: American Bar Association, Business Law Section, SEC Staff Letter (Jan. 18, 2012), available at http://www.sec.gov/divisions/investment/noaction/2012/aba011812.htm (the "2012 ABA Letter").

IAA INVESTMENT ADVISER ASSOCIATION

# Investment Adviser Regulatory Landscape
# Dorsey Symposium on Private Equity

*Paul D. Glenn, Speaker*

September 28, 2017

# Presenting today…

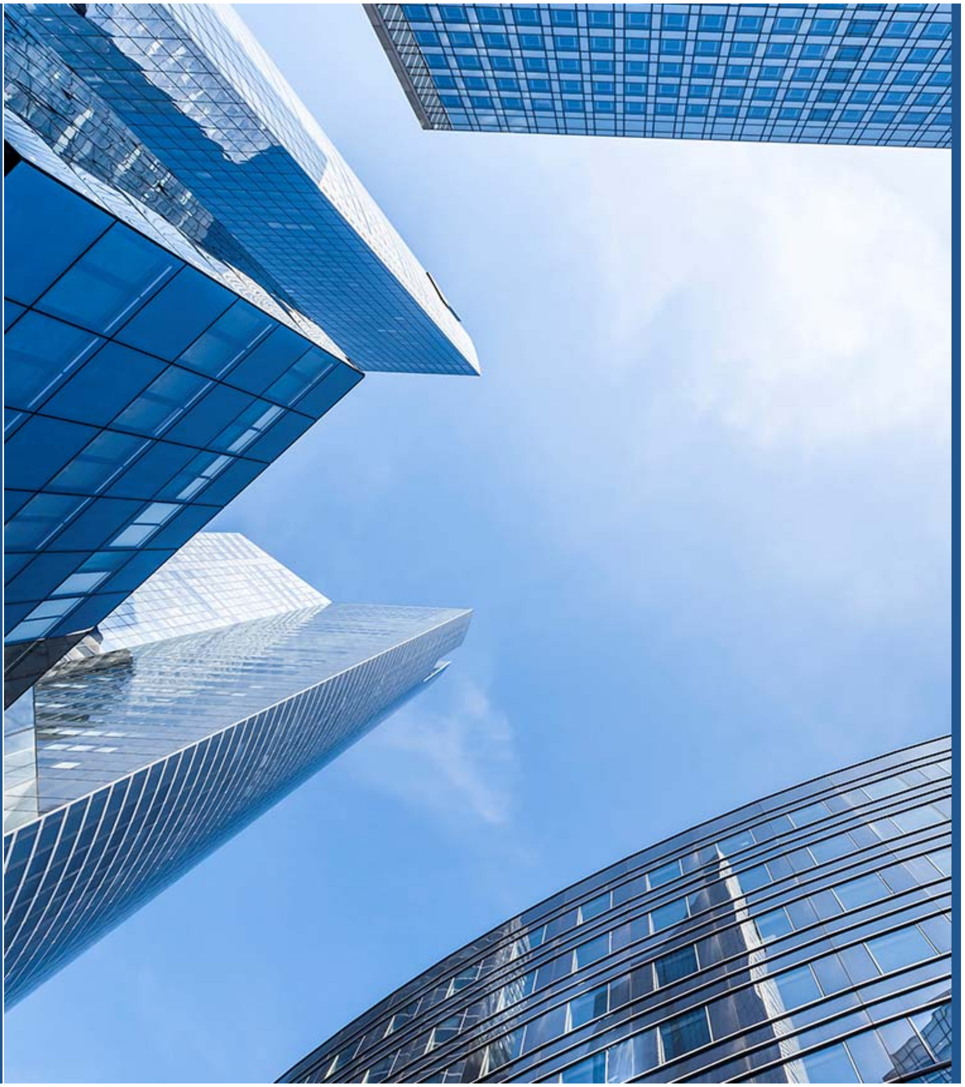
**Paul Glenn**
Special Counsel

# The IAA's 2017 Policy Priorities

- Review and improvement of key Advisers Act Rules
- Preserve Advisers Act fiduciary standard and extend duties to brokers
- Maintain SEC oversight of advisers
- Ensure regulators consider rule impacts on smaller advisers
- Rationalize SEC-CFTC regulatory overlap
- Protect seniors from financial abuse
- Address cybersecurity threats
- Oppose FSOC designation of asset managers of funds as SIFIs; enhance FSOC transparency
- Support tax reform/oppose "Rothification"

# Briefing Agenda

- IAA's 2017 Policy Priorities
- Capitol Hill and Administration Update
- Regulatory Update
  - SEC
    - Regulatory Developments
    - Examination & Enforcement
  - DOL
  - Treasury
  - CFTC
- International
- Other Developments



# Changes in Washington

Executive Orders

Personnel Changes

Congressional Developments

# Executive Orders

→ President Trump's Executive Orders (2-for-1), Core Principles, DOL, impacting regulators and regulations

→ In general, executive orders do not apply to the SEC and other independent agencies. However, the SEC and CFTC Chairs have indicated their intent to try to comply with the letter or the spirit of the executive orders

→ The orders do apply to the DOL, Treasury, and other executive agencies

# Changes at the Regulatory Agencies

## SEC

Jay Clayton
Chair (I)

Kara Stein
Incumbent (D)

Michael Piwowar
Incumbent (R)

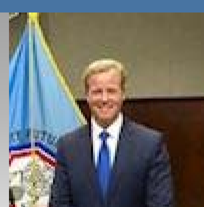
Hester Peirce
(nominated) (R)

Robert Jackson
(nominated) (D)

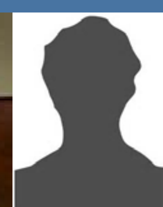
## CFTC

Chris Giancarlo
Chair (R)

Sharon Bowen
Incumbent (D)



Brian
Quintenz
(R)



Russ
Behnam
(D)

Dawn Stump
(nominated)
(R)

## DOL

Alexander
Acosta
Secretary

# Congressional Developments

Dodd-Frank Act Reform

SEC Funding

Tax Reform

→ "Rothification"

→ Carried Interest

Senior$afe Act

IAA Letter to Senate Banking Committee on SEC definition of small business

# Regulatory Developments
# SEC – Chairman Clayton's Guiding Principles

SEC must be guided by:

- Its mission
- Long-term interests of Main Street investors
- Its historic approach to regulation
- Lasting and cumulative effects of incremental regulation
- Recognition of changes caused by technology and innovation,
- Retrospective review of rulemaking after adoption
- Inclusion of costs of demonstrating compliance in considering costs of a rule; and
- Coordination with other regulators

# SEC Advocacy

## IAA Letter to Chairman Clayton on Suggested Recommendations for Adviser Regulation


- Retrospective reviews of rules—advertising, custody, pay to play, electronic delivery, accredited investor

- Recommendation on current proposals
  - Business continuity plans and transition plans proposal
  - Derivatives proposal for registered investment companies

- Recommendations for ongoing policy debates
  - Oversight of advisers
  - Fiduciary



IAA

# SEC Advocacy

**Investment Adviser Oversight**

- Oversight and examination of registered advisers is inherently a government function
  - Support strengthening OCIE
  - Oppose SRO for advisers
  - Concerns with third party exams

**IAA Letter to Chairman Clayton on Fiduciary Standard for Investment Advice**

- Preserve Advisers Act fiduciary standard for registered advisers
- Create equally stringent new standard of conduct for broker-dealers
- If standard is not as robust, prohibit “holding out” without Advisers Act registration

# SEC Division of Investment Management

- New Director
  Division of Investment Management

Dalia Blass

# SEC Rules

## Form ADV Part 1A Amendments

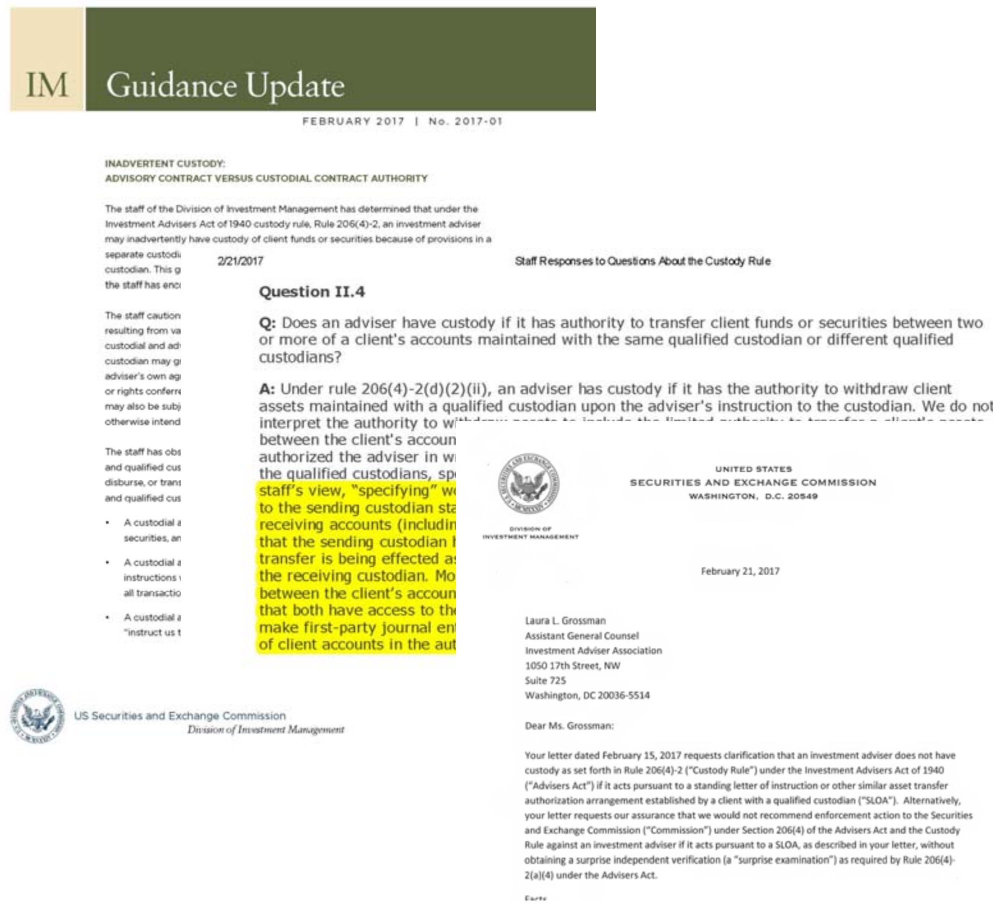
- Part 1A amendments adopted August 2016
  - Compliance date – any ADV filing after October 1, 2017
  - SEC FAQs June 12, 2017 / Information Update Aug. 2017
- Additional information about advisory business and clients
- Separately Managed Account (SMA) Clients reporting on asset types, derivatives and borrowing, custodians of SMA RAUM
- New Schedule R umbrella registration for private fund advisers “relying” on filing adviser’s ADV
- IAA Form ADV Part 1 Amendments Working Group

# SEC Rules
## Custody Rule

→ No-Action Letter to IAA on Standing Letters of Authorization

→ FAQ II.4 first-person transfers

→ SEC IM Guidance Update on Inadvertent Custody



# FinTech and Robo Advising

- → February 20 Division of Investment Management Guidance Update on Robo-Advisers
- → IAA Fintech Committee Meeting at SEC with IM, OCIE and Enforcement

# SEC Examinations

- Status of 2017 priorities
  - ReTIRE
  - Automated Investment Advice
  - Recidivist Representatives
  - Multi-Branch

## SEC Examinations

- Continued focus on Cybersecurity
  - “It is critical that we regularly assess the cybersecurity landscape and adapt accordingly as we strive to fulfill our mission.” - SEC Chairman Clayton

# SEC Examinations

- Continued focus on Cybersecurity
  - Ransomware Alert
  - Observations from Cybersecurity 2 Initiative
- New OCIE Advertising Release
  - Reviewed pronouncements Sept 14, 2017

# SEC Examinations

- Priorities going forward
  - "Main Street" Investors
  - Cybersecurity
  - IPO Allocations
  - Electronic Correspondence

# SEC Enforcement

- Performance Advertising
- Disclosure of Conflicts of Interest
- Cherry Picking

# **SEC Enforcement** continued

- Insider Trading Standards

  → Salman v. U.S., U.S. Supreme Court December 2016, personal benefit

  → U.S. v. Martoma, Second Circuit August 23, 2017, relationship suggests a *quid pro quo*

# DOL Fiduciary Rule

- Definition of “fiduciary” was applicable on June 9, 2017
- Impartial conduct standards also required as of June 9
- Remaining provisions currently go into effect Jan. 1, 2018, but DOL has proposed to delay implementation until July 1, 2019
- President Trump’s February 3 memorandum and DOL requests for comment on the rule
- IAA filed comments on application of fiduciary status to advisers during pre-contract/marketing stage, use of IFE, level-fee/streamlined BIC

# Treasury Department Developments

IAA Meeting with Treasury Officials

IAA Letter to Treasury

- EO 13772, Core Principles for Financial Regulation
- EO 13771, Reducing Regulation and Controlling Regulatory Costs (“2-for-1”)
- EO 13777, Enforcing the Regulatory Reform Agenda
  - → AML
  - → FBAR

# CFTC

## Project KISS and CPO/CTA Registration Regulation

→ CFTC seeking recommendations on improvements to rules. IAA to recommend more efficient and more rational rules for CPO and CTA registration, recordkeeping and reporting

## Recordkeeping Rule 1.31

# International

- MiFID II
  - Takes effect January 3, 2018
  - Key issues for U.S. asset managers
  - Global implications

# GIPS

**Proposal for GIPS 20/20 Overhaul**

- IAA Comment Letter July 16, 2017

- CFA Institute to issue proposed changes in Spring 2018 for implementation in 2019

Celebrating IAA INVESTMENT ADVISER ASSOCIATION 80TH ANNIVERSARY

# Thank You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WHITEPAPER

# Six Months into the Liquidity Risk Management Program Rule

ACA COMPLIANCE GROUP
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# WHITEPAPER

# Six Months into the Liquidity Risk Management Program Rule

In October 2016, the Securities and Exchange Commission ("SEC") adopted new requirements under the Investment Company Act of 1940 ("IC Act") to require registered open-end investment companies, including open-end exchange-traded funds ("ETFs") but excluding money market funds, to implement a liquidity risk management program.[1] The liquidity program rule aims to (i) reduce the risk of a fund failing to meet its redemption obligations to shareholders, and (ii) mitigate dilution of interests of remaining fund shareholders. Though large mutual fund complexes do not need to comply with the new rule until December 1, 2018, this whitepaper examines points of consideration for fund complexes and their advisers that have surfaced in the six months since the rule took effect.[2]

## Prospectus Disclosure Changes

Open-end funds must disclose additional information regarding redemption payments and the methods used to satisfy redemption requests in initial registration statement filings on Form N-1A, and post effective amendments to current prospectuses filed on or after June 1, 2017.

A fund must further describe its procedures for redeeming the fund's shares, including (i) the number of days a fund typically expects it to take to pay redemption proceeds to redeeming shareholders following receipt of shareholder redemption requests; and (ii) the methods the fund typically uses to meet redemption requests, including whether it uses those methods regularly or only in stressed market conditions.

A fund must also disclose the typical number of days or estimated range of days that the fund expects it will take to pay out redemption proceeds for each method used (e.g., check, wire, automated clearing house), focusing on when the fund expects to make the payment versus when the shareholder expects to receive the proceeds.

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[1] Rule 22e-4 under the IC Act (the "liquidity program rule"). See IC Act Release No. 32315 (October 13, 2016) (the "Adopting Release").

[2] Large mutual fund complexes are those with $1 billion or more in assets under management. Note that "smaller" fund complexes (those with less than $1 billion in assets under management) have until June 1, 2019, to comply with the rule's provisions.

## Planning for Program Adoption

The liquidity program rule has multiple moving parts and appears to require a collaborative exercise across:

- a fund adviser's organization,
- the fund's board of directors (or trustees) (herein, the "board"), and
- vendors and service providers outside the organization.

Many fund advisers at this point have started the process of:

- **defining** the liquidity program,
- **deciding** who to involve in the planning and building of the liquidity program,
- **establishing** a project management plan, and
- **educating** the board about the rule and the adviser's plans. Further, advisers have begun to take meetings with vendors on their liquidity classification methodologies, capabilities, and systems.

Further, advisers have begun to take meetings with vendors on their liquidity classification methodologies, capabilities, and systems.

> An important part of the project management plan centers around board meeting dates.

Advisers need to take into consideration the timing of such meetings and work backwards from December 1, 2018, to ensure they have enough time to:

- present a draft liquidity program for the board's consideration,
- approve the plan, and
- implement the plan in a shadow environment to ensure the liquidity program's accuracy and effectiveness.

**As a rule of thumb, we hear that advisers should present a draft liquidity program to the board for review and comment by the turn of the calendar year.**

Advisers should then incorporate feedback from the board and any further adviser revisions into a second, possibly final, liquidity program to be presented at the following board meeting. Depending on meeting timing, this could give a firm upwards of a quarter to implement the liquidity program in a shadow environment, ensuring its build and classification assumptions are correct. This allows advisers to iron out any possible tweaks or kinks before December 1. Fund complexes and advisers that went through the recent money market fund revamp will understand the need for project planning and shadow testing.

## Individual or Committee

The board, including a majority of independent directors (or trustees), must approve the designation of a fund's adviser (or sub-adviser if appropriate), officer, or officers responsible for administering the liquidity program. On at least an annual basis, the liquidity program administrator must provide the board a written report on the adequacy of a fund's liquidity program, including the highly liquid investment minimum ("HLIM"), and the effectiveness of its implementation.

The liquidity program rule does not allow for portfolio managers alone to be responsible for administering the liquidity program. However, portfolio managers can be part of a committee approach to administering the liquidity program. At larger organizations, the committee approach seems to be the leading candidate for program administrator, while smaller organizations may look to lean on one individual, such as the fund's president or a risk officer, if there is one. Notably, advisers can take a multidisciplinary approach to the committee's composition, drawing members from operations, portfolio management, trading, legal, risk, and compliance. Functionally the committee will need to determine voting and non-voting members, as other fund or adviser committees do. In some ways, the liquidity program's administration may resemble that of the valuation committee. This is not really a surprise given the correlations between valuation processes and liquidity determination processes.

Of course, no new investment company regulation could happen without factoring in the chief compliance officer. In this case, the chief compliance officer, or his or her designee, appears best suited to be part of the liquidity committee, and not the sole individual liquidity program administrator. In this scenario, the chief compliance officer would oversee the liquidity program under the requirements of Rule 38a-1 under the IC Act, and report accordingly to the board.

## Technology

From liquidity classifications, to setting the HLIM, to pushing information to new Form N-PORT, technology will play a significant role in establishing an effective liquidity program. A fund must classify the liquidity of its portfolio investments at least monthly, using information obtained after reasonable inquiry and taking into account market, trading, and investment-specific considerations. To classify portfolio investments among the four liquidity categories (highly liquid, moderately liquid, less liquid, and illiquid), advisers will need an established, repeatable rules-based process.[3]

[3] Note that the definition of an illiquid investment changes under Rule 22e-4. The rule defines an illiquid investment as any investment that may not reasonably be expected to be sold or disposed of in current market conditions within seven calendar days, without the sale or disposition significantly changing the market value of the investment. This differs from the historical definition that an illiquid investment was any security that could not be sold within seven days at approximately the price at which it is valued.

Since the nature of investments (e.g., large-cap equities versus bank loans) and number of investments will factor into the complexity of the process, classifying investments by hand or on a simple spreadsheet may not be viable. As an alternative, an adviser could look into building in-house capabilities, hiring a third-party vendor, or utilizing the possible (and probable) capabilities of the fund's administrator. Building in-house capabilities requires dedicated information technology resources in terms of both human and monetary capital, as well as the time and effort necessary to establish classification parameters and assessment criteria. On the plus side, the assessment criteria and assumptions generated using this approach would be "home grown," reflecting the adviser's investment approach and thinking about the market(s) and instruments in which it invests.

Hiring a third-party vendor, or even relying on the fund administrator, requires initial and annual due diligence to understand the vendor, the product, and the algorithms that underlie the classification methodologies (including the basis for a firm's comfort and confidence in the accuracy of the classification data).[4]

While the adviser may purchase such classification capabilities, it must realize that it is still responsible for the classification of assets, and the vendor only provides data points for such classification. Advisers still must conduct continued oversight of the markets, asset classes and individual portfolio investments. Advisers weighing the purchase of third-party classification models also must consider how they might override such classifications. Such a process needs to contemplate how a firm decides, communicates, and effects a classification override, an issue advisers may also encounter in the valuation of investments by pricing vendors. Additionally, funds and advisers will need to determine how they will provide their portfolio holdings to the vendor, taking into consideration the protection of such information, including a fund's portfolio holdings disclosure policies, as well as cybersecurity concerns.

Whether advisers build the aforementioned technology in-house or purchase it from a third party, firms will need to consider how to communicate classification determinations and other related liquidity information to the fund administrator. The liquidity program rule's requirement to classify assets (at least) monthly correlates to the requirement to provide the SEC with monthly portfolio and liquidity information via Form N-PORT. If the fund administrator is contracted to complete such form submissions, funds and advisers need to consider how to provide such investment classification information to the administrator for inclusion in Form N-PORT.

Advisers that employ sub-advisers will also need to consider the "pipeline" needed to transport the liquidity classifications from the sub-adviser to the adviser and/or the fund administrator. In some ways, this question depends on who determines the liquidity classifications (see the following discussion on sub-advisers).

[4] The SEC noted in the Adopting Release that a fund should consider having the same individual(s) assigned to administer the liquidity program undertake the due diligence of the third party and any data received from it.

## Sub-Advisers

The rule appears to provide flexibility to funds regarding how they include sub-advisers in the liquidity determination process. The SEC staff appears to have realized that there was no one-size-fits-all scenario in determining whether an adviser and/or a sub-adviser should be directly responsible for determining liquidity classifications.

**Funds and their advisers appear to be contemplating three scenarios:**

- **Pushing their liquidity program on their sub-advisers –** Under this scenario, advisers push the fund's liquidity program down to the sub-adviser, making the sub-adviser a reviewer of liquidity classifications, and providing agreement with such classifications. This could potentially occur on a monthly basis, with the sub-adviser reconciling the fund's/adviser's classifications against what it believes to be the classification of an asset class or portfolio investment. From a sub-adviser perspective, this scenario could result in varying classifications of an asset class or portfolio investment held across different fund clients.
- **Delegating the classification responsibility to the sub-adviser –** Under this scenario, the sub-adviser would make classification determinations under its own policies and considerations, but within the parameters of the fund's liquidity program. In such cases, the sub-adviser's chief compliance officer and the fund's chief compliance officer (and possibly the adviser's chief compliance officer) would need to develop and oversee the policies. The sub-adviser's policies and liquidity program would have to be flexible enough to address the sub-adviser's role across multiple fund complexes where liquidity programs and expectations could differ.
- **Sharing in the process at some level –** This hybrid scenario would constitute some mixture of the scenarios discussed above, where the adviser and sub-adviser share responsibility in some way. Funds could also make such determination on a sub-adviser-by-sub-adviser basis (e.g., easier assets, such as large-cap equities, could be classified by the adviser, but more difficult assets, such as bank loans, could be classified by the sub-adviser given their (hired) expertise in the asset class). Funds could also determine whether the size of the sub-adviser was relevant (e.g., whether to delegate classification responsibility to a large global asset manager over a smaller shop).

For situations where multiple sub-advisers manage a sleeve of a fund, the fund and the adviser need to determine how to make liquidity classifications. Should the responsibility sit at the adviser with sub-adviser input as needed? Or should each sub-adviser be responsible for liquidity classifications? In the latter case, the adviser must determine how to classify an asset when different sub-advisers assign it different classifications. One solution might be to take the lowest classification and apply it to the portfolio holding as a whole.

Sub-advisers should reach out to their adviser partners to understand the adviser's thinking. While the adviser may still be determining how to address the rule's requirement, let alone the sub-adviser's involvement in liquidity classification, the sub-adviser will want to be an early part of the conversation or a recipient of information to understand how to address the rule. Sub-advisers should expect different fund families to have different approaches to the rule, and will need to be able to adjust accordingly.

## Highly Liquid Investment Minimum

A fund must determine its HLIM, or the minimum amount of the fund's net assets that the fund invests in highly liquid investments that are assets. In determining its HLIM, a fund must consider factors, as applicable, similar to those considered in assessing its liquidity risk.

The HLIM requirement involves monitoring a fund's portfolio investments' liquidity for compliance. A fund with multiple \sub-advisers may find this more difficult if it has to coordinate portfolio liquidity information provided by each sub-adviser.

Further, as advisers look at the overall liquidity for the fund, they may want to decide whether the liquidity program, or at least the exercise, should look at or account for other sources of liquidity available to the fund in the form of lines of credit, bank borrowings, and/or nter-fund lending. When making this decision, advisers should keep in mind that a fund that has an available line of credit may not subtract the amount available to it from the fund's HLIM.

## Exchange-Traded Funds

Per the Adopting Release, "ETFs that elect to redeem authorized participants in cash in more than a *de minimis* amount, like mutual funds, would need to ensure that they have adequate portfolio liquidity (in conjunction with any other liquidity sources) to meet shareholder redemptions." As part of its liquidity program policies and procedures, an "In-Kind ETF" is expected to describe how it will manage and/or approve any portion of a redemption that is paid in cash, and document its determination that such a cash amount is de minimis.[5] According to the SEC, In-Kind ETFs may take under consideration (i) the amount and frequency with which cash is used to meet redemptions, and (ii) the circumstances and rationale for using cash to meet redemptions.

In practice, this *de minimis* cash threshold appears to be giving ETFs some pause. For instance, would index rebalance transactions run afoul of the *de minimis* cash threshold and push normally in-kind redeeming ETFs into having to comply with the full requirements of the rule?[6] What would happen in one-off stress conditions if the ETF had to redeem in cash versus in-kind—would that cause the In-Kind ETF to lose its "status"? The SEC staff may need to clarify these points, among others, in further guidance or FAQs.

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5 In-Kind ETF means an ETF that meets redemptions through in-kind transfers of securities, positions, and assets other than a de minimis amount of cash, and that publishes its portfolio daily.

6 The program rule allows In-Kind ETFs to avoid having to classify the liquidity of their portfolio investments and to establish an HLIM.

## Conclusion

Advisers and fund complexes are in various stages of developing their liquidity programs to comply with the liquidity program rule's requirements. While there is still time before December 1, 2018, advisers and fund complexes have numerous considerations, assumptions and questions to assess, address and answer. Though the fund industry would like the SEC staff to provide guidance on the liquidity program rule, given the intricacies and complexities of the rule, fund complexes must continue to develop their plans, policies and programs to ensure they meet the compliance date. Advisers and fund complexes can factor any guidance that may come from the SEC staff into the development of their plans, policies and programs. Delay, however, would put fund complexes behind the proverbial eight-ball.

ACA's registered investment company consultant specialists stand ready to assist funds, advisers, and sub-advisers alike in building out a liquidity program and policies.

## About the Author


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Erik is a Director at ACA Compliance Group. Erik focuses on the mutual fund industry, providing ongoing and customized regulatory compliance consulting and compliance program review services to registered investment companies, their investment advisers and sub-advisers, and other service providers. Erik joined ACA in 2012 as a Senior Principal Consultant.

Prior to joining ACA, Erik was a Compliance Director at Legg Mason. In that role, he headed the firm's Global Compliance Examinations team, overseeing compliance program and risk control reviews of Legg Mason's worldwide investment advisory affiliates and distribution units.

Before Legg Mason, Erik served as a Securities Compliance Examiner in the U.S. Securities and Exchange Commission's Office of Compliance Inspections and Examinations (Investment Adviser/Investment Company) where he conducted regulatory examinations of registered investment advisers and registered investment companies. At the SEC, Erik helped launch the CCO Outreach Program. In 2005, he received the Chairman's Award of Excellence.

Prior to the SEC, Erik worked in the Mutual Funds Legal and Accounting Departments of Deutsche Asset Management. Erik led the Domestic Equities fund accounting team, responsible for the daily accounting and processing of mutual fund net asset values, and the semi-annual creation of fund financial statements. Erik also served in the Legal Department where he reviewed and drafted registration documents and participated in boards of directors meetings.

Erik is a Certified Fraud Examiner. He earned his Bachelor of Business Administration degree in Finance from Loyola College (now Loyola University Maryland).

## About ACA Compliance Group

ACA Compliance Group ("ACA") is a leading provider of risk management and technology solutions that focus on regulatory compliance, performance, financial crime, and cybersecurity. We partner with our clients to help them mitigate the regulatory, operational, and reputational risks inherent in their business functions. Our clients include leading investment advisers, private fund managers, commodity trading advisors, investment companies, broker-dealers, and domestic and international banks.

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# DISCUSSION OF RESULTS: 2017 ALTERNATIVE FUND MANAGER COMPLIANCE SURVEY RESULTS

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**SEC ENFORCEMENT AND INVESTMENT ADVISERS**

**TRENDS IN RECENT ACTIONS**

**By: Thomas Gorman[1]**

## I. INTRODUCTION

The SEC's inspection program has been increasingly aggressive in recent years. At the same time OCIE has built an increasing close relationship with the Enforcement Division. The result has been an increase in the number of actions involving investment advisers. The cases briefly summarized below are examples drawn from a number of key areas such as advertising, conflicts, cherry picking, due diligence, inadequate procedures, undisclosed fees and unfair advantage. While these areas overlap to some degree, an examination of the actions illustrates the themes that are the focus of OCIE and Enforcement.

## II. KEY AREAS

### A. Advertising

Adviser advertising has long been a key area of focus. Recently, OCIE published "Most Frequent Advertising Rule Compliance Issues," drawn from its exams (Sept. 14, 2017). Examples of the types of cases being brought in this area are summarized below.

***ZPR Investment Management Inc. v. SEC***, No. 16-153263 (11th Cir. Decided June 30, 2017). Registered investment adviser ZPR Investment was founded in 1994 its now president and sole shareholder, Respondent Max Zavanelli. To enhance the reputation of his firm, Mr. Zavanelli had the firm adopt the Global Investment Performance Standards or GIPS. Adoption of the voluntary standards assures investors that the presentation of investment performance is based on full disclosure under specified requirements that permit an "apples to apples" comparison among firms.

Beginning in early 2008 the adviser placed advertisements in financial magazines claiming to be GIPS compliant. These claims were considered important by Mr. Zavanelli in marketing institutional clients. More advertisements claiming GIPS compliance were taken out in the fall of 2008. While those published in the spring of 2008 were in fact GIPS complaint, those in the fall were not. If the fall ads had been GIPS complaint they would have shown that the firm's performance lagged behind its benchmark index by as much as 10%.

[1] Mr. Gorman is a partner at Dorsey & Whitney LLC in Washington, D.C. and a former SEC enforcement official. He is the author of the a widely followed blog which analyzes SEC enforcement trends, www.secactions.com

Mr. Zavanelli also published a newsletter. In the April and December 2009 editions he wrote that the firm was GIPS compliant. The December edition contained disclaimers, however, which stated in part that the "investment report you are reading is not GIPS compliant. It was never intended to be nor can it be. . . Our report remains not GIPS compliant."

Following an inspection, in early 2010 the SEC staff informed the adviser in a letter that while its December 2008 advertisement claimed GIPS compliance, it was not. The staff sent a second letter in August noting that an investigation was being conducted. Despite these letters, in furnishing Morningstar information for reports in August 2010 and later in March 2011, a firm employee responded "no" to a question about whether the adviser was under investigation. The firm continued to publish ads in early 2011 claiming GIPS compliance when it was not, despite assurances to the SEC staff that it would make sure all ads stated it was not compliant.

The Commission instituted an administrative proceeding against the firm and its founder, charging violations of Advisers Act Sections 206(1), (2) and (4). Ultimately the Commission concluded that the firm violated each of the Sections based on the fall 2008 and spring 2011 magazine ads, the 2009 newsletters and the 2011 Morningstar report. It also found that the firm violated Advisers Act Sections 206(2) and (4) as to the 2010 Morningstar report. Mr. Zavanelli was determined to be liable for all of the misrepresentations regarding GIPS compliance in violation of Advisers Act Sections 206(1) and (2) and for aiding and abetting the violations by the firm. The Commission imposed a cease and desist order on both Respondents, an industry bar on Mr. Zavanelli, and a civil penalty of $575,000 on him and $250,000 on the firm.

The Eleventh Circuit granted in part and denied in part a Petition for Review. Specifically, the court vacated the violations and monetary sanctions regarding the December 2009 newsletter but affirmed the other violations and sanctions in the Commission's order. The key issue was if the misrepresentations were material. The question of materiality is determined at the time of the alleged misstatement, the circuit court noted. In this case, with one exception, there can be no doubt that the misstatements regarding compliance with the GIPS standards were material. Compliance with those standards is important to the reasonable investor, as the Commission found. The point was bolstered by Mr. Zavanelli's conclusion that GIPS compliance would enhance the firm's marketing, particularly with institutional investors. Petitioners' claims that the information was later furnished to the investors and that it was available on the adviser's website do not change the misleading nature of the statements.

The December 2009 newsletter was different. In that newsletter, on the page after the misleading statement, investors were specifically told that the report was not GIPS compliant. The disclaimer went on to note that the report was never intended to be GIPS compliant. This rendered the initial false claim immaterial. While general cautionary or boilerplate language would not suffice, in this instance the disclaimer was clear and unequivocal, addressing the exact question of GIPS compliance. Accordingly, the Court reversed the Commission's determination on this point.

***SEC v. Navellier & Associates, Inc.***, Civil Action No. 1:17-cv-11633 (D. Mass. Filed August 31, 2017) is an action against a firm, a registered investment adviser, and Louis Navellier, its founder, principal, CIO and CEO. This is another action arising out of an investment strategy tied to F-Squared Investments, Inc. From 2010 to 2013, defendants marketed an investment called Viro AlphaSector based on information obtained from F-Squared. Defendants did not conduct due diligence regarding the investment. In addition, when red flags arose and it turned out that in fact AlphaSector did not have a successful track record but had only been back-tested, defendants changed the name and sold it without informing clients. The complaint alleges violations of Advisers Act Sections 206(1), 206(2) and 206(4). The case is pending. *See* Lit. Rel. No. 23925 (August 31, 2017).

***In the Matter of J.P. Morgan***, Adm. Proc. File No. 3-17036 (January 6, 2016). JPM Securities is a wholly-owned subsidiary of JPMorgan Chase & Co. The firm is a registered broker dealer and investment adviser. It provides brokerage services to a business unit called J.P. Morgan Private Bank which is a marketing name for a segment that provides banking and investment services in the U.S. to high net worth and ultra-high net worth customers. Over a period of four years beginning in 2009, JPM Securities used marketing materials which were false despite repeated warnings by personnel. Specifically, the materials stated that JPM Securities compensated registered representatives in J.P. Morgan Private Bank based solely on the performance of investments in customer accounts. In fact, they were paid a salary and a bonus which depended on a number of factors that did not include client account performance. Over a three-year period beginning in 2011, four JPM Securities employees noted that the statement about broker compensation was inaccurate. No changes were made. The Order alleges willful violations of Securities Act Section 17(a)(2). To resolve the proceeding Respondent undertook remedial action considered by the Commission. The firm also consented to the entry of a cease and desist order based on the Section cited in the Order and to a censure. In addition, JPM Securities will pay a penalty of $4 million.

***In the Matter of Alpha Fiduciary, Inc.***, Adm. Proc. File No. 3-16974 (November 30, 2015) names as Respondents Alpha Fiduciary, a registered investment adviser, and its majority owner Arthur Dogline. From August 2010 to March 2013 Respondents distributed to clients advertising regarding its Global Tactical Multi Asset Class Strategies. It claimed returns of up to 58.62%. The advertising referenced certain hypothetical testing but was imprecise and did not specifically inform investors that the results were based on back-testing. The firm also failed to implement written compliance policies and procedures to prevent employees from using advertising that violates the Advisers Act. The Order alleges violations of Advisers Act Sections 206(2) and 206(4). To resolve the matter, the firm agreed to a series of undertakings which include the retention of a consultant, furnishing customers a corrected ADV and making available certain disclosures to prospective clients for one year. Each Respondent consented to the entry of a cease and desist order based on the Sections cited in the Order and to the entry of a censure. In addition, they will pay a penalty of $250,000. *See also In the Matter of Michael L. Shea*, Adm. Proc. File No. 3-16975 (November 30, 2015)(Mr. Shea was the vice president and business development director of Alpha Fiduciary during a portion of the period discussed above; he consented to a cease and desist order based on the same Sections as the firm and to a censure; he also agreed to pay a penalty of $25,000).

***In the Matter of Virtus Investment Advisers, Inc.***, Adm. Proc. File No. 3-16959 (November 16, 2015). Respondent Virtus has been a registered investment adviser since 1969. F-Squared had been a registered investment adviser since March 2009. That same year Virtus and F-Squared began talks to have F-Squared serve as a sub-adviser for two Virtus-advised mutual funds. Those funds would then adopt the AlphaSector strategy originated by F-Squared. F-Squared launched its first AlphaSector index in late 2008. The firm claimed it had actual test results for the index back to 2001. In fact, they were back-tested. Nevertheless, Virtus recommended the firm to the boards of two funds using the false materials. The false claims were also incorporated into advertising materials. Respondent ignored warning signs about the claims and had no procedures for evaluating them. The Order alleges violations of Advisers Act Sections 204, 206(2) and 206(4) and Investment Company Act Section 34(b). To resolve the proceedings Respondent agreed to implement certain undertakings, including the retention of a compliance consultant. The firm also consented to the entry of a cease and desist order based on the Sections cited in the Order and to a censure. It will pay disgorgement of $13.4 million, prejudgment interest and a civil penalty of $2 million.

***In the Matter of Trust & Investment Advisors, Inc.***, Adm. Proc. File No. 3-16542 (May 18, 2015) is a proceeding which names as Respondents the registered investment adviser and its CEO, Larry Pitts, and CFO, George Prugh. It centers on the failure of the Respondents to correct violations based on not developing a compliance manual and to correct misrepresentations in its marketing materials. Those errors were cited during inspections in 2004 and 2005. Despite promises the errors would be corrected, they continued. The Order alleges violations of Advisers Act Sections 206(2) and 206(4). Respondents resolved the matter, consenting to the entry of a cease and desist order, based on the Sections cited in the Order, and to a censure. In addition, the firm and Mr. Pitts will pay a civil penalty of $50,000.

***In the Matter of Bennett Group Financial Services, LLC***, Adm. Proc. File No. 3-16801 (Sept. 9, 2015) is a proceeding which names as Respondents the firm, a one-time registered investment adviser, and its founder, Dawn J. Bennett. The Order alleges that Ms. Bennett and the firm significantly overstated the assets under management to customers and others and misrepresented investment performance by touting results from a model rather than actual investment results. In part, the misrepresentations were made by Ms. Bennett on her radio show. Additional misrepresentations were made during the staff investigation. The firm also failed to adopt and implement the required procedures. The Order alleges violations of Securities Act Section 17(a), Exchange Act Section 10(b) and Advisers Act Sections 206(1), 206(2) and 206(4). The proceeding will be set for hearing. Following a hearing the Commission affirmed a finding of violation. Advisers Act Rel. No. 4678 (March 30, 2017).

### B. Conflicts

Conflicts of interest has long been a focus of the OCIE inspection program. It is also a focus of the Enforcement Division, as the examples below illustrate.

***In the Matter of The Robare Group***, Adm. Proc. File No. 3-16047 (September 2, 2014) names as Respondents the registered investment adviser, its founder, Mark Robare, and a limited partner, Jack Jones. The allegations in the Order focus on an undisclosed arrangement between the adviser and its Broker. Robare Group, which offers portfolio management services, has, from inception, used the Broker for execution, custody and clearing services for advisory clients. The adviser recommends that its clients invest in several mutual funds offered on the Broker's platform. In 2004, Robare Group and the Broker entered into a "Commission Schedule and Servicing Fee Agreement." The agreement provided in part that the adviser would recommend "No Transaction Fee" funds offered on the Broker's platform. In return the Broker would pay from two to 12 basis points to the adviser. That agreement remained in effect until late 2012 when a new "Investment Advisor Custodial Support Services Agreement" was executed. The new agreement also provided that the Broker would pay the adviser for clients that invested in its funds.

***In the Matter of Guggenheim Partners Investment Management, LLC***, Adm. Proc. File No. 3-16735 (August 10, 2015). GPI is a registered investment adviser that provides services to institutional clients, high net worth individuals and private funds. It is a wholly owned, indirect subsidiary of Guggenheim Partners, LLC, a private financial services firm based in Chicago and New York. The primary violation alleged in the Order centers around a July 29, 2010 loan for $50 million from a GPI client to a senior executive of the advisor. The senior executive used the loan to invest in two transactions GPI put clients in, including the lending client. While executives at the firm knew about the loan it was never reported to compliance or disclosed as firm policies required. The Order also alleges that in 2009 GPI inadvertently charged fees to a client which were inappropriate. The fees were repaid after a considerable period of time. In addition, GPI employees failed to comply with firm policy regarding gifts from clients and the treatment of errors. The firm also furnished incorrect records to the staff because they included client information from other advisers. That client information was incorrectly coded as resulting from GPI transactions. The Order alleges violations of Advisers Act Sections 204, 204A, 206(2) and 206(4). To resolve the proceeding the firm will implement certain undertakings, including the retention of a consultant and, generally, the implementation of the recommendations made by that person. The firm also consented to the entry of a cease and desist order based on the Sections cited in the Order, a censure and to pay a penalty of $20 million.

***In the Matter of BlackRock Advisors, LLC***, Adm. Proc. File No. 3-16501 (April 20, 2015). The Order names as Respondents BlackRock Advisers, a registered investment adviser, and Bartholomew Battista, the firm's CCO. Daniel Rice III is a managing director and co-portfolio manager of energy sector assets held in BlackRock registered funds, private funds and separately managed accounts. His compensation derives in part from the management fees of the managed funds and separate accounts. In December 2006, Mr. Rice formed the Rice Energy Irrevocable Trust to hold interests in Rice Energy, a name given to a then projected series of entities that would be formed. The next month, Mr. Battista reviewed and discussed the matter with Mr. Rice. BlackRock concluded that the proposal did not present any conflict of interest. Subsequently, Mr. Rice formed the series of companies which were collectively known as Rice Energy. By March 2010 Rice Energy concluded a deal with Alpha Natural Resources, Inc, or ANR a publically traded coal company whose shares were held by the funds and accounts managed by Mr. Rice. A joint venture was formed with Rice Energy. At the time of the deal funds and separate accounts managed by Mr. Rice held over two million shares of ANR stock. In January 2010, Mr. Rice told BlackRock that he wanted to serve on the board of directors of the joint venture. BlackRock's Legal and Compliance Department reviewed the matter and concluded that there were potential conflicts of interest in entering into the joint venture in view of the portfolio holdings managed by Mr. Rice. The deal also raised concerns regarding access to ANR-specific information that could be beneficial to Mr. Rice rather than his clients. Nevertheless, BlackRock permitted Mr. Rice to continue under certain restrictions. There was no follow-up by the firm. BlackRock did not inform the boards of directors of the Rice-managed registered funds or advisory clients about Rice Energy. No disclosure was made by Mr. Rice or BlackRock. Disclosure came instead in June 2012 when the *Wall Street Journal* published three articles about Mr. Rice and Rice Energy. The Order alleges violations of Advisers Act Sections 206(2), engaging in a course of conduct which constitutes a fraud and deceit, and Section 206(4)-7, failing to adopt and implement reasonable procedures to prevent the violation. In addition, Respondents caused certain BlackRock funds to violate Investment Company Act Rule 38(a)-1(a) which requires registered investment companies, through their chief compliance officer, to provide a report at least annually to the fund's board of directors, addressing each material compliance matter that occurred since the date of the last report. To resolve the matter BlackRock agreed to a series of undertakings which include the retention of an independent compliance consultant who will prepare a report with recommendations the firm will adopt. In addition, BlackRock consented to the entry of a cease and desist order based on the Sections cited in the Order. Mr. Battista also consented to the entry of a cease and desist order, but his was based on Advisers Act Section 206(4) and a related rule and Investment Company Act Rule 38a-1. The firm agreed to pay a penalty of $12 million while Mr. Battista will pay $60,000. This is the first case to charge a violation of Investment Company Rule 38a-1.

### C. Cherry Picking

This traditional issue has gone high-tech. Now OCIE and the Division of Enforcement use statistical analysis to bolster the trade analysis to support a charge. The following case is an example of this new approach.

***In the Matter of Howarth Financial Services, LLC***, Adm. Proc. File No. 3-18172 (Sept. 12, 2017) is an action against Howarth Financial, a state registered adviser, and its founder, principal and sole owner, Gary Howarth. The action centers on the period from late March 2012 through early July 2013. During the period Respondents used two approaches to cherry pick trades. In the first method, Mr. Howarth allocated favorable purchases to his personal accounts while losing trades went to those of the clients. In most cases if the price of the security went up during the day, it was sold, with the proceeds being allocated to personal accounts. If the price declined, the security was allocated to client accounts but not sold. The second method involved the use of an omnibus account to first sell and then purchase shares of the same security. The process began generally with the sale of a security held in firm client accounts but not in Mr. Howarth's personal accounts. An omnibus account was used. If the price declined, Respondent purchased the same number of shares at the lower price and then allocated the trade, and thus the profit, to his personal account. If the price did not decline no purchase was made. Instead, Mr. Howarth typically allocated the sale to the client accounts. The difference between Mr. Howarth's first-day returns and those of his clients is highly statistically significant. The probability that the disproportionate allocation of favorable trades was due to chance is less than one in a billion. During the period his personal accounts were allocated 623 day trades of which 88.4% were profitable. The client accounts were allocated just four day trades of which only one was profitable. During the same period client accounts were allocated 302 losing trades while the personal accounts had just 19 unrealized trades, all of which were losing transactions. Subsequently, the brokerage firm used by Respondents terminated the relationship. Respondents made about $38,172. The Order alleges violations of Exchange Act Section 10(b) and Advisers Act Sections 206(1) and 206(2). To resolve the matter each Respondent consented to the entry of a cease and desist order based on the Sections cited in the Order. Mr. Howarth was also barred from the securities business. Respondents were also, on a joint and several basis, ordered to pay disgorgement of $38,172, prejudgment interest and a penalty of $160,000.

### D. Due Diligence

A number of actions have alleged a failure to properly conduct due diligence. In the advertising area, for example, the F-Squared cases are based on this theory. Accordingly, this issue should be considered in conjunction with those presented in the advertising cases. The example below is a variation of the F-Squared and other cases.

***In the Matter of Sylvester King, Jr.***, Adm. Proc. File No. 3-17839 (August 23, 2017). Mr. King was a registered representative and adviser representative. Outside of his positions, beginning in 2009 and continuing until 2012, he participated in selling $5 million of unregistered, illiquid securities to certain professional athlete brokerage customers and advisory clients in an internet branding company known as Global Village. He took these actions without undertaking any due diligence regarding the investments. Rather, he sold them based on information from Global, some of which was incorrect. The Order alleged that Mr. King willfully aided and abetted and caused Morgan Stanley and Wells Fargo Advisers (where he had been employed) to violate Section 17(a)(1) of the Exchange Act. To resolve the proceeding Mr. King consented to the entry of an order barring him from the securities business with a right to apply for reinstatement after three years. Following the lifting of the stay in his bankruptcy proceeding Mr. King will pay a penalty of $80,000. *See also In the Matter of Aaron R. Parthemer*, Adm. Proc. File No. 3-17878 (August 23, 2017) (similar action against a registered representative and advisor representative; settled with agreement to pay a penalty of $160,000 after the stay in his bankruptcy proceeding is lifted).

### E. Inadequate Procedures

While inadequate procedures is often a charge added to an enforcement action, in some instances it is the only charge as in the following case.

***In the Matter of Deerfield Management Company, L.P.***, Adm. Proc. File No. 3-18120 (August 21, 2017). Deerfield is a registered investment adviser that provides advisory services in the healthcare sector exclusively to its associated funds. In 2012 the firm adopted a Compliance Manual, revised in 2013. The Manual contained certain sections regarding insider trading. It specified concerns about the misuse of material nonpublic information by the firm or its employees. The advisor engaged research firms and their political intelligence analysts to furnish information regarding government decision-making. This created a potential risk of obtaining inside information. Accordingly, the Manual established certain procedures for the use of "experts" and "expert networks." The Manual did not apply those procedures to "research firms." Rather, it essentially relied on an examination of the firm's procedures, an approach that was not effectively enforced. When issues and conflicts arose, such as dealing with a firm whose COO was a political intelligence analyst, there was no follow-up. Eventually this resulted in the firm receiving inside information about CMS on which trades were executed. The Order alleges violations of Advisers Act Sections 204A. To resolve the proceeding the adviser consented to the entry of a cease and desist order based on the Section cited in the Order as well as to a censure. In addition, the adviser will pay disgorgement of $714,110, prejudgment interest and a penalty of $3,946,267. In accepting the offer of settlement the Commission considered the remedial acts of the adviser. See also *In the Matter of Marwood Group, LLC*, adm. Proc. File No. 3-16970 (Nov. 24, 2015) (adviser receiving inside information charged with inadequate procedures; settlement required admissions); *See also SEC v. Blaszczak*, Civil Action no. 1:17-cv-03919 (S.D.N.Y. Filed May 24, 2017).

### F. Undisclosed fees

A failure to fully disclose fees is another key area. A series of recent cases have been brought in this area. The following are examples.

***In the Matter of Apollo Management V, L.P.***, Adm. Proc. File No. 3-17409 (August 23, 2016). The proceeding centers on inadequately disclosed fees, a failure to fully disclose the terms of a loan agreement and inadequate supervision. Respondents are Apollo Management V, L.P., Apollo Management VI, L.P., Apollo Management VII, L.P. and Apollo Commodities Management, L.P. Each is a private equity fund adviser registered with the Commission as an investment adviser. The parent of each is Apollo Management. First, Respondents failed to properly disclose how they terminated monitoring fee agreements until after investors had put in their capital and the fees were paid. Second, in June 2008 the general partner to Fund VI --the general partner of Apollo Investment Fund VI, L.P. or Fund VI -- entered into a loan agreement with Fund VI and four parallel funds and failed to adequately disclose that the accrued interest would be allocated to the capital account of Advisers VI. Finally, from January 2010 through June 2013 a former senior partner of Respondents improperly charged personal items and services to advised funds. After repeated instances and an internal investigation, Respondents reported the conduct to the Commission. The Order alleges violations of Advisers Act Sections 206(2) and 206(4). To resolve the proceeding Respondents consented to the entry of a cease and desist order based on the Sections cited in the Order. In addition, Respondents will pay disgorgement of $37,527,000 and prejudgment interest which will be paid to a disgorgement fund. They will also pay a penalty of $12,500,000 and acknowledge that the amount was limited to that sum based on their cooperation.

***In the Matter of Cadaret, Grant & Co. Inc.***, Adm. Proc. File No. 3-18087 (August 1, 2017). The firm is a registered broker-dealer and investment adviser. First, from 2011 through 2016 the firm invested certain clients in mutual fund shares that carried 12b-1 fees despite the fact that the client returns were reduced and other institutional shares were available for which the fees are not paid. Second, during the same five-year period the adviser also received payments from two mutual fund complexes. The fees were to support the marketing and distribution of those funds' shares to advisory clients. The amount of the fees depended on the size of the investment. These fees were separate and apart from the 12b-1 fees and not disclosed. Third, the Form ADV stated that the firm would secure best execution for its clients. By placing clients in fund shares that carried the 12b-1 fees rather than institutional shares, the firm failed to comply with this representation. Finally, the firm failed to refund certain prepaid advisory fees. The Order alleges violations of Advisers Act Sections 206(2), 206(4) and 207. To resolve the matter Respondent consented to the entry of a cease and desist order based on the Sections cited in the Order and to a censure. In addition, the firm will pay disgorgement of $3,048,000 to compensate advisory clients impacted by the conduct detailed in the Order, additional disgorgement of $2,591,000 and prejudgment interest and a penalty of $280,000.

### G. Wrap fee programs

The Commission has brought a series of cases involving wrap fees. These cases are a variation of those listed in other areas. Some of the actions focus on a failure to disclose facts regarding "trading away" while others center on a failure to disclose the payment of 12v-1 fees or other items.

***In the Matter of Barclays Capital Inc.***, Adm. Proc. File No. 3-17978 (May 10, 2017). Barclays was a registered investment adviser and broker-dealer. During the period here – generally 2010 to the end of 2014 – the firm served as an adviser to clients in its wrap fee programs. While the firm had multiple programs with different objectives, generally they used third-party managers or sub-advisers. Those persons were, according to Barclays, evaluated and monitored with due diligence conducted to ensure that client accounts were properly maintained. This was detailed in Form ADV. Despite representations in its filings, client agreements, brochures and market materials, the firm failed to perform the initial due diligence and ongoing monitoring as represented. The materials describing the due diligence and monitoring were thus materially false and misleading. In addition, over a four year period beginning in January 2011, Barclays represented to clients that it would calculate its investment advisory fees based on the average of the three month-end values of each account's assets in the billing quarter but, in fact, did not. Rather, in excess of 22,000 accounts were overcharged by a total of about $2 million. Finally, during the same period the firm did not have adequate procedures and systems to ensure that certain mutual fund clients received fee waivers or less expensive shares for which they were eligible. Thus, many clients were overcharged for the shares purchased. The Order alleges violations of Securities Act Sections 17(a)(2) and (3) and Advisers Act Sections 206(2), 206(4) and 207. In resolving the matter the firm agreed to certain undertakings, including the payment of over $3.5 million to certain wrap fee clients whose investments underperformed and who paid excess fees. The firm also consented to the entry of a cease and desist order based on the Sections cited in the Order and to a censure. In addition, the adviser will pay disgorgement of $49,785,417, prejudgment interest and a penalty of $30 million. *See also In the Matter of Robert W. Baird & Co., Inc.*, Adm. Proc. File No. 3-17532 (Sept. 8, 2016); *In the Matter of Raymond James & Associates, Inc.*, Adm. Proc. File No. 3-17531 (Sept. 8, 2016) (proceeding based on similar allegations; resolved with an agreement to implement certain undertakings, a cease and desist order based on the same Section and the payment of a $600,000 penalty); *In the Matter of Fenway Partners, LLC*, Adm. Proc. File No. 3-16938 (November 3, 2015).

***In the Matter of Stifel, Nicolaus & Co., Inc.***, Adm. Proc. File No. 3-17879 (March 13, 2017) is a proceeding which names the brokerage and investment banking firm as a Respondent. The Order alleges violations of Advisers Act Section 206(4) based on the failure to adopt and implement written policies and procedures designed to review information received from sub-advisers in wrap fee programs regarding their trading away practices. Specifically, the firm gives clients the opportunity to invest in separately managed wrap fee programs. In that program, the sub-adviser has the discretion to not direct the execution of a particular equity trade through an executing broker other that Stifel (whose fees are covered by the wrap program) for which the client may be charged an additional fee – a practice called "trading away." Until the first quarter of 2015 Stifel did not collect information on the costs of that practice from sub-advisers. After collecting that information in the first quarter of 2015, the firm distributed certain material to its financial advisors in a document summarizing select information about the trading away practices of the sub-advisers. That included a chart showing the percentage of time they traded away and the average cost. The document was not distributed to clients. The firm did update its client brochures, noting that clients should contact their financial advisor for additional information regarding the practice. Thus, clients were not informed regarding the amount of the additional trading away costs so the information could be considered in evaluating whether to use a particular sub-adviser. In resolving the case the firm took certain remedial steps including updating and expanding the disclosures in its client brochure, initiating the collection of information from sub-advisers on the practice in the first quarter of 2015, adding questions on the point to a questionnaire sub-advisers complete, and giving notice to clients that additional information on sub-advisers was available. The firm also agreed to implement undertakings which include: upgrading its policies and procedures; designing and implementing a way to provide clients and advisors in the program information about trading away practices and costs; and developing training for financial advisors about the wrap fee program sub-advisers' trading away practices and associated costs. In resolving the case the firm consented to the entry of a cease and desist order based on the Section cited in the Order and agreed to pay a penalty of $300,000.

### H. Unfair advantage/misrepresentation

When the firm created an unfair trading advantage for one client, but then made misrepresentations about it to other clients, the Commission brought a Securities Act Section 17(a)(2) claim.

***In the Matter of State Street Bank and Trust Company***, Adm. Proc. File No. 3-18158 (Sept. 7, 2017) is a proceeding against the banking subsidiary of State Street Corporation. To build a trading platform for GovEx the firm sought to attract liquidity. To do that certain incentives were offered. With Subscriber A, the firm developed a tool called Last Look which permitted that subscriber to take a last look at a potential match for a brief period. Using this tool, between July 2010 and October 2010, Subscriber A rejected 57 of the 157 matches to quotes placed by the Last Look Account. Each had a $1 million face value for a total of $57 million. When other customers asked about the tool, Respondent denied having it or using it. Eventually its use was halted. The Order alleges violations of Securities Act Section 17(a)(2). To resolve the proceeding Respondent consented to the entry of a cease and desist order based on the Section cited in the Order. Respondent also agreed to pay a penalty of $3 million.

## III. CONCLUSIONS

Enforcement actions regarding investment advisers reflect overlapping themes centered on select issues.

- *Advertising:* Adherence to advertised standards; conducting due diligence prior to making an investment recommendation; and full disclosure regarding items such as compensation listed in distributed materials and investment results;

- *Conflicts:* Adequate disclosure regarding items such as parallel investing by firm employees along-side clients and undisclosed fees such as 12b-1 fees and monitoring fees;

- *Cherry picking:* The beginning of the statistical analysis approach to analyzing results; look for this approach to be expanded in the future;

- *Procedures:* Full implementation of existing policies and procedures;

- *Wrap fees:* Advertising and conflicts as well as items such as fund share selection, 12b-1 fees and the full impact of monitoring fees;

- *Unfair advantage/misrepresentation:* Advisers have a fiduciary duty and fundamental fairness is the key.

- *Overall:* A key issue underlying all of the categories is always whether clients are being treated fairly.

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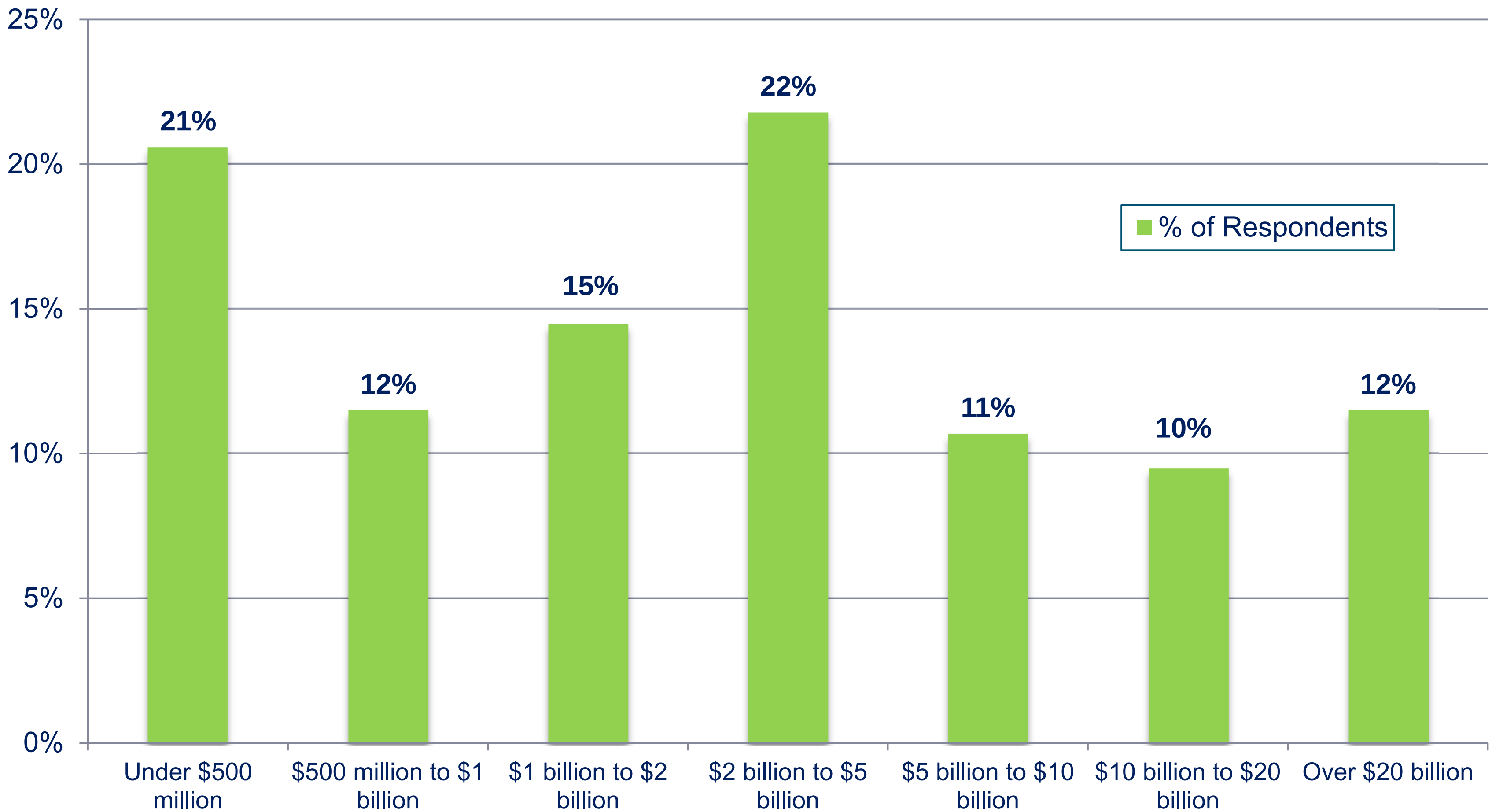
# DEMOGRAPHICS OF SURVEY RESPONDENTS

# RESPONDENTS' REGULATORY ASSETS UNDER MANAGEMENT

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# SURVEY RESPONDENT DEMOGRAPHICS

- Age of the firm:
  - **5%** brand new firm (less than 1 year in business)
  - **21%** relatively new firm (1 to 5 years in business)
  - **56%** established firm (5 to 25 years in business)
  - **18%** long-timer (more than 25 years in business)
- Location:
  - **69%** solely from the United States
  - **20%** primarily from the United States with one or more non-U.S. locations
  - The remaining respondents operated primarily or solely from a non-U.S. location

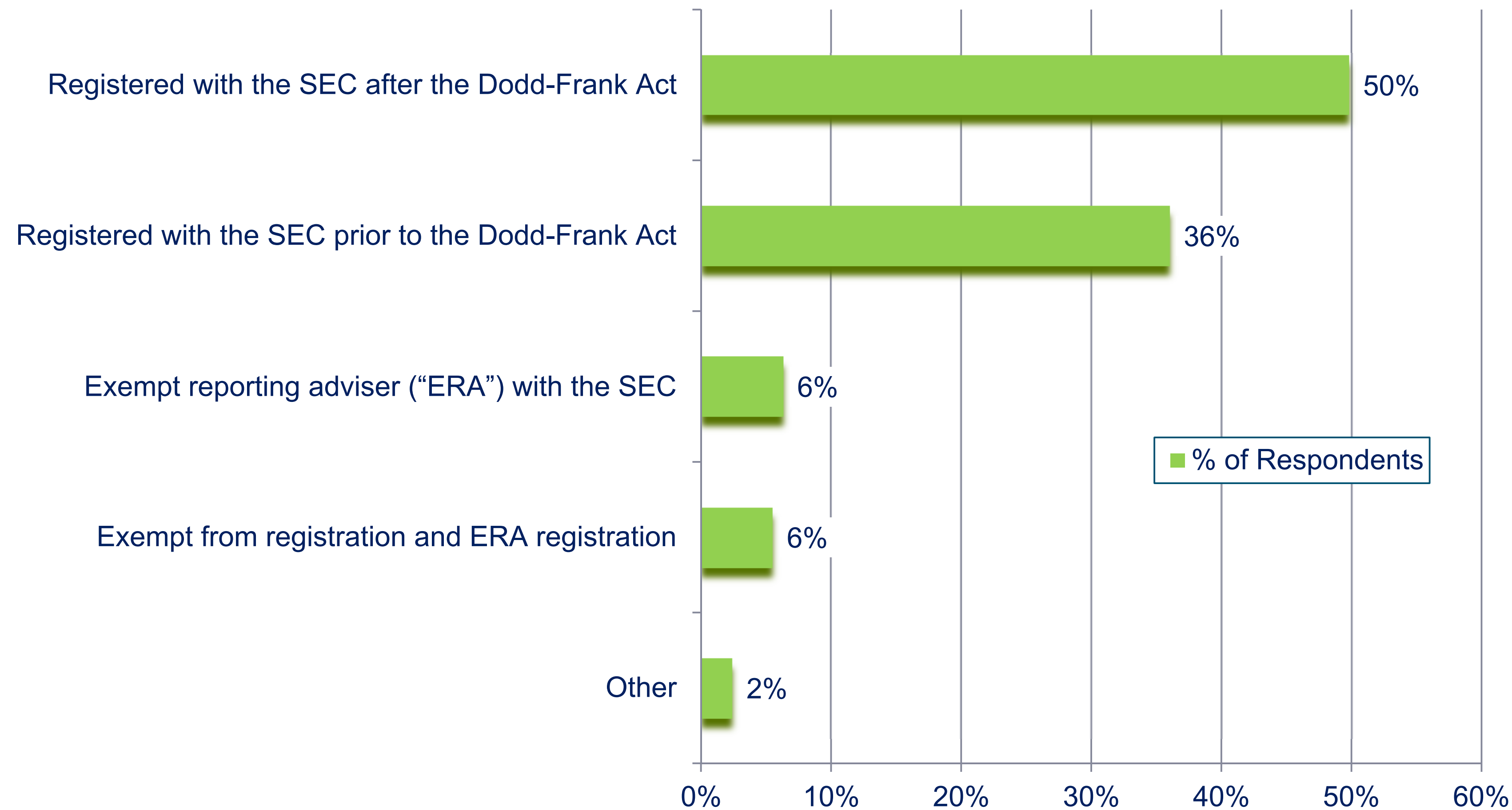
# SURVEY RESPONDENT DEMOGRAPHICS

- Number of employees:
  - **20%** between 1 to 10 employees
  - **48%** between 11 and 50 employees
  - **27%** between 51 and 250
  - The remaining respondents have more than 250 employees
- Number of full time compliance personnel:
  - **12%** no compliance personnel
  - **45%** 1 individual
  - **34%** between 2 and 5 individuals
  - The remaining respondents have 6 or more individuals

# SURVEY RESPONDENT DEMOGRAPHICS

- Number of clients provided investment advisory services to:
  - **51%** between 1 and 10
  - **19%** between 11 and 25
  - **16%** between 26 and 100
  - **14%** over 100
- Types of clients:
  - **94%** private investment funds
  - **45%** manage separately managed accounts, including “funds-of-one” or single investor funds
  - **16%** manage registered investment companies
  - **9%** manage undertakings for Collective Investment in Transferable Securities (“UCITS”)
- **64%** consider themselves “Hedge Fund Managers”
- **36%** consider themselves “Illiquid Fund Managers”

# SEC REGISTRATION STATUS

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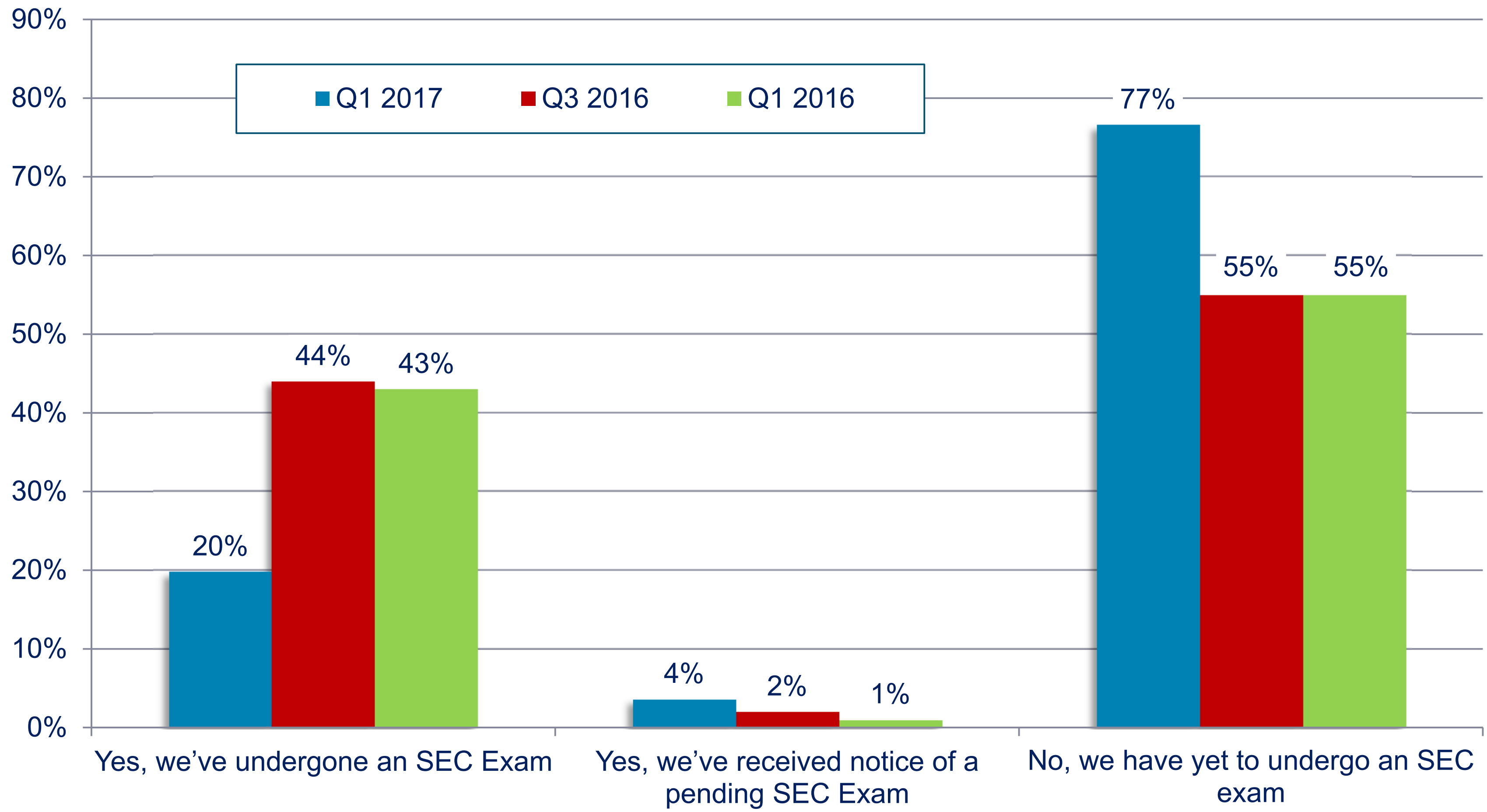
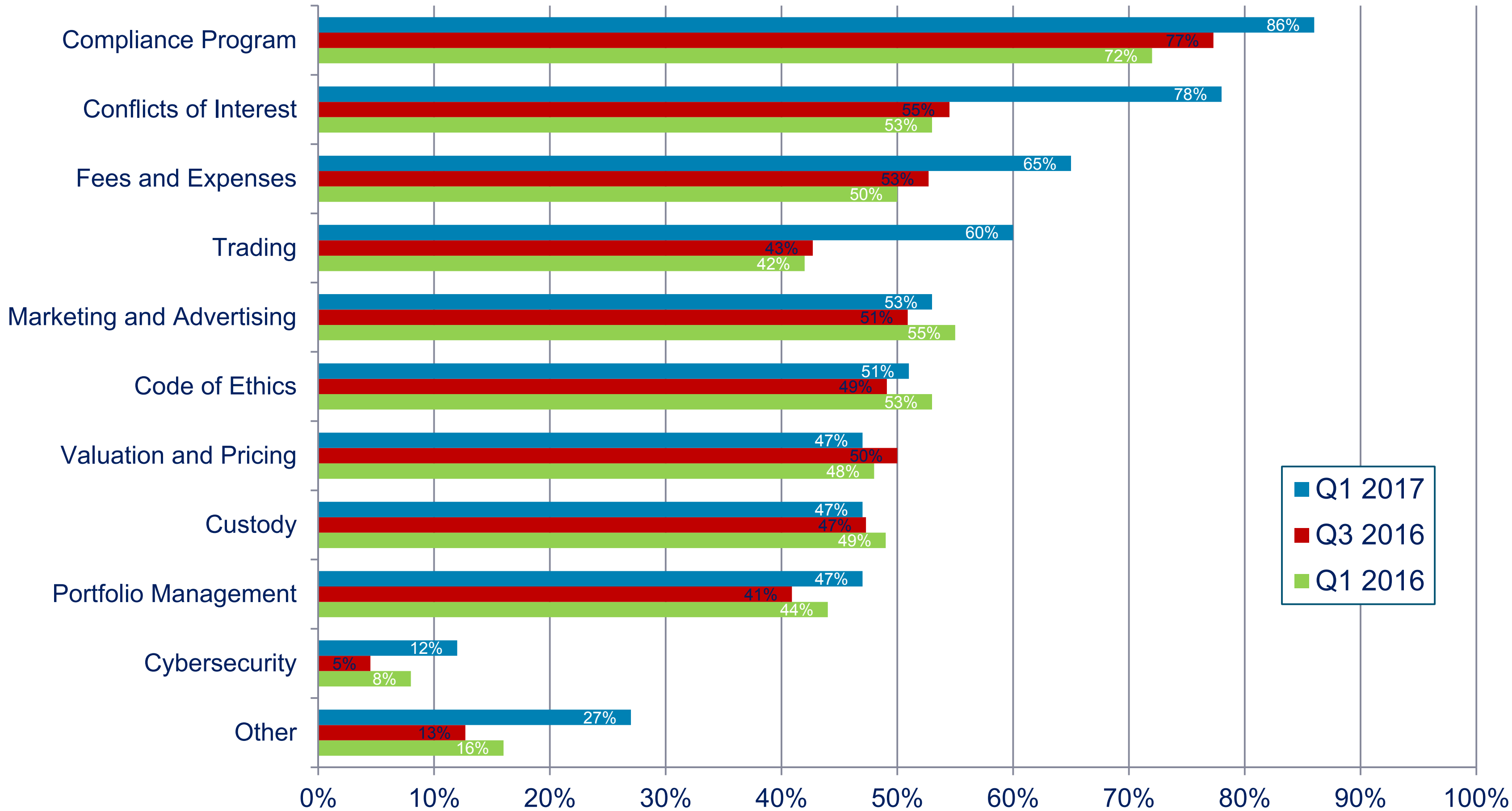
# SEC EXAM UPDATE

# SEC EXAM UPDATE



# COMPARISON: SEC EXAM AREAS OF FOCUS

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# MATERIAL NON-PUBLIC INFORMATION

# INFORMATION BARRIERS

- Implementation of Information Barriers
  - **55%** of hedge fund respondents
  - **52%** of illiquid fund respondents
- Types of Information Barrier Controls
  - **85%** maintain written barrier policies and procedures
  - **79%** conduct employee training and education
  - **70%** implement formal surveillance of employee trading
  - **66%** conduct surveillance of employee electronic communications
  - **65%** require employees to provide attestations

# ONLINE DATA SITES

- **56%** of respondents use online data sites (e.g., SyndTrak, Intralinks, DebtDomain) to obtain information during the investment research and due diligence process
- Controls in place:
  - **57%** add issuers to the restricted list if employees access private-side information to the extent that they are publicly traded or issue publicly traded debt
  - **46%** require employees to maintain unique log-in credentials for online data sites
  - **43%** only allow certain employees to access online data sites
  - **42%** stated that compliance or legal review employee personal trading while considering which private-side information was accessed via online data sites
  - **20%** have not implemented any controls

# CONFIDENTIALITY AGREEMENT & NON-DISCLOSURE AGREEMENT CONTROLS

- **69%** stated that there are a limited number of employees who are permitted to execute confidentiality agreements (“Confi”) and nondisclosure agreements (“NDA”)
- **61%** indicated that they maintain a log of all Confis and NDAs
- **57%** review each Confi and NDA to determine whether the issuer should be included on the restricted or watch list, as applicable
- **38%** review Confis and NDAs on an ongoing basis to determine whether they are no longer active
- **29%** include all issuers with which they have a Confi and NDA on the restricted or watch list, as applicable

# RESTRICTED LIST

- Who the Restricted List is applied to:
  - **72%** firm-wide, our firm does not have multiple asset management or business units
  - **23%** firm-wide, across multiple asset management or business units
  - **3%** by unit, and each unit maintains their own Restricted List

- Types of trading checked against the Restricted List:
  - **96%** check employee trading against the Restricted List
  - **66%** check the firm's trading in client accounts against the Restricted List
  - **32%** check the firm's trading in proprietary trading against the Restricted List

- Frequency of checking employee trading against the Restricted List:
  - **60%** upon receipt of a request for employee trade preclearance
  - **33%** firm's compliance software alerts of transacts in Restricted List
  - **32%** at least quarterly

# RESTRICTED LIST

- Distribution of Restricted List:
  - **61%** distribute the Restricted List to employees
  - **34%** do not make the Restricted List available to employees (other than those who need to know for business reasons)
  - **5%** provide the Restricted List upon employee request

- Frequency of reviewing Restricted List to remove issuers:
  - **62%** as needed (e.g. immediately when the firm no longer maintains MNPI)
  - **13%** Quarterly
  - **9%** Monthly

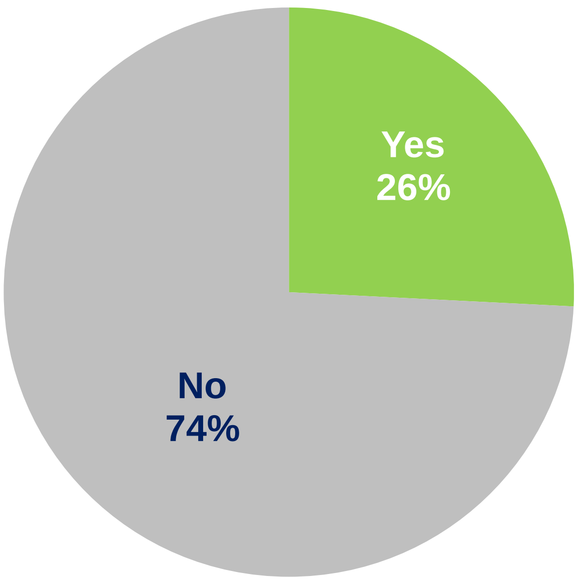
- Restricted List included in order management system:
  - **46%** hard code into their order management system
  - **41%** do not have an order management system
  - **13%** do not hard code into their order management system

# ADDITIONS TO THE RESTRICTED LIST

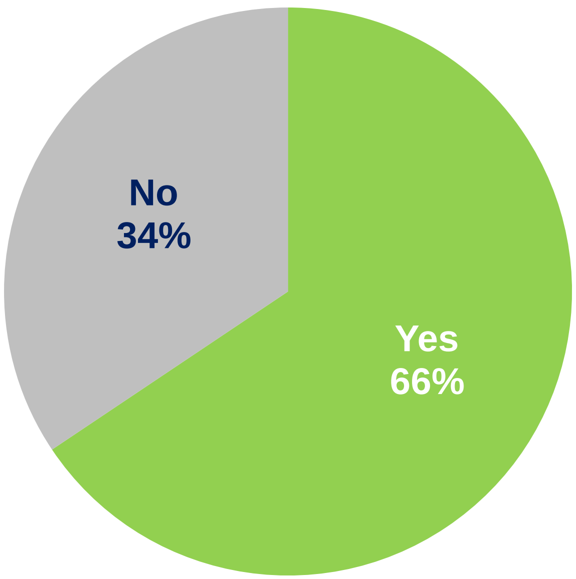
- **72%** add an issuer if they intentionally or unintentionally received material non-public information relating to a publicly-traded company
- **52%** add the issuer if the firm has an active Confi or NDA in place with a company that issues publicly traded equity or debt
- **44%** add if an employee sits on the board of directors of a public company as a result of their employment
- **41%** add if an employee sits on the board of directors of a public company independent of their employment

# USE OF POLITICALLY CONNECTED INDIVIDUALS FOR RESEARCH

Do employees speak with politically-connected or contract with third-parties who speak with such politically-connected individuals?



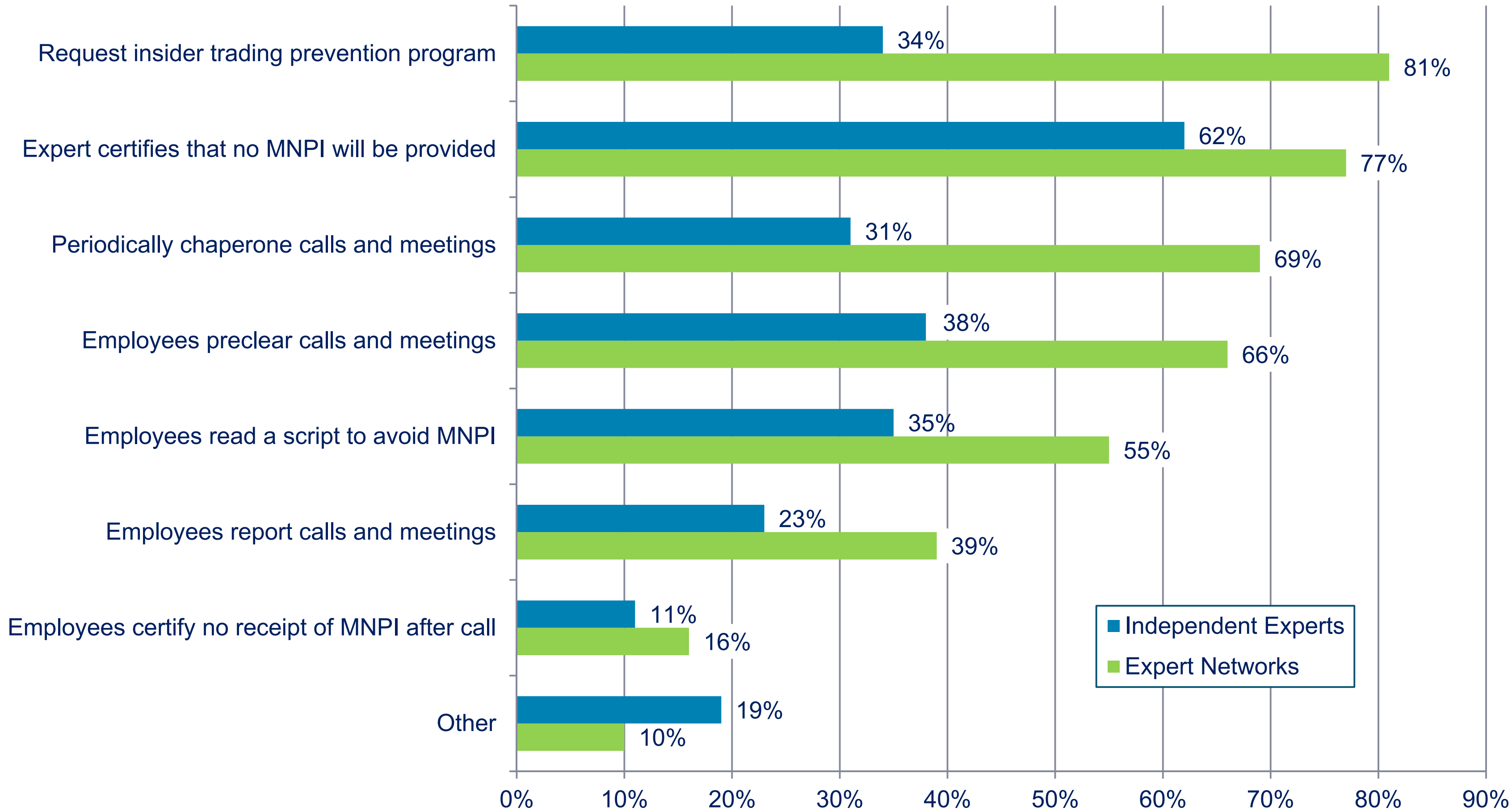

Do your firm's written policies, procedures, and/or controls specifically address discussions with politically-connected individuals?



# THIRD-PARTY INDUSTRY EXPERTS AND/OR CONSULTANTS

- Use of Third-Party Experts and/or Consultants
  - **53%** use third-party industry experts and/or consultants
- Use of Expert Networks
  - **41%** only retain third-party industry experts and/or consultants through an expert network
  - **39%** use both experts and/or consultants retained through an expert network firm and those contracted directly
  - **20%** never use expert networks to retain experts and/or consultants

# CONTROLS: EXPERT NETWORK FIRMS VS. INDEPENDENT INDUSTRY EXPERTS

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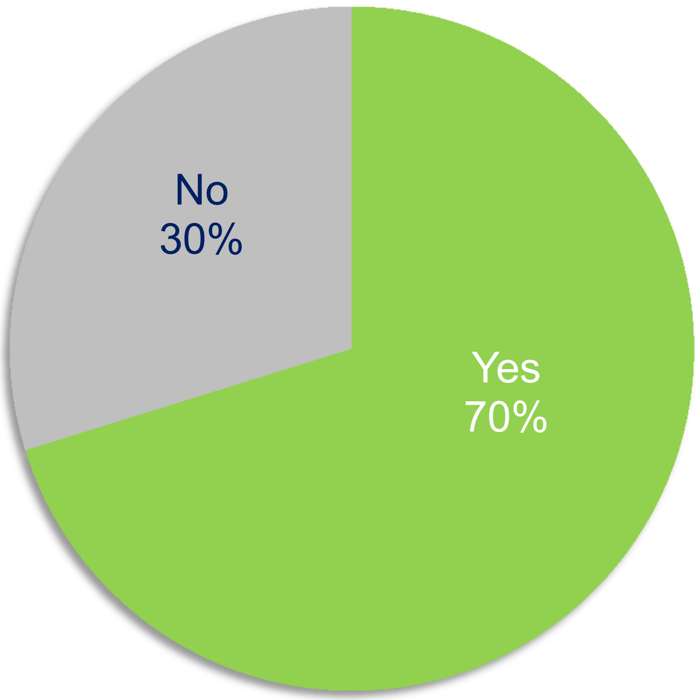
# THIRD-PARTY RESEARCH PROVIDERS – RESTRICTIONS

- **66%** permit employees to speak with any consultant that has signed or is subject to a contract containing non-disclosure of material non-public information and confidentiality clauses
- **46%** restrict employees are from speaking with past employees of any public company for a certain period of time after termination of employment with that public company
- **28%** restrict employees from speaking with current employees of any public company
- **23%** limit employees to a certain number of calls with the same research consultant over a specific time period

# THIRD-PARTY RESEARCH PROVIDERS – COMPLIANCE TESTING

- **52%** review emails of employees who conduct calls with third-party research providers to determine whether any potential material non-public information is discussed about public companies
- **45%** verify that all third-party research providers with which employees have had calls or meetings have an executed contract with the firm that includes the required material nonpublic information prohibition and confidentiality language
- **42%** compare invoices from the third-party research providers itemizing the research calls billed to the firm with the preclearance requests, to ensure all research calls received the required preclearance
- **25%** compare the timing of third-party research provider calls with target company news and the trading activity of employees and client accounts, to determine

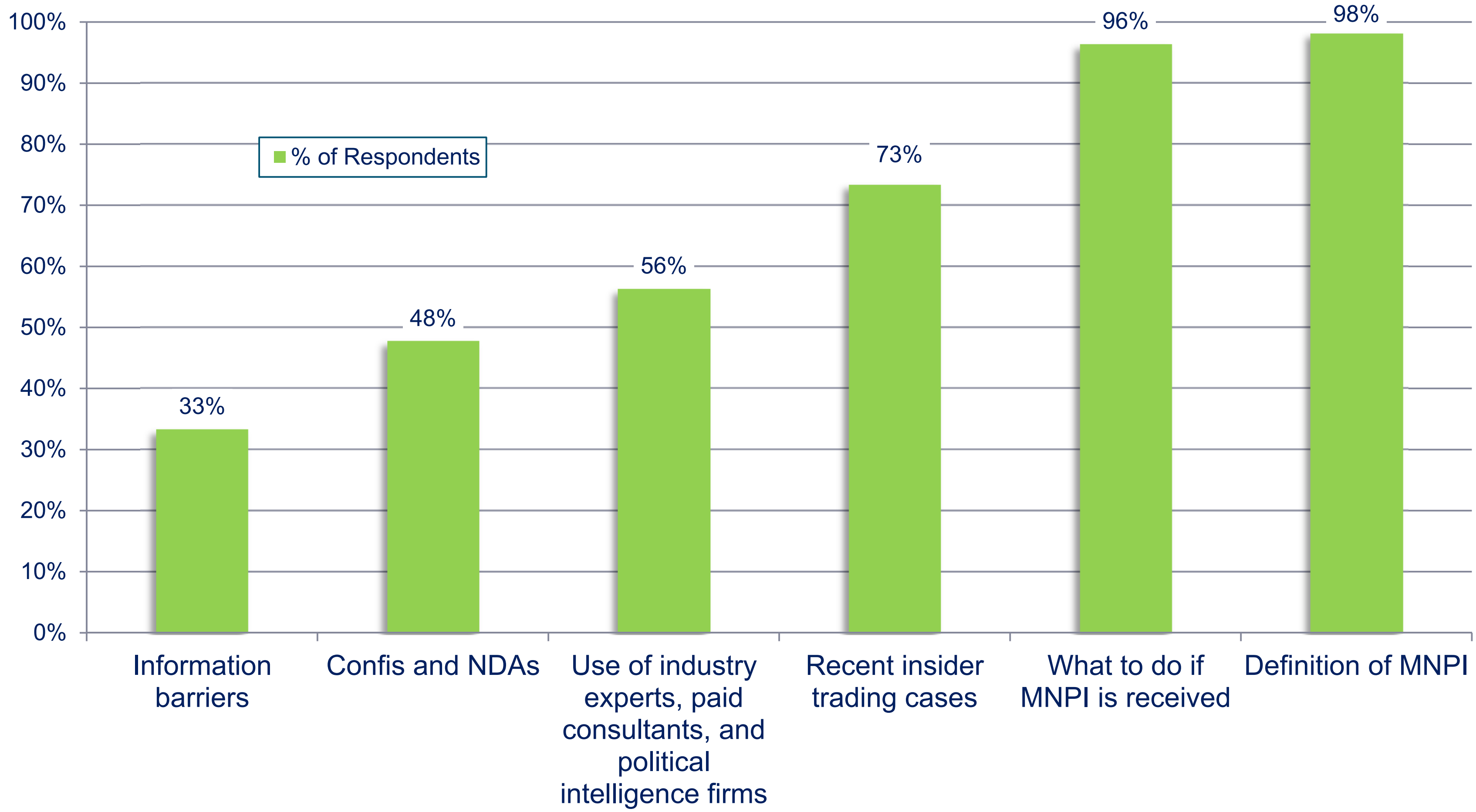
# DO YOU PERMIT EMPLOYEES TO SPEAK DIRECTLY TO SENIOR EXECUTIVES OF PUBLIC ISSUERS?




## What types of controls are in place?

- **32%** log/inventory of all calls and meetings
- **24%** require employees to report calls, meetings, and the information obtained
- **17%** periodically chaperone calls and meetings
- **40%** do not have controls in place for employees who speak directly to senior executives of public issuers

# INSIDER TRADING / MNPI TRAINING TOPICS

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# INADVERTENT RECEIPT OF MNPI

- **17%** of respondents indicated that they had inadvertently received material non-public information through corporate access events or other direct interactions with senior executives of public issuers

- **13%** reported inadvertent receipt through interaction with sell side firms (e.g., idea dinners, chat rooms)

- **9%** reported inadvertent receipt through interaction with industry experts and consultants

- **4%** reported inadvertent receipt through interaction with industry experts and consultants through an expert network

# FEES & EXPENSES

# FEES & EXPENSES – HEDGE FUNDS VS. ILLIQUID FUNDS

- **8%** | **46%** Annual Limited Partner meeting expenses
- **73%** | **37%** Brokerage fees
- **67%** | **49%** Custodial fees
- **21%** | **64%** Dead or broken deal expenses
- **33%** | **N/A** Expenses related to software tools, programs or other technology utilized in managing the hedge fund (e.g., order management systems)
- **36%** | **24%** Filings or other regulatory costs (e.g., Form PF, Form 13F)
- **65%** | **17%** Fund Board of Directors fees
- **91%** | **87%** Incentive fee/performance allocation/carried interest
- **46%** | **54%** Insurance premiums
- **7%** | **46%** Limited Partner Advisory Board meeting expenses
- **99%** | **98%** Management fee
- **59%** | **69%** Offering and organizational expenses
- **52%** | **36%** Research expenses
- **77%** | **78%** Third-party (outside counsel) legal fees
- **71%** | **74%** Third-party accounting fees
- **83%** | **46%** Third-party administrator fees
- **27%** | **58%** Travel expenses (e.g., in connection with research, due diligence, fundraising, etc.)

Hedge Fund Managers | Illiquid Fund Managers

# FEES & EXPENSES – HEDGE FUNDS VS. ILLIQUID FUNDS

- **15%** | **67%** Cap offering and organizational expenses
- **77%** | **27%** Do not cap ANY fund expenses
- **65%** | **76%** The firm pays expenses and is reimbursed by the relevant fund(s)
- **15%** | **13%** The main fund is invoiced directly by the vendors and subsequently invoices other relevant funds to reimburse their portion
- **59%** of illiquid fund managers pay the expenses through the firm and are reimbursed by portfolio companies or properties
- Hedge funds and illiquid fund managers were fairly consistent in their methods of expense disclosure

Hedge Fund Managers | Illiquid Fund Managers

# EXPENSE ALLOCATIONS – ILLIQUID FUNDS

- **45%** of respondents bill the relevant portfolio company directly for ongoing expenses specifically related to that portfolio company

- **40%** of respondents are allocating all ongoing expenses related to a specific portfolio company or property to all participating illiquid fund clients, including parallel vehicles, based on invested capital.

- **4%** of respondents solely allocate expenses to the main fund and co-invest/parallel vehicles aren't allocated any portion of the expense

- **72%** of illiquid fund managers allocate dead or broken deals to clients

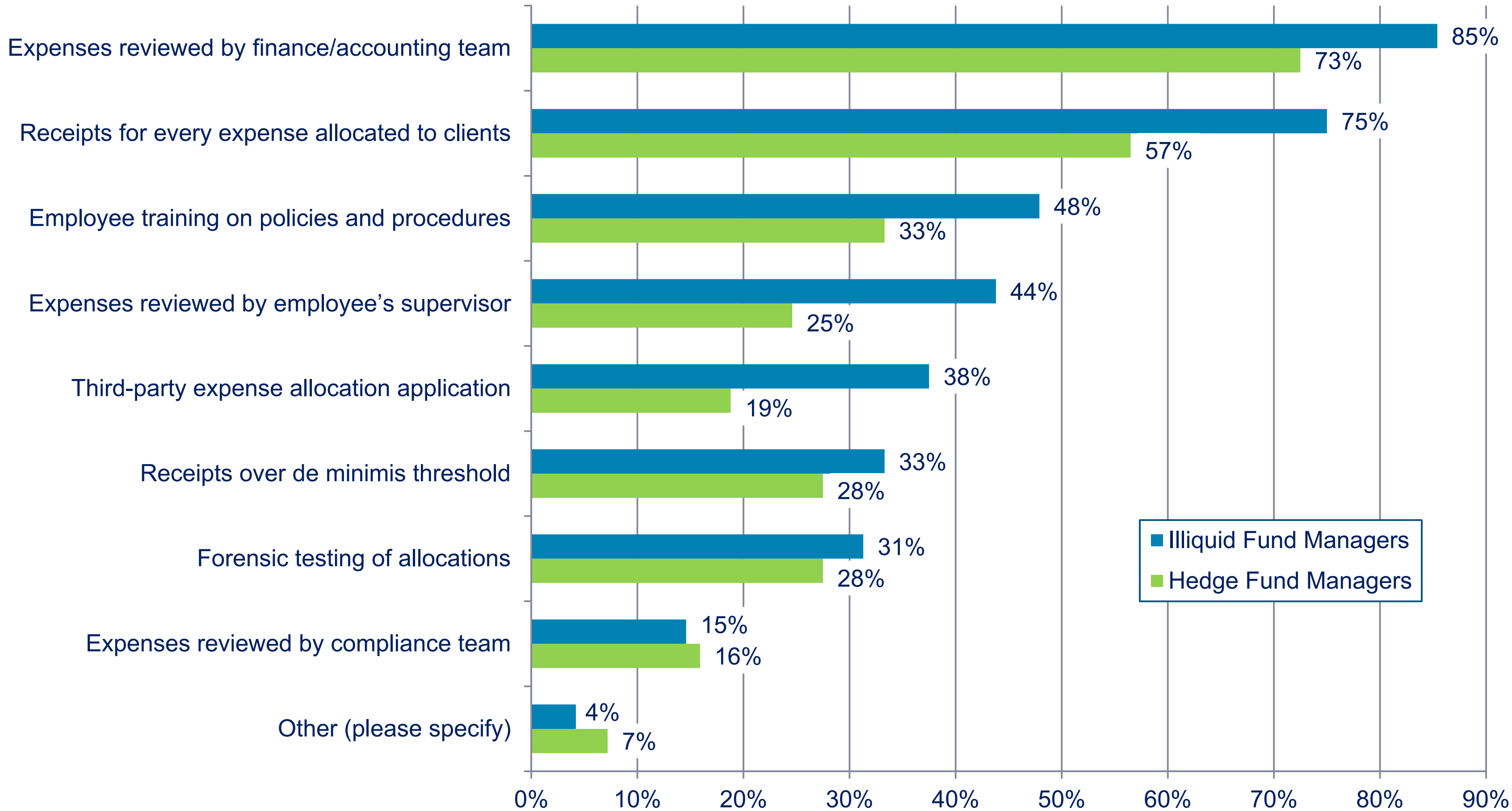
- **18%** do not allocate dead or broken deal expenses to parallel co-investment vehicles.

# TRAVEL EXPENSES – HEDGE FUNDS VS. ILLIQUID FUNDS

- **47%** | **58%** of respondents charge travel expenses to clients
  - **77%** | **80%** maintain formal guidelines for such travel expenses
- **36%** | **43%** of respondents have Senior Advisors, Operating Advisors, or similar consultants
  - **90%** | **69%** subject Senior Advisors, Operating Advisors, or similar consultants to the same travel expense policies and procedures as employees
- **17%** | **48%** of respondents use private jets for business purposes
  - **75%** | **79%** charge the equivalent of a first class ticket to the clients

Hedge Fund Managers | Illiquid Fund Managers

# TRAVEL EXPENSE ALLOCATION CONTROLS

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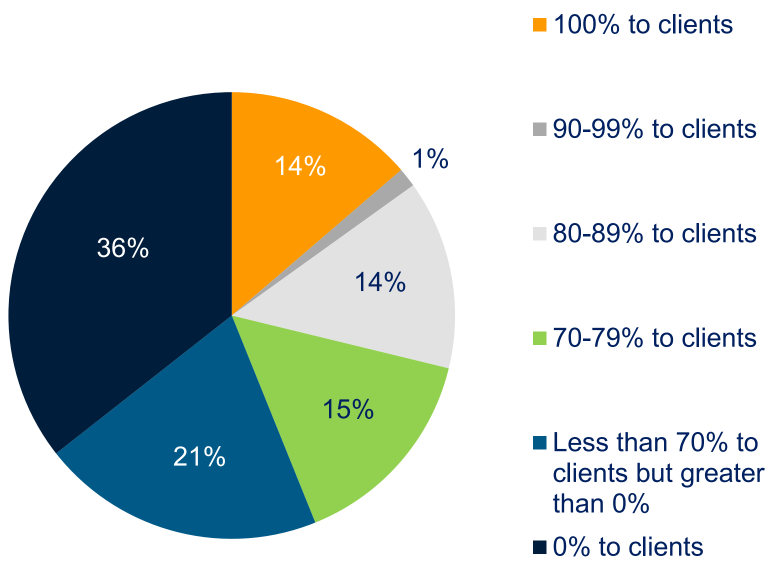
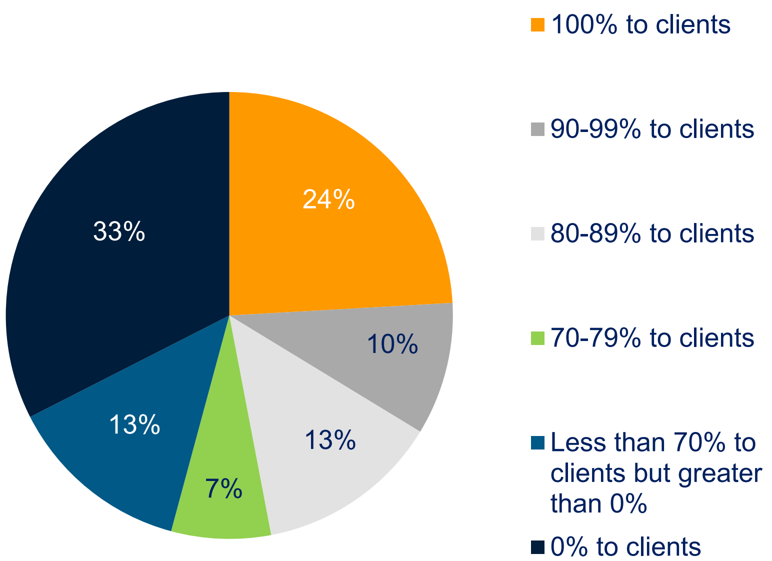
# COMPARISON: INSURANCE PREMIUM ALLOCATIONS

## Hedge Fund Managers




## Illiquid Fund Managers



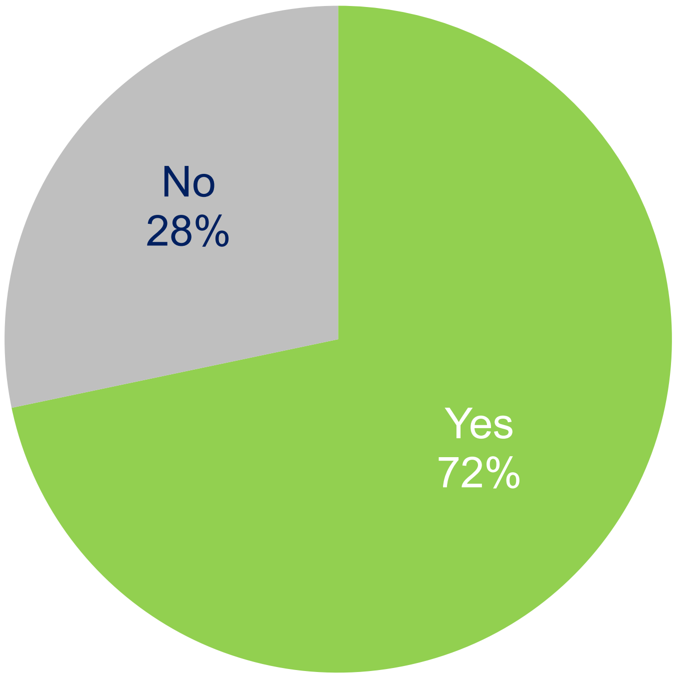
# IN-HOUSE SALARIES AND OVERHEAD EXPENSES

- **23%** | **34%** of respondents expense in-house salaries to clients
  - **65%** | **46%** of such firms have not conducted an analysis to determine whether the expenses associated with in-house salaries paid by private fund clients were comparable with market rates
- **20%** | **43%** charge a portion of actual overhead related to the salaries charged to private fund clients
- **35%** | **14%** apply an "overhead factor" related to the salaries charged to private fund clients

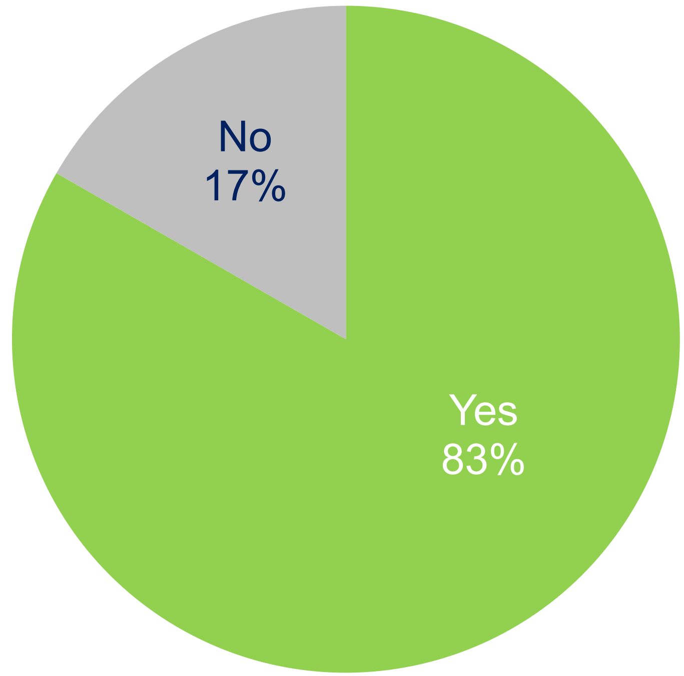
Hedge Fund Managers | Illiquid Fund Managers

# COMPARISON: EXPENSE ALLOCATION POLICIES

## Hedge Fund Managers




## Illiquid Fund Managers

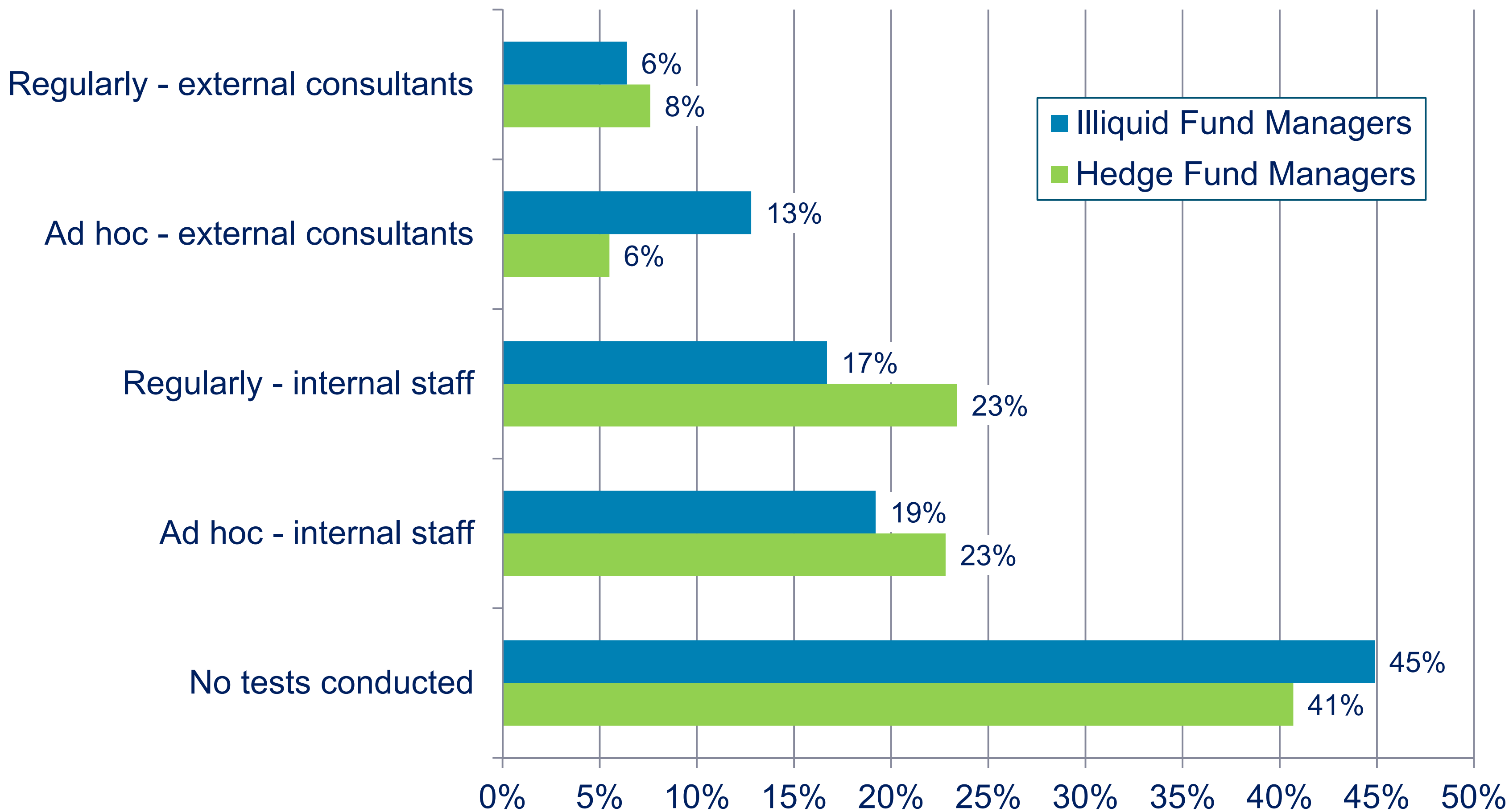


# EXPENSE ALLOCATION COMPLIANCE CONTROLS

- **23%** | **41%** Employees receive formal training on expense allocation policies and procedures
- **13%** | **23%** Employees must certify compliance with written expense allocation policies and procedures
- **46%** | **49%** Duties are segregated so that employees who do not incur fund client expenses independently review each expense for reasonableness and decide which expenses should be borne by the private fund clients
- **37%** | **26%** have not implemented other compliance controls to address expense allocation

Hedge Fund Managers | Illiquid Fund Managers

# EXPENSE ALLOCATION REASONABLENESS REVIEWS

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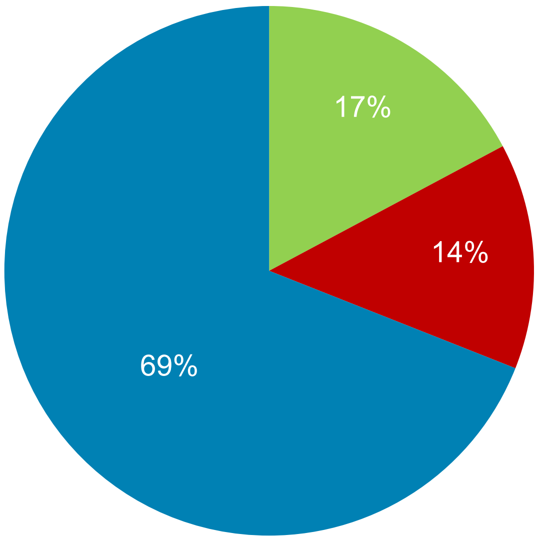
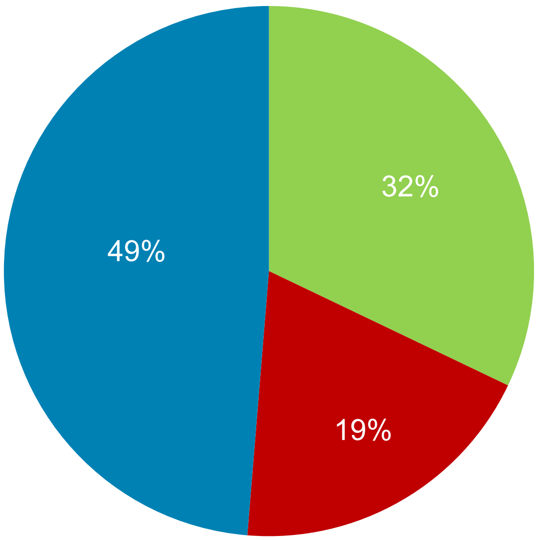
# COMPARISON: EXPENSE REPORTING

## Hedge Fund Managers




- All expenses regardless of the amount
- Only the most significant fund expenses
- No reporting of fund expenses

## Illiquid Fund Managers




- All expenses regardless of the amount
- Only the most significant fund expenses
- No reporting of fund expenses

# FEE INCOME

- At least **76%** of illiquid fund respondents receive income related to the ongoing management and oversight of portfolio companies
- **49%** of illiquid fund respondents receive advisory, monitoring, or consulting fees on an ongoing basis
- **39%** of illiquid fund respondents receive transaction fees related to initial closings or add-on investments
- **17%** of hedge fund respondents receive income related to the management of investments

# FEE INCOME OFFSETS

- **23%** | **25%** do not offset against management fees
- **50%** | **38%** offset the management fee by 100% of any fee income
- **0%** | **13%** offset the management fee by less than 100% of any fee income
- **12%** | **12%** offset the management fee by either 100% or less than 100%, depending on the fund
- **52%** of illiquid fund respondents that receive fee income allocate it to all relevant funds, including parallel and co-investment vehicles

Hedge Fund Managers | Illiquid Fund Managers

# TRANSACTION AND ORIGINATION FEES

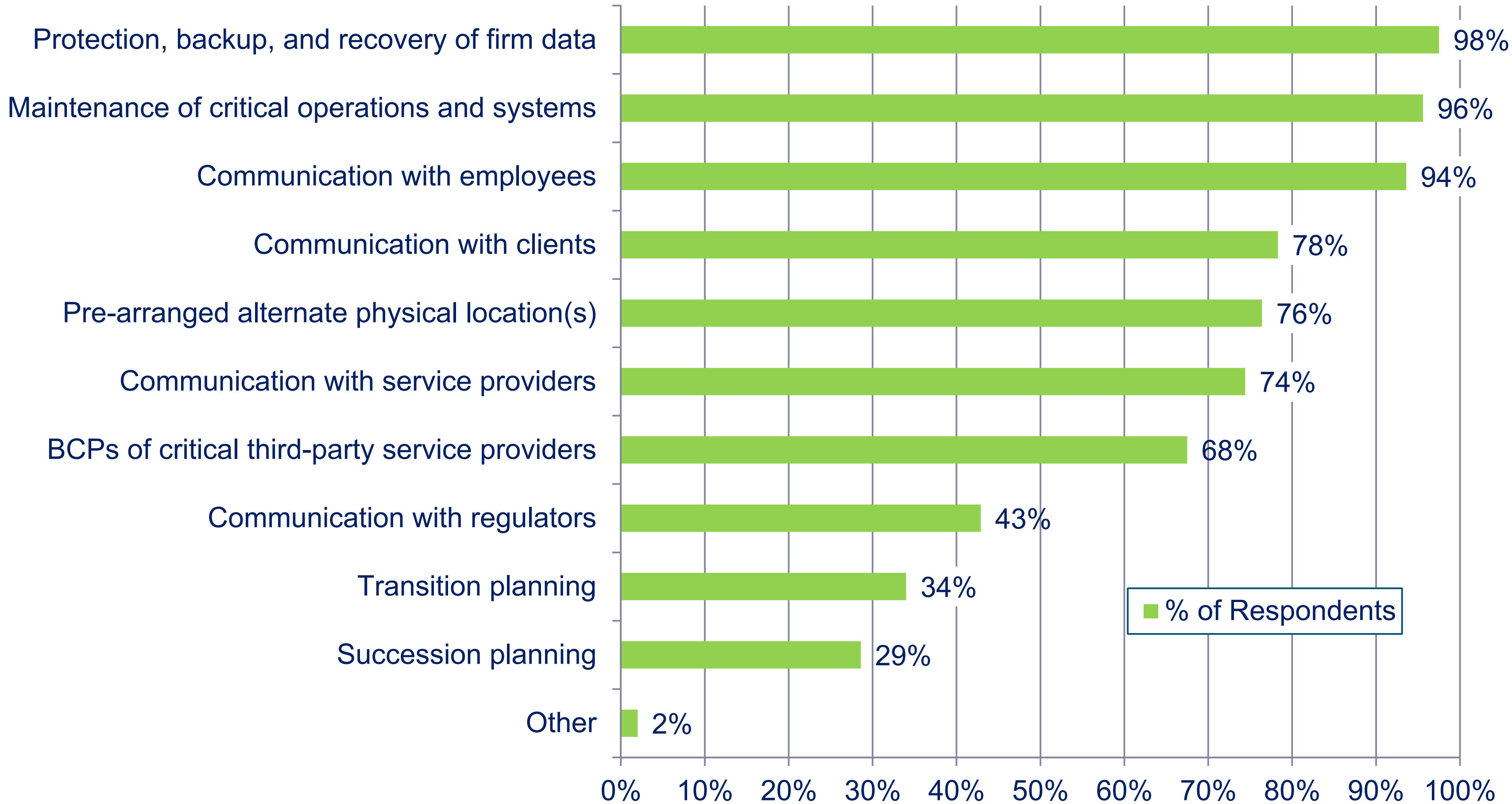
- **61%** of illiquid fund respondents receive transaction/ origination fees related to initial closings or add-on portfolio company/ property investments
  – **49%** of such respondents are not registered as broker-dealers, but have conducted an analysis to determine that receipt of transaction fees does not constitute broker-dealer activity
- **79%** of respondents have decided to continue collecting transaction/ origination fees
- Types of income that are used to offset the management fee:
  – Directors' fees received by employees of our firm – **46%**
  – Transaction fees – **41%**
  – Advisory/monitoring/consulting fees – **37%**
  – Income is not offset against management fees – **31%**
  – Directors' fees received by Senior Advisors – **10%**
  – Broken deal fees – **12%**
  – Property management fees – **2%**

# BUSINESS CONTINUITY & TRANSITION PLANS

# BUSINESS CONTINUITY AND TRANSITION PLAN IMPLEMENTATION

- **48%** have adopted a BCP, but it has not been updated to address the SEC's proposed rule
- **44%** have adopted a BCP in line with the SEC's proposed rule
- Primary person/department responsible for the development and administration of the BCP:
  - CCO/Compliance – **37%**
  - CTO/Information Technology – **28%**
  - COO/Operations – **20%**

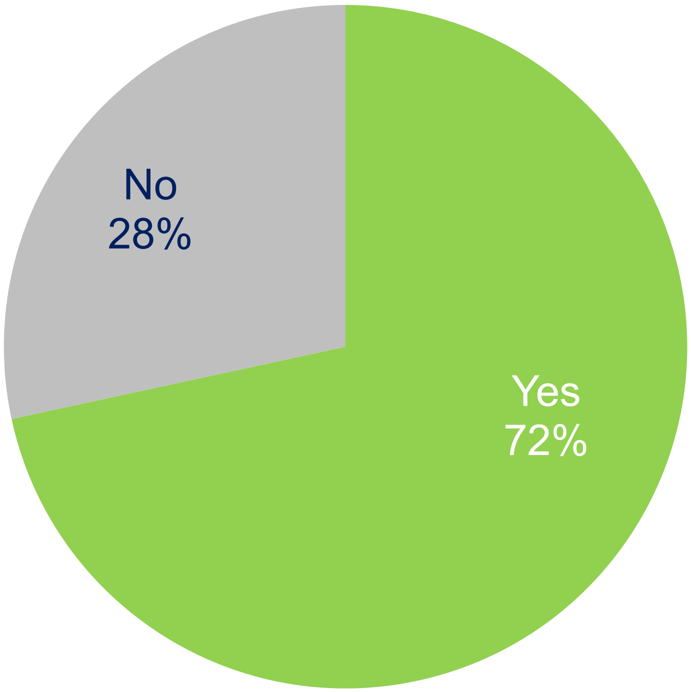
# COMPONENTS OF THE BCP



# RETENTION AND TESTING

- Backup methodologies:
  - **71%** stored on a server located at an offsite location
  - **60%** replicated to a cloud-based solution
  - **28%** stored on a server within the office
  - **22%** stored on physical tapes
- Frequency of BCP testing:
  - **63%** annually
  - **15%** semi-annually
  - **7%** quarterly
  - **8%** have not tested the BCP

# DOES YOUR FIRM REVIEW THE BCP EFFORTS OF KEY THIRD-PARTY SERVICE PROVIDERS?




How often are the BCPs reviewed?

- **63%** annually
- **38%** initially
- **15%** upon contract renewal

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# SUCCESSION AND TRANSITION PLANNING

- **30%** of respondents maintain a formal succession plan or "key man" provisions outside of the language in the fund's partnership agreement
- **9%** of firms have adopted a formal transition plan
  - **85%** include policies and procedures intended to safeguard, transfer and/or distribute client assets
  - **57%** include information regarding the corporate governance structure of the adviser

# QUESTIONS?

# ACA CONTACTS

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# MiFID II Understanding and Practical Preparation

ACA COMPLIANCE (EUROPE)

## MiFID II for US Advisors – Frequently Asked Questions

**What is MiFID II?**
A comprehensive set of reforms to the Europe-wide regime for financial services introduced in 2007 by the Markets in Financial Instruments Directive ("MiFID"). MiFID II is wide-ranging in its impact points, including market structures, organisational requirements on authorised firms, and conduct of business and investor protection rules. All obligations derived from MiFID II come into force from 3 January 2018. Here are some of the most common questions we have been asked by US advisors:

**Who is affected by it?**
All "investment firms" are caught by MiFID II – that is to say all entities located in one or more EU member states that are authorised under MiFID II to provide investment services and/or products. If you have a subsidiary or other affiliated entity located in the EU, then it is likely to be authorised (depending on the exact structure) either as a MiFID firm (in which case, directly caught by MiFID II), or under the Alternative Investment Fund Managers Directive ("AIFMD"), or as a UCITS management company (the latter two have their own sets of rules, but could still be caught by some aspects of MiFID II).

**So, if we have no physical presence or affiliate entities in the EU…?**
Then you will not be authorised as an investment firm under MiFID II and not directly subject to its requirements. There may be other indirect impact points, some of which we consider below.

**What if we have EU clients (funds, segregated accounts)?**
Assuming investment management is being provided out of the US, or another "third country", then the location of the client is not relevant in a MiFID II context (investment management being assumed to be provided in the home state of the advisor).

**What if we market our funds in the EU and/or have an EU investor base?**
Many US advisors rely on reverse solicitation for the occasional enquiry from EU investors. Otherwise, it is likely that you will market your funds under AIFMD or UCITS rules, probably through the services of a distributor. Under MiFID II, you may find that you are asked to provide information to your distributors required by their own obligations under new product governance rules, including an assessment of the target market.

Marketing purely segregated account investment services within the EU is not provided for under current MiFID rules and therefore must be done in accordance with local law. MiFID II does potentially introduce a new regime for such "third country firms" (see below).

**What if our investment strategy involves EU financial instruments or trading with EU counterparties?**
MiFID II introduces some radical changes to the structure of EU financial markets. The most significant of these include the extension of transparency requirements (the pre- and post-trade publication of "price and size") to non-equity instruments, the obligation to trade certain classes of standardised OTC derivative contracts on EU trading venues, and limits on the percentage of equities traded in dark pools. These reforms may have significant impacts on both the liquidity of certain instruments, and in the way in which firms execute their investment strategies. See also the following question on dealing commissions.

**What about transaction reporting?**
Whilst not subject to a direct reporting obligation, US advisors trading in relevant instruments (broadly those admitted to trading on EU venues or which derive their pricing from such instruments) with EU counterparties may be required to provide information to facilitate their own reporting obligations, including a legal entity identifier (LEI).

# MiFID II Understanding and Practical Preparation

ACA COMPLIANCE (EUROPE)

**Will we be affected by MiFID II's new rules on paying for research and dealing commissions (soft dollars)?**
Again, if you are not a MiFID firm, you are not directly subject to the new rules (which require investment managers to either pay for research themselves or via a so-called Research Payment Account). The only thing you may notice is that EU brokers are obliged under MiFID II to separate the research and execution elements of dealing commissions (although it is an open question as to whether they are either required or inclined to do this for non-EU clients).

The more complicated scenario arises with US advisors with EU-affiliated entities, which are themselves subject to MiFID II rules. Here the incompatible jurisdictions on research and dealing commissions will require careful policy crafting to ensure that firms with a presence on both sides of the Atlantic remain compliant.

**I heard that MiFID II introduces a new regime for non-EU firms…**
Yes, there is provision in MiFID II for third country firms to provide investment services and products to EU clients. There is no need for a physical presence in the EU in the case of services to professional clients (whereas a branch is required for retail). However, registration as a third country firm is also dependent on a prior "equivalence" determination (in essence, a level regulatory playing field compared with the home state) from the European regulator ESMA which, as we have seen with EMIR and AIFMD, is likely to be a highly politicised process.

**Will I be affected by the new rules on algorithmic trading?**
Again, the new organisational requirements on firms with algorithmic and high frequency trading strategies only apply in the first instance to MiFID investment firms. However, there are also potential "look through" requirements falling on non-EU algo-traders who either trade directly on EU venues, or via EU direct electronic access ("DEA") providers.

**Will I be affected by the new limits on commodity derivative positions?**
Unlike most MiFID II provisions, the new rules on commodity derivative position limits apply to all "persons" who are either members of, or participants on, EU trading venues – in other words, the location of the position taker is irrelevant. The limits are similar to the recently introduced CFTC position limit regime, but with scope across a broader range of contracts.

**Does Brexit change anything (from an outsider perspective)?**
Any portfolio management structure which relies on a primary presence in the UK to provide passporting rights into other EU locations (either to carry out portfolio management or offer investment services) will need to rethink this – in essence, the position of a UK investment manager will be somewhat similar, in relation to the EU, to a US adviser (assuming that no special deal is negotiated in the next 21 months).

**How can ACA Europe help?**

- Carry out a gap analysis on your current arrangements
- Provide detailed analysis on specific issues
- Provide peer comparisons with similar firms
- Design MiFID II-compliant policies
- Train staff on the impact of MiFID II reforms

To discuss further how ACA can help, please contact **Adam Palmer** or **Martin Lovick** or your regular ACA consultant with any questions or +44 (0) 207 0420 500

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**Genna Garver, *Of Counsel, Chair Investment Management Group, Dorsey & Whitney LLP***

Genna Garver works closely with clients to understand their unique needs and guide them through the complex maze of Investment Regulation.

Genna takes pride in the close personal attention she provides when advising investment management clients in connection with federal and state securities laws, private fund formation and securities offerings. She has extensive experience representing financial institutions in transactional and regulatory matters. She focuses on representing investment advisers, hedge funds and other private investment funds implementing various investment strategies.

Genna advises clients on: formation and offering matters for both domestic and offshore funds; SEC and state investment adviser, broker-dealer and private fund regulation; Investment Advisers Act registration and compliance programs; and mock audits and regulatory examinations and investigations.

Genna is Of Counsel in Dorsey's Corporate Group and chairs the Investment Management practice.

**Paul D. Glenn, *Special Counsel, Investment Adviser Association***

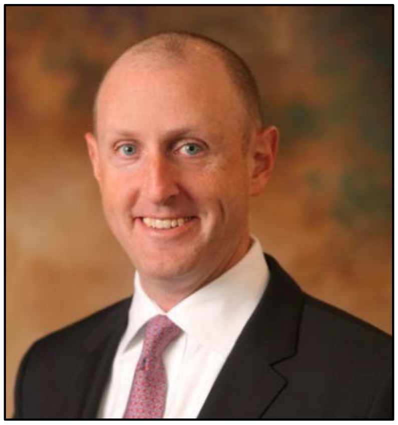
Paul is Special Counsel at the Investment Adviser Association and started at the IAA in 2006. Paul has worked at the US Securities and Exchange Commission as a trial attorney and special counsel in the Division of Enforcement and the Office of General Counsel, respectively. Paul also has experience working for the Office of the Comptroller of the Currency (then OTS), US Treasury, as Deputy Chief Counsel and special counsel. He has served as Vice President and Director of Compliance for PNC Bank N.A. in Washington, DC, (formerly Riggs) and Washington First Bank N.A. in Reston, VA (formerly Millennium Bank N.A.). Paul has his masters of law degree (LLM) from Georgetown University Law Center and his Juris Doctor and Bachelor of Arts (Political Science) from Case Western Reserve University. Paul also has an honorary doctor of laws degree from Nyack College, Nyack, NY. Paul is a member of the Bar of the Supreme Court of Ohio, the Supreme Court of the United States, and other federal courts.

**Thomas O. Gorman, *Partner, Dorsey & Whitney LLP***

Tom's practice focuses on defending SEC, CFTC and other regulatory investigations and actions including related DOJ criminal cases.

Tom has defended public companies and individuals in regulatory actions involving insider trading, market manipulation, financial fraud, corporate governance matters, accounting and auditing issues, FCPA issues, and similar matters. He has also defended securities class action and derivative suits and led teams conducting internal investigations focused on financial fraud and other securities law issues. He regularly speaks on, and publishes articles regarding, securities litigation issues including the FCPA, internal investigations, financial fraud and insider trading. He has been interviewed on these issues by the New York Times, Wall Street Journal, Washington Post, Financial Times, and other leading publications in addition to appearing on CNBC, CNN, and other TV networks. Tom publishes a widely-read securities blog, www.secactions.com, which analyzes trends in securities enforcement inquiries and litigation, and provides expert commentary for the LEXIS Securities web page. He serves as a member of the editorial board of the Securities Regulation Law Journal.

Tom's practice also regularly includes other complex business litigation matters arising under the securities, commodities, antitrust laws and the federal racketeering statutes, examples of which include: Minpeco, S.A. v. Hunt in which he and a team of attorneys obtained a $197.1 million treble-damage verdict on behalf of a Peruvian governmental entity after a six-month jury trial against the Hunt brothers and others (the jury found that the defendants had engaged in price fixing, monopolization, and manipulation activities in the world silver markets in violation of the antitrust, commodity, and racketeering laws); defense of a large German multinational that resulted in a government-to-government agreement creating a reparations fund for U.S. citizens interned in Nazi concentration camps during World War II; defense of the Republic of Peru in 54 actions in five countries involving over $6 billion in commercial bank debt; representation of the Central Bank of Nicaragua regarding its commercial bank debt disputes; securing a $25 million verdict after a five-month jury trial in a case based on international business transactions; and the successful defense of a large real estate company in a three-month jury trial in an antitrust action.



**Jeffrey C. Morton, *Partner & Co-Founder, ACA Compliance Group***

Jeffrey C. Morton is a partner and co-founder of ACA. Among other things, Mr. Morton is responsible for conducting mock SEC inspections and compliance program reviews of investment advisers, hedge fund managers and private equity funds. Prior to forming ACA, Mr. Morton spent over five years as a Securities Compliance Examiner and Staff Accountant in the SEC's Office of Compliance Inspections and Examinations in Washington, D.C.

Mr. Morton speaks at numerous industry-sponsored conferences on a variety of topics, including: compliance benchmarking and testing and private equity and hedge fund compliance. Mr. Morton is also the co-founder of the New York City Chief Compliance Officer's Roundtable, which meets semi-annually to discuss hot SEC and other regulatory compliance issues.

Mr. Morton graduated from the University of Scranton and is a member of National Society of Compliance Professionals, Advisory Board of the Private Equity CFO Association (NY Chapter), the Managed Funds Association, and the Alternative Investment Management Association (AIMA). Mr. Morton also serves on the board of directors of Elwyn Inc., a non-profit organization recognized nationally and internationally for the education and care of individuals with special needs.

**Mitzie Pierre, *Chief Compliance Officer, US and Canada, IFM Investors***

Juris Doctor (Howard University School of Law), Bachelor of Science in Business Administration (Finance) (Florida State University)

Mitzie is responsible for IFM Investors' compliance and regulatory obligations in the US and Canada. Prior to joining IFM Investors, Mitzie was Assistant Vice President and Canada Chief Compliance Officer at Partners Group in New York. She has also held legal, compliance and business roles at E1 Asset Management, FINRA and GE.