INVESTMENT MANAGEMENT LEGAL + REGULATORY UPDATE

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REGULATION

SEC Proposes Rule Requiring Hedging Disclosure

On February 9, 2015, the Securities and Exchange Commission (SEC) proposed amendments to its rules to implement Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which added Section 14(j) to the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Section 14(j) directs the SEC to require each issuer to disclose, in any proxy or consent solicitation material for an annual meeting of the shareholders of the issuer, whether any employee or member of the board of directors of the issuer, or any designee of such employee or member, is permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities: (1) granted to the employee or member of the board of directors by the issuer as part of the compensation of the employee or member of the board of directors; or (2) held, directly or indirectly, by the employee or member of the board of directors. As noted in the report issued by the Senate Committee on Banking, Housing, and Urban Affairs at the time of adopting Section 955 of the Dodd-Frank Act, this additional disclosure would serve to "provide transparency" to shareholders "to know if executives are allowed to purchase financial instruments to effectively avoid compensation restrictions that they hold stock long-term, so that they will receive their compensation even in the case that their firm does not perform."

A more complete analysis of the amendments can be found in our client alert, available here.

SEC Reports the Result of its Cybersecurity Sweep of Broker-Dealers and Investment Advisers

An SEC cybersecurity sweep examination by the SEC's Office of Compliance Inspections and Examinations (OCIE) found that 88 percent of the broker-dealers (BDs) and 74 percent of the registered investment advisers (RIAs) they visited experienced cyberattacks directly or indirectly through vendors, the SEC reported in a February 3, 2015 Risk Alert.

The sweep found that, while the vast majority of all BDs and RIAs have adopted written information security policies, the SEC staff found some gaps in cybersecurity protection among many firms. BDs and RIAs will find the report useful to help them learn how they compare to their

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peers in their development of cybersecurity procedures. Indeed, the OCIE Risk Alert reminds firms that cybersecurity is one of OCIE's 2015 exam priorities.

For those registered firms looking ahead to their next examination, OCIE's release also provides a hint of how it will focus its efforts in future reviews on the adequacy of a firm's policies and procedures.

OCIE's examination results highlight the magnitude of the issues and challenges that firms face when establishing cybersecurity procedures. While it is not surprising that so many BDs and RIAs have experienced cyberattacks, it is a somber reminder that systems are vulnerable. Moreover, OCIE reports that more than half of the BDs, and almost half of the RIAs they examined, reported receiving fraudulent emails seeking to transfer client funds. Over a quarter of the BDs reported losses related to fraudulent emails, but no single loss in excess of $75,000.

For its sweep, OCIE examined 57 registered BDs and 49 registered RIAs in order to "discern basic distinctions among the level of preparedness of the examined firms."

The Good News

OCIE reported that:

- 93 percent of BDs and 83 percent of RIAs examined have written information security policies.

- Nearly as many of the firms have written business-continuity plans that address mitigating the effects of a cybersecurity incident, and/or outline the firm's plan for recovering from such an incident.

- A similar number of firms conduct periodic risk assessments to identify cybersecurity threats, vulnerabilities, and potential business consequences.

- Almost all firms have conducted a firmwide inventory of their technology resources, including physical devices and systems, software platforms, network resources, connections to firm networks from external sources, and hardware, data, and software.

- Almost all firms use encryption.

- While 65 percent of the BDs examined offer their customers online access to account information, all of them provide their customers with information about reducing cybersecurity risk in conducting business with the firm. And, of the 26 percent of RIAs that primarily advise retail clients and provide online access to account information, three-quarters of those tell their customers how to reduce cybersecurity risks.

- Most of the BDs, and a little over half of the RIAs, use published cybersecurity risk management standards, such as those published by the National Institute of Standards and Technology.

Room For Improvement

OCIE also reported findings that indicated that many firms still have a ways to go in developing cybersecurity procedures, or bringing their existing procedures up to snuff.

- Only 72 percent of the examined firms incorporate cybersecurity requirements into their contracts with vendors and other business parties, and only 24 percent of RIAs do so.

- Only 51 percent of firms have procedures related to information security training for vendors or business partners.

- Very few firms address how they determine whether they are responsible for client losses resulting from cyber-incidents.

- A little over half of the BDs, and only 21 percent of RIAs, have cybersecurity insurance.

- Only about two-thirds of the BDs, and less than one-third of RIAs, have a designated Chief Information Security Officer (CISO).

For more information, including our take and analysis, see our blog.

House Passes Bill to Ease Volcker Rule and Other Regulatory Requirements

The U.S. House of Representatives on January 14, 2015, voted (271-154) to pass H.R. 37, the "Promoting Job Creation and Reducing Small Business Burdens Act." If enacted, the bill, among other things, would extend the Volcker Rule conformance date for collateralized loan obligations (CLOs) and ease requirements for investment advisers of small business investment companies (SBICs) and venture capital firms. The bill also includes a number of measures that correct issues arising in the JOBS Act, or that otherwise are intended to promote capital formation.

Rep. Jeb Hensarling of Texas championed this bill as beginning to "get America back to work" and start growing the economy. He said that the bill corrects some "unintended consequences" of the 2,000-page Dodd-Frank Act.

Democrats, as expected, were critical of the bill. Rep. Maxine Waters said that the bill was intended to delay the effect of the Volcker Rule, which was designed to stop "government-supported banks from gambling with bank depositors' money."

Our take: It is encouraging to see action to reduce regulatory burden. H.R. 37 is only a small step, and there are other aspects of the Dodd-Frank Act that Congress or the regulators should reconsider.

A more complete analysis of the bill can be found in our client alert, available here.

OCIE Publishes Exam Priorities for 2015

The OCIE recently published its examination priorities for 2015. This year's letter is significantly shorter than last year's letter, and takes a more thematic, less detailed approach to the discussion of OCIE's key focus areas.

Many of the themes in the letter are consistent with OCIE's 2014 examination priorities, as well as with issues identified by the SEC staff over the course of the last year. One notable new theme, however, is OCIE's identification of transfer agents as "gatekeepers" that may warrant closer attention from the OCIE staff.

OCIE also encouraged would-be whistleblowers to reach out to the staff with information about activities that may "violate the federal securities laws or otherwise [operate] to harm investors."

OCIE identified three key areas of focus in 2015:

- Retail investors, including those involved in retirement investing and the use of traditionally "institutional" products in the retail marketplace;
- Market-wide risks, including structural risks and trends involving multiple firms; and
- Data analysis, including the use of data to identify firms that appear to be involved in fraudulent or other illegal activities.

Registered investment advisers, broker-dealers, municipal advisers, and transfer agents should take the time to carefully review OCIE's letter and consider if their compliance programs adequately and appropriately address the risks identified by OCIE.

A more complete analysis of the letter can be found in our client alert, available here.

Heightened Scrutiny of Brokers – SEC Approves FINRA's Proposed Background-Check Rule

In recent years, questions have been raised in many quarters about how brokers with questionable backgrounds have been able to move among firms and remain in the industry. FINRA has responded by enhancing broker-dealer obligations for reviewing the backgrounds of its newly hired brokers.

The SEC recently approved proposed FINRA Rule 3110(e), which requires FINRA member firms to verify the information in Form U4 within 30 calendar days of filing. The proposed rule, which will take effect on July 31, 2015, is intended to improve the information that winds up in FINRA's Central Registration Depository (CRD) and BrokerCheck. FINRA's 2015 Regulatory and Examinations Priorities Letter (January 6, 2015) discusses its concern regarding "high-risk and recidivist brokers," including firms' due diligence on prospective hires, and highlights the proposed rule with respect to investor protection.

To read the full alert, click here.

FINRA Issues a Packed Priorities Letter for 2015

FINRA opened 2015 with a lengthy and ambitious agenda of regulatory priorities. This year's Regulatory and Examination Priorities Letter is much longer than those issued in the last two years, and repeats many of those years' priorities, while adding additional products and practices. Amidst this smorgasbord of priorities, several are highlighted in FINRA's accompanying press release, and so might have a favored place at the table:

- sale and supervision of interest-rate-sensitive and complex products, including alternative mutual funds;
- controls around the handling of wealth events in investors' lives;
- management of cybersecurity risks;
- treatment of senior investors; and
- high-risk brokers and removing bad actors from the securities industry.

In the letter, FINRA seeks to unify its priorities around a set of systemic issues that it believes differentiate good firms from noncompliant firms: putting customer interests first; firm culture; supervision, risk management, and controls; product and service offerings; and conflicts of interest. FINRA will use data analytics to identify potential problem areas within firms, and expects firms to use similar methods to identify problems themselves.

We summarize some of the more significant issues raised in the letter, along with our recommendations about how to prepare for a risk-based FINRA examination of these issues. As always, the best way for a broker-dealer to prepare for a FINRA examination and avoid enforcement interest is for the firm to put itself in the head of a FINRA examiner and address the areas that FINRA is likely to examine in light of the firm's business, history, and supervisory structure.

To read the full alert, click here.

FSOC, At It Again, Places Asset Managers in Its Crosshairs

In seeking comment on potential risks to the U.S. financial system created by asset managers, the Financial Stability Oversight Council (FSOC) again places asset managers in its crosshairs. This crusade can potentially lead to unnecessary, costly, and counterproductive regulation of asset managers.

To read the full alert, click here.

CFTC Staff Grants Family Offices No-Action Relief From Registration as Commodity Trading Advisors

The Commodity Futures Trading Commission's (CFTC) Division of Swap Dealer and Intermediary Oversight (DSIO) recently issued no-action relief for failure to register with the CFTC as a commodity trading advisor (CTA) to any "Family Office" that provides advisory services to a "Family Client" (CTA Letter). The relief supplements prior relief (Letter No. 12-37) for Family Offices from registration as a commodity pool operator (CPO).

A Family Office is generally a professional organization that is wholly owned by clients in a family, and is exclusively controlled (directly or indirectly) by one or more members of a family and/or entities controlled by a family.

Family Offices previously relied upon the exemption from CPO registration for pools offered only to qualified eligible persons; this exemption was contained in CFTC Reg. 4.13(a)(4). CTAs that advised such exempt pools were likewise exempt from CTA registration. CFTC Reg. 4.13(a)(4) was repealed in 2012, but Letter No. 12-37 addressed only CPO registration requirements and was silent with respect to relief from registration as a CTA.

A more complete analysis of the letter can be found in our blog.

SEC to Require Living Wills and Stress-Testing for Investment Advisers

In a speech on December 11, 2014, SEC Chair Mary Jo White announced three broad "proactive initiatives" to address the risks of "increasingly complex portfolio composition and operations" in the asset management industry.

White amplified items on the SEC's agenda, announced in November, and said that the SEC will consider new regulations to require stress testing and living wills for asset managers.

Acknowledging that long-term changes in the asset management business have created "new risks and challenges," White said that new regulations should build on the "lessons of the financial crisis."

White announced the initiatives for the $63 trillion asset management business in the context of rapid growth, noting that assets under management have doubled since 2004 alone, and pointing to the increased complexity of products created in response to investor demands.

The SEC, she said, has focused in the past on controlling conflicts of interest, as well as enhancing reporting and disclosure regimes; it has also focused on issues related to private fund advisers. Now, she said, the SEC will begin initiatives focusing on portfolio composition and operational risks.

Enhanced data reporting. The SEC is considering new rules that would require standardized reporting for derivatives used by funds and securities lending. The data-collection efforts may extend to private funds.

- *Our take:* We can expect the SEC to require registered funds and private funds to report specific data more regularly, concerning derivatives holdings and securities lending activities. This data might be used for the SEC's surveillance and enforcement efforts, in a manner similar to how the SEC plans to use data derived from public company financial reporting and audit trail information.

Controls on risks related to portfolio composition. White identified liquidity risks and the use of derivatives as key staff priorities. Registered funds must establish controls that identify and manage those risks.

Consistent with the January 2014 guidance published by the Division of Investment Management, White said that the staff is concerned that mutual funds may have difficulty meeting redemptions if portfolios come under stress and are forced to sell securities at fire-sale prices, which in turn could drive down asset prices for other funds and other investors. The staff is also concerned that funds' use of derivatives frequently results in "leveraged investment exposures and potential future obligations that can create risks."

White called for a "comprehensive approach" to address risks related to liquidity and derivatives. While

White was short on specifics, she said that the SEC's staff is reviewing options such as updated liquidity standards, disclosures of liquidity risks, or limits on leverage created by use of derivatives.

- *Our take*: It is not clear what the actual rule proposals would look like. An educated guess is that the SEC will refine the definition of "liquidity" — that is, when a fund should consider an investment to be illiquid. The current definition is buried in instructions to Form N-1A and, most recently, in the 2014 amendments to the money market fund rules. A new definition may be more market-oriented, taking into account the perceived tightening of the fixed income market and shrinking bond inventories. The SEC may also attempt to pull in the reins on leverage, or tighten asset-segregation requirements. In any event, these proposals are likely to generate substantial controversy and public comment.

Transition planning and stress testing. Borrowing from the Dodd-Frank Act playbook, the SEC may require large asset managers to adopt the functional equivalent of "living wills" to ensure that clients' needs are protected when an asset manager loses key personnel or plans to shut its doors. The SEC likely will require advisers to adopt "transition plans" to prepare advisers and their clients to deal with an "actual severe disruption in the adviser's operations."

The SEC will also implement a Dodd-Frank Act requirement by requiring annual stress testing by large broker-dealers, investment advisers, and registered investment companies. The requirement would be based upon stress testing requirement for banks, and more recently, money market mutual funds.

- *Our take*: It appears that the SEC may be attempting to control the debate over whether asset managers should be designated "systemically important financial institutions," or SIFIs, possibly in reaction to the controversial report on this topic published by the Office of Financial Research, at the direction of the Financial Stability Oversight Council. The SEC may be sending a message that it, rather than the federal banking regulators, is better positioned to address the systemic risks of asset managers. The requirements for living wills and stress testing should come as no surprise to observers of how regulations evolve, and indeed many funds and advisers have been moving in this direction. But these requirements undoubtedly will increase compliance costs, and take up real estate on crowded fund board agendas.

We expect that, over time, more and more information will trickle out of the SEC about these initiatives. Meanwhile, it is too early to tell how the new proposals will affect funds and advisers.

Former Investment Management Director Offers Top 10 Lessons Learned in 2014

In a December 10, 2014 speech, Norm Champ, then-director of the SEC's Division of Investment Management, offered a glimpse at the top 10 industry lessons learned in 2014. While admitting that his Top 10 list "may not be as entertaining as one you would see on Letterman," Champ said the list provides a view into both how the Division operates and its future goals. To view the complete list, see our blog post, but here are three highlights:

Number 9: The Division Is Not a "Regulatory Island." Champ said that the Division "seek[s] to encourage an inclusive, collaborative working environment within the Division, across the Commission, and with outside stakeholders." He cited recently adopted amendments to the money market funds rule as an example of collaboration with the Department of the Treasury and the IRS. Other observers may take a different view of the level of "collaboration" involved in getting the money market rule across the finish line (see our related blog post).

Number 5: Appropriate Innovation Is Necessary to Meet the Needs of Investors. Champ acknowledged the need for new and innovative investment products to meet the needs of investors, and said that the Division is "working to become smarter, more strategic and more targeted in anticipating, identifying the monitoring the risks of the current landscape." He characterized the no-action and exemptive relief process as a "laboratory" enabling the Division to conduct this work. Clearly, sometimes those experiments fail (as in the case of nontransparent, actively managed ETFs), but sometimes the experiments lead to new products (as in the case of exchange-traded mutual funds).

Number 3: Open Communications With the Industry and the Public Is Imperative. Champ focused on the Division's ongoing initiative to engage fund boards and senior management personnel as an example of its communications outreach. Champ said, however, that this initiative has thus far focused on meetings with some of the country's "large asset managers." We are concerned that this may skew the Division's view of the industry and its level of sophistication, particularly with respect to systems and infrastructure. This could put smaller asset managers at a disadvantage as the Division develops guidance and new regulation.

ENFORCEMENT + LITIGATION

SEC Charges Alt Fund Adviser With Custody Violations

The SEC on February 12, 2015, entered findings against an investment adviser to several alternative mutual funds for maintaining $247 million in cash collateral at broker-dealer counterparties instead of the fund's custodial bank. The SEC staff discovered the alleged violations during a routine examination. Without agreeing with or denying the charges, the adviser agreed to pay a $50,000 penalty to settle the SEC's charges.

The SEC charged that the adviser violated the custody requirements of Section 17(f)(5) of the Investment Company Act of 1940 because it did not ensure that the funds' custodial bank maintained the cash collateral held by broker-dealer counterparties. The cash collateral related to the funds' investments in total-return and portfolio-return swaps.

The SEC's order found that the investment adviser also violated Section 12 of the 1940 Act and related Rule 12b-1(h) because it failed to implement directed brokerage policies and procedures, which required the adviser to create and maintain an approved list of executing brokers for the funds, and to monitor the funds' compliance with the directed brokerage requirements. In addition, the SEC found that the adviser caused the managed funds to violate Rule 38a-1, the Investment Company Act compliance rule.

- *Our take*: This settlement appears to be the fruit of the SEC's sweep examination of alt funds. We expect to see more similar enforcement cases. The case reinforces the need to ensure that funds follow their established compliance policies, and to not lose sight of the basics, such as compliance with the custody rules. In the case of this type of cash collateral, funds typically comply with the custody rules by establishing a tri-party agreement among the fund, the counterparty, and the fund custodian.

FINRA Sanctions Member Firm for Failure to Deliver ETF Prospectuses

FINRA recently sanctioned a broker-dealer (the "Firm") for failure to deliver prospectuses in connection with its sale of ETFs. FINRA also found that the Firm failed to implement a supervisory system reasonably designed to achieve compliance with securities laws and regulations governing ETF prospectus delivery. The Firm was censured and agreed to a fine of $3 million. This fine is a significant increase in the amounts imposed by FINRA since 2011 in its disciplinary proceedings against member firms for their failures to meet their prospectus delivery obligations (see our related blog post).

FINRA found that the Firm failed to deliver prospectuses for approximately 255,000 purchases of 160 ETFs during the period from September 2010 to November 2010. The Firm self-reported the delivery failures to FINRA.

According to FINRA, the Firm used manual reviews of three stock exchange websites to identify newly listed ETFs. If a new ETF was identified, the reviewer manually entered a code in the Firm's automated system to trigger prospectus delivery when it sold an ETF. FINRA found that the procedures did not require quality checks, and that supervisors in fact did not perform such checks. FINRA said that it was "reasonably foreseeable that the manual process could result in human errors, [but] the Firm's supervisory system did not provide a sufficient process through which the Firm could detect and prevent these errors."

FINRA also found that the Firm's decentralized supervisory system was not reasonably designed to ensure compliance with ETF prospectus-delivery obligations. As a result of a previous FINRA matter, the Firm was required to certify that its policies and procedures regarding delivery of ETF prospectuses were reasonably designed to ensure compliance with the federal securities laws and NYSE rules. However, when the individual who signed the 2007 certification departed the Firm, there was no longer clear ownership of ETF prospectus delivery. FINRA said that the decentralized supervisory system contributed to the Firm's failure to identify deficiencies in its ETF prospectus delivery process and to timely remedy the inadequacies in its manual process. Moreover, FINRA said that the Firm did not timely respond to red flags indicating that it had experienced failures to deliver.

According to FINRA, the firm's testing of ETF prospectus delivery that was conducted by internal audit, compliance, and operations control was conducted on a limited sample of trades. FINRA said that the small sample size was inadequate to ensure verification of the Firm's procedures, and internal audit did not assign an appropriate risk level to testing the ETF delivery procedures.

For more information, including our take and analysis, see our blog.

SEC and PCAOB Combine Their Focuses on Broker-Dealer Audits and Independence in Settlements With Fifteen Audit Firms

On December 8, 2014, the SEC and Public Company Accounting Oversight Board (PCAOB) announced settlements with 15 audit firms for violating independence rules applicable to auditors of broker-dealers. The PCAOB sanctioned seven firms for violating independence rules when those firms prepared the financial statements of brokerage firms that were also their audit clients. The SEC sanctioned eight auditors for similar independence violations and for causing those clients to violate SEC rules by submitting financial statements that did not comply with Generally Accepted Accounting Standards.

For more information, including our take and analysis, see our blog.

TIDBITS

- On February 3, 2015, the SEC announced that David Grim had been named Acting Director of the Division of Investment Management. He replaces Norm Champ, the division's former director, who left the SEC at the end of January. Mr. Grim had been the division's deputy director for the past two years; he had been responsible for overseeing all aspects of the division's disclosure review, rulemaking, guidance, and risk-monitoring functions.

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