Investment Advisers Act Compliance Developments in 2015*

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Introduction

Asset management at its simplest involves three principal aspects: outreach to prospective investors; operating the investment product; and interacting with the markets in which the investments are made. An asset manager's employees often have roles that fit into one of the above: sales, operations, and portfolio management. The year 2015 is shaping up to have an unusual focus on the center of that string of relationships which trace the path from end-investor to asset class -- that is, the nuts and bolts of "operations." This is because regulators have recognized that soundness and controls help markets and their participants maintain integrity and the public's confidence despite the ebbs and flows of asset allocations and market swings. Not since the introduction of the Sarbanes-Oxley Act has so much scrutiny been visited upon firms' internal controls and processes.

This article focuses on several key operations-oriented compliance developments for investment advisers in 2015:

- *Cybersecurity and other tech-related issues*. Safekeeping assets and maintaining sound information systems is an obvious focal point of regulatory scrutiny this year. The risk is real and the harm can be tremendous.
- *Increased reporting of data*. The U.S. Securities and Exchange Commission and other regulators are intensifying their sifting of the data they gather on numerous forms. In coming months, asset managers can expect regulators to both seek more input (more new forms) and produce more output (studies analyzing the data, and rules implementing regulators' conclusions about the data). Compliance staffers must endeavor to stay ahead of both.
- *Other core operational functions.* Risks and threats to an asset management firm's operational integrity take many forms, and the SEC has placed these on par with more traditional concepts of compliance under the U.S. Investment Advisers Act of 1940.

Death, Taxes, and … Cyber Insecurity

The internet of finances has placed the pocketbooks and investments of all of us online, accessible with a virtual key that is as simple or as complicated as our username and password. Financial firms, as they have done since before the era of the stagecoach, take further steps to build barriers to outside threats. It is no secret that hackers have targeted money managers and their service providers, and those attacks are sure to continue. Whether measures involve multiple-step verification, encryption, firewalls, monitoring, or other electronic or physical safeguards, investment advisers have their work cut out for them. In light of this ongoing threat, the SEC and other regulators are engaging in various related initiatives. All of this is supplemental to an adviser's fiduciary duty, its data safeguarding obligations under Regulation S-P and other applicable laws, and commercial and reputational concerns arising from potential harm to customers. Some regulatory initiatives follow.

FINRA Cybersecurity Sweep

The Financial Industry Regulatory Authority, which regulates broker-dealers (including those dual-registered as investment advisers), initiated a sweep in January 2014 to enhance its understanding of data threats and industry responses. FINRA has announced that it will publish the results of the sweep in 2015 and that, subsequently, FINRA members will be called on to identify their critical assets and implement appropriate controls to protect them.[1] Even for non-FINRA members, this report may be a useful resource as investment advisers and their vendors address cyber threats.

SEC Cybersecurity Roundtable

In March 2014, the SEC built on its growing focus on cybersecurity by holding a roundtable dedicated to the subject. For a full morning and afternoon, panelists covered ground ranging from the cybersecurity landscape, to disclosure and trading systems, to concerns specific to asset managers. With respect to investment advisers, the SEC Chair's opening remarks highlighted data protection and identity theft vulnerabilities in particular.

OCIE Risk Alert

The following month, the staff of the SEC's Office of Compliance Inspections and Examinations, or OCIE, issued a Risk Alert describing its Cybersecurity Initiative.[2] That Risk Alert includes an appendix that sets out a couple of dozen separate questions that OCIE incorporated into sweep examinations of registered advisers. OCIE later issued another Risk Alert summarizing the results of its examination sweep.[3] OCIE's latest list of examination priorities also highlights cybersecurity, and, for years to come, cybersecurity is sure to remain a topic on that annually-published list.

Note on OCIE's cybersecurity examination initiative

During OCIE's Cybersecurity Initiative, examiners asked SEC-registered investment advisers and broker-dealers questions that touched on the following topics, among others:

- Procedures for maintaining an inventory of different technologies used by the business
- Findings from the firm's risk assessments to identify both cybersecurity threats and physical threats
- Written plans for recovery from a cybersecurity incident
- The nature of any insurance that covers such incidents
- Guidance and training for personnel
- Restricting data access to need-to-know personnel
- Processes for system maintenance
- Controls against malware
- Data encryption policies, and data destruction policies
- A tally of customer online access risks
- Service provider and vendor risks
- Processes for detecting unauthorized activity
- Identifying the personnel responsible for many of the foregoing items

While most of the documents or topics identified are not required books and records, a prudent firm may wish to consider whether taking measures with respect to some or all of these are worth considering for its business.

Legislative Initiatives

Calls for legislation to promote cybersecurity, formalize the reporting of cyber-related incidents, and adopt a federal consumer privacy bill of rights should be expected to result in substantial obligations on a financial business to monitor, keep records, and make internal and external reports in connection with data security processes and incidents. Every financial business has private information about its clients or others, and while protecting that information has long been a priority, an investment advisory firm will need to stay ahead of any specific, technical requirements imposed by forthcoming law or regulation.

International Developments

Multi-national firms, or those having affiliates or even just clients across the globe, must also consider the recent and forthcoming development of cross-border standards such as under the European Union's Data Privacy Directive, and any standards that may arise from trans-Atlantic or trans-Pacific trade partnerships.

The Future is Now

Investment advisers should consider risks-of-the-unknown embedded within new financial technologies. "Fintech," a word that can have many meanings, refers here to the application of innovative technologies to facilitate public participation in new financial and investment platforms or products. Many advisers will seek to take part in this expansion of direct retail access to the markets.

Fintech breakthroughs promise to go far beyond the past decade's adoption of web sites, feeds, and apps that are now commonly used in retail financial contexts. Examples of forthcoming innovations include:

- the further evolution of digital payment systems,
- the proliferation of "decentralized" companies that purport to have no jurisdictional domicile,
- the expansion of peer-to-peer lending, offering, and trading platforms, and
- the use of bitcoin and other virtual currency as the basis for exchange, investment, or enterprise.

Given that financial regulation abhors a vacuum, most of these developments face challenges – both in determining what rules apply in the first place, and in implementing the new technologies in compliance with those rules. Above all, advisory firms who engage in these areas should be aware that much of the regulatory framework that potentially applies to Fintech concepts is at a nascent stage, and that the only certainty is that regulation will progress in fits and starts.

First of all, depending on the nature of the product, the federal securities or commodities laws may be implicated. Ironically, despite the de-regulatory bent of certain Fintech proponents, under certain scenarios the formal federal registration of a product may present the path of least resistance. Otherwise, consumer protection initiatives of the Consumer Financial Protection Bureau or the Federal Trade Commission could provide *ad hoc* federal oversight, as they do for many categories of retail financial transactions. In the unusual event that a financial instrument completely avoids federal regulation, its purveyor might well then scour the patchwork of laws of the 50 states, the District of Columbia, and other jurisdictions. In this era of a borderless internet, online offerings and transactions can inadvertently run afoul of overseas laws as well. For its part, the SEC has not turned a blind eye to online public offerings conducted from overseas locations, in which non-accredited U.S. investors were not prevented from investing. On top of everything else, tax implications are also in flux.

Note about the potential regulation of Fintech products

As the production of new Fintech tools accelerates, attention must be given to whether they constitute:

- securities (thus potentially implicating the U.S. Securities Act of 1933 and its rules on registration, or exemptions from registration);
- advice on securities (the Advisers Act);
- pooling securities (the U.S. Investment Company Act of 1940);
- trading in securities (the U.S. Securities Exchange Act of 1940, including broker-dealer provisions)
- derivatives or commodity interests (provisions administered by the U.S. Commodity Futures Trading Commission).

The federal definition of a "security" is a complicated one, reflecting over 80 years of regulatory guidance and case law, and may encompass many things that appear wholly unlike traditional stocks and bonds. Other complications may arise out of the securities laws of non-U.S. jurisdictions, as well as other U.S. federal laws and the various state laws.

In sum, a healthy respect for compliance obligations can help an entrepreneur avoid such consequences as reputational harm, fines, bans, and even rescission rights. Asset managers would do well to keep those regulatory risks in mind as they look forward to incorporating these new technologies into their business operations or investment programs.

The same goes for algorithms and other automated trading strategies (and the failure of an adviser to base its marketing on the algorithm's actual trading results or to fulfill the firm's promises to rely solely on the promised algorithm), which the SEC's Enforcement staff have targeted of late. Going forward, the SEC has sought funding to examine "the increasing use of technology in operations that facilitate such activities as high-frequency and algorithmic trading,"[4] so more Enforcement developments or even substantive new regulation can be anticipated.

Traditional Operational Functions

The SEC's focus on the operations of investment advisers and investment companies goes beyond technology. Some topics of particular interest are noted below.

Protecting Traditional Client Assets

Electronic data is just one client asset to be protected. Traditional assets -- money and securities -- remain at the top of the list, and the SEC has been vigorous in enforcing the Advisers Act custody rule. The SEC's Division of Investment Management has also been providing custody rule-related guidance, including in the form of an IM Guidance Update that spells out ways in which a private equity fund manager may handle certain scenarios involving special purpose vehicles or escrow arrangements.[5] A client asset that is somewhat less obviously considered an asset -- a client's right to vote its proxies or have the adviser vote them in the client's best interest -- is likely to move to the forefront as greater scrutiny is applied to the concentration of market share among the major proxy advisory firms that provide many asset managers and institutional investors with recommendations on voting proxies.

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Data, Data, and More Data

The good news is that, by now, most asset managers have their feet under them with respect to the SEC's Form PF, the CFTC's Form CPO-PQR and Form CTA-PR, and the related National Futures Association filings, not to mention greater visibility of filing obligations on cross-border transactions under the U.S. Treasury International Capital (TIC) system and the U.S. Department of Commerce's similarly-focused Bureau of Economic Analysis filings. For many of these forms, the formerly-steady stream of FAQs has slowed to a trickle of online updates, managers have by now submitted a few rounds of filings, and the rules of the road have been absorbed into operational staffs' periodic routines.

Next up? For registered investment companies, expect to see the reform of Form N-SAR, the semi-annual report that uses a combination of outdated technology and a non-user-friendly format. For investment advisers generally, expect ever-more granular reporting, including on separately-managed accounts. SEC Chair Mary Jo White has said:

> While funds and advisers currently report significant information about their portfolios and operations to the Commission, these reporting obligations have not, in my view, adequately kept pace with emerging products and strategies being used in the asset management industry. For example, our rules do not require standardized reporting for many types of derivatives used by funds today. This is a clear gap, particularly given the growth in the volume and complexity of derivatives used by funds. Similarly, we do not today receive the most complete information about securities lending by funds, which is done by approximately a quarter of funds.
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> The staff is developing recommendations for the Commission to modernize and enhance data reporting for both funds and advisers. Even the reporting of basic census information should be updated so that we are better able to monitor industry developments and potential compliance issues. Beyond that, the reporting and disclosure of fund investments in derivatives, the liquidity and valuation of their holdings, and their securities lending practices should all be significantly enhanced. Collecting more data on separately managed accounts, where the adviser manages assets owned by a particular client, will also better inform examination priorities and the assessment of the risks associated with those accounts, which are a significant portion of the business of many investment advisers.[6]

On that basis, investment advisory firms can expect to face added operational burdens in tracking and reporting data. Furthermore, compliance staffs should be aware of the

SEC Enforcement Division's "use of big data to detect and investigate violations," after sifting big data for "problematic patterns" and "troubling trends.[7] Similarly, the Division of Investment Management's Risk and Examinations Office has been increasing its use of data to engage in risk monitoring, review market trends that may include complex investment structures, compile ongoing financial analysis of the asset management industry, and maintain awareness of the risk-taking activities of investment advisers and funds.

FSOC on the Move

As 2015 progresses, the U.S. Financial Stability Oversight Council, or the FSOC, will continue to analyze the asset management industry's contributions to systemic risks facing the economy. To date, the FSOC's most-publicized mission has been to identify systemically important financial institutions, or SIFIs. Its views on money market funds and its consideration of nonbank financial companies (such as, potentially, major investment advisory firms) as SIFIs has brought the FSOC squarely into the asset management space historically occupied by the SEC. In considering its next steps, the FSOC has requested public comment on a variety of matters relating to the asset management industry.[8] One key topic in its call for comment is labelled "operational functions" and covers a variety of areas, which further suggests means that keeping an eye on operational effectiveness is the order of the day.

That FSOC request for public comment also asked a number of questions about the risks of mismatches between the liquidity of a portfolio's assets and investors' rights to withdraw cash; risks arising from the use of leverage in investing; and the effects on clients and the financial system of the insolvency of asset managers. Compliance officers can anticipate that the SEC will ask similar questions during its interactions with investment managers.

Note on the FSOC's focus on asset management firms' operational functions

The FSOC's discussion of investment adviser operations in its request for public comment on the asset management industry includes the following topics:

- Risks associated with transferring client accounts or assets from one manager to another, including any special risks relating to:
  - transferring derivatives or other asset types
  - any asset class for which no other manager is qualified to substitute
  - foreign markets or service providers
  - the speed with which assets can be transferred in good order
  - having to liquidate assets in connection with such a transfer
- Key functions for which the market share of service providers is particularly concentrated
- Due diligence when selecting a provider or tools for:
  - valuation
  - oportfolio risk management
- Operational risk transmission among affiliates upon the failure of one of them
- The effect of an asset manager's bankruptcy or dissolution on its funds
- Best practices employed by asset managers to assess and mitigate the operational risks associated with service providers
- Contingency plans to deal with failures of service providers

Sub-TA Arrangements in Focus

Transfer agency tends to sit deep within what is considered Operations. The TA function processes investors' holdings as they invest and withdraw money, and fulfills countless other roles including arranging the payments of dividends and distributions, tracking missing shareholders, and dealing with lost share certificates. In the competitive money management industry, many intermediaries have become possessive of their client relationships, and seek to institute omnibus arrangements for reasons as varied as keeping sensitive client information confidential, controlling access to a book of business, and not trusting others to provide the special touch that customers value. Since an intermediary's customers are not bound to remain with the intermediary, responsive full service is often the name of the game.

As in any market, there are diverse means of compensating such a service provider. Some are compensated by their customers. Others are compensated by the mutual funds in which their customers invest, under shareholder servicing agreements or sub-transfer agency (sometimes called "sub-TA") arrangements that are structured in a variety of ways. Part of the rationale for a mutual fund to compensate a sub-TA is that the intermediary acts as a central point that handles mailings and other outreach to the intermediary's customers who invest in the fund, thus saving the fund the trouble of doing so and augmenting the benefits to fund shareholders.

Sub-TA services are often bundled with other operational, administrative and customer-facing services, and may be provided in exchange for an asset-based fee, a fee per account, a combination of the two, or another fee arrangement. In some cases, such services (either expressly or *de facto*) may include facilitating the distribution of fund shares, which is where most of the regulatory scrutiny comes in. For the past 35 years, ever since the SEC adopted Rule 12b-1 under the Investment Company Act, the payment for distribution out of mutual fund assets has been subject to an elaborate regulatory regime that includes disclosures, board of directors determinations, and prohibitions.[9] An overlay of FINRA regulation on the kinds and extent of compensation that a broker-dealer may accept adds further complexity to this topic. In the coming year, based on signals from the SEC staff, some registered fund boards and sponsors can expect to be challenged in their handling of sub-TA arrangements, along with scrutiny of related fees and services, in cases where the arrangements may be deemed to involve direct or indirect payments for the distribution of fund shares. Among ops staffers, a firm's transfer agency, recordkeeping, and other operational systems may need to be adapted as new approaches are implemented.

Operational Integrity in General

Other operational topics of interest to an investment adviser's compliance department include:

- *Operational risk generally*: The SEC Chair has said that, "by 'operational risk,' I generally mean risk from inadequate or failed internal processes and systems."[10]
- *Operational integrity*: The SEC's Investment Management chief has underscored the importance of reviewing operational integrity as a matter of monitoring risk.[11]
- *Whistleblowers*: Advisers should take care that their processes are set to handle whistleblower complaints with the highest priority in order to address any valid issues raised and mitigate risks to the enterprise.
- *Committee functions*: The Enforcement Division has taken issue with actions that it considered improper by investment advisers' internal committees.[12]
- *Valuation controls*: The SEC's budget request for fiscal year 2015 includes a request for additional staff to examine, among other things, the processes and controls for valuation of complex, illiquid assets.[13]
- *Document delivery*: FINRA has brought actions against several violations of the obligations to deliver such documents as trade confirmations, or prospectuses relating to purchases of shares issued by exchange traded funds, or ETFs.
- *Portfolio composition risks*: Although more of a portfolio management or compliance function than the foregoing items, responsibility for identifying portfolio composition risks may implicate operations personnel who help with risk management analysis and the monitoring of compliance with investment restrictions.

Note on existing mutual fund regulations on portfolio composition

SEC Chair White, in her Safeguards Speech, suggests that the SEC may impose specific, substantive investment restrictions on funds. These would be in addition to those that already exist. Although the federal securities laws operate primarily as a disclosure regime, the Investment Company Act has long imposed a number of limitations on the portfolios of registered investment companies or funds regulated as business development companies (or BDCs), including the following:

- *Diversification:* A registered fund or BDC that markets itself as "diversified" must limit its investments in any one issuer; additional diversification requirements arise under Subchapter M of the U.S. Internal Revenue Code
- *Concentration:* A registered fund must adopt a policy to either concentrate its portfolio in an industry or group of industries, or undertake not to so concentrate
- *Borrowing and use of derivatives:* A registered fund is limited in its ability to use leverage, whether directly or by means of derivative instruments, or to otherwise engage in borrowing, and a BDC is subject to similar limitations but to a different degree
- *Investments in other registered investment companies:* Funds, whether regulated or not, are limited in their ability to invest in registered funds
- *Investments in or with affiliates:* A registered fund is generally prohibited from investing in, or transacting with, affiliates of its investment adviser; a BDC, despite having more flexibility, is subject to a similar regime; even the adviser of a separate account may be required by the Advisers Act to obtain prior client consent to any transaction with the account's investment adviser or its affiliate
- *Names rule:* If a registered fund's name identifies a certain asset class or strategy, the fund may be required to invest the bulk of its portfolio in assets suggested by the name
- *Short sales and securities lending:* SEC guidance limits the extent to which a registered fund or BDC may engage in short selling or in lending its securities
- *Illiquid assets:* Given its obligation to pay redemption proceeds promptly, a registered open-end mutual fund must maintain a minimum level of liquidity
- *Eligible portfolio assets:* A BDC is restricted in the kind of assets it may acquire.
- *Disclosed restrictions:* A fund, whether registered or not, may be subject to greater restrictions if provided in its prospectus, other disclosure documents, or charter

Conclusion

While 2015 holds exciting prospects for future innovations, asset managers should expect a regulatory push to get back to basics. While the past decade has been the era of the CCO (chief compliance officer), the next phase is bringing the COO (chief operating officer) to the compliance forefront. Firms' operations and compliance departments should be working hand-in-hand like never before to face the regulatory challenges posed by cybersecurity threats, manage risks relating to technological innovations in the financial sector, and adapt core internal controls as circumstances demand.

ENDNOTES

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[1] Regulatory and Examinations Priorities Letter, FINRA (Jan. 6, 2015).

[2] *OCIE Cybersecurity Initiative*, National Exam Program Risk Alert (Apr. 15, 2014).

[3] *Cybersecurity Examination Sweep Summary*, National Exam Program Risk Alert (Feb. 3, 2015).

[4] *FY 2015 Budget Request by Program*, SEC ("SEC Budget Request"), at 56, available at https://www.sec.gov/about/reports/sec-fy2015-budget-request-by-program.pdf.

[5] IM Guidance Update, *Private Funds and the Application of the Custody Rule to Special Purpose Vehicles and Escrows* (June 2014).

[6] Mary Jo White, Chair, SEC, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry* (Dec. 11, 2014) (speech) ("Safeguards Speech"). Internal footnotes were omitted from the above excerpt.

[7] Andrew Ceresney, Director, SEC Enforcement Division, Remarks to the American Bar Association's Business Law Section Fall Meeting (Nov. 21, 2014).

[8] Notice Seeking Comment on Asset Management Products and Activities, Financial Stability Oversight Council (Dec. 18, 2014).

[9] In 2010, the SEC attempted to clarify and modify the ground covered by today's Rule 12b-1, by proposing amended rules and new guidelines. *See Mutual Fund Distribution Fees; Confirmations*, Investment Company Act Release No. 29367 (July 21, 2010). The 278 page proposing release covered a range of related topics, including proposals as to limits on distribution fees and clearer disclosures to investors about sales charges, and it touched on sub-TA fees. To date, the rule has not been adopted and is no longer central to the SEC's announced regulatory agenda.

[10] Safeguards Speech.

[11] Norm Champ, Director, SEC Division of Investment Management, Remarks to the ALI CLE 2014 Conference on Life Insurance Company Products (Nov. 13, 2014) (speech).

[12] *See, e.g., In the Matter of Vero Capital Management, LLC, et al.,* Investment Advisers Act Rel. No. 3991 (Dec. 29, 2014) (instituting proceedings claiming, among other things, that requisite client consent under Advisers Act Rule 206(3) was not properly obtained when approved by an internal committee of the adviser).

[13] SEC Budget Request, at 58.