Investment Management Regulatory Update

July 26, 2016

SEC Rules and Regulations

SEC Issues Proposed Rule Regarding Adviser Business Continuity and Transition Plans

On June 28, 2016, the SEC proposed a new rule and rule amendments to require registered investment advisers ("**RIAs**") to adopt and implement written business continuity and transition plans reasonably designed to address risks related to a disruption in their operations (the "**Proposed Rule**"). According to the press release accompanying the Proposed Rule (the "**Release**"), the Proposed Rule is meant to ensure that RIAs have effective plans to minimize harm to investors and clients in the event of such disruptions.

The Proposed Rule would add a new Rule 206(4)-4 under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**") and amend Rule 204-2 under the Advisers Act. Rule 206(4)-4 would require RIAs to adopt and implement written business continuity and transition plans and to review such plans on an annual basis. The amendment to Rule 204-2 would require RIAs to retain copies of all such plans and the records of such annual reviews for five years.

The Proposed Rule requires written plans to include policies and procedures "reasonably designed to address" operational and other risks related to a significant disruption in the RIA's operations. According to the Release, such disruptions may be the result of natural disasters, terrorist acts, cyber-attacks, technological failures or the loss of key personnel, facilities or service providers. Disruptions may also arise from the sale or merger of the RIA or other discontinuation of the RIA's operations or portion thereof. In the Release, the SEC explained that although the Proposed Rule discusses a single business continuity and transition plan, an RIA could have two separate business continuity and transition plans: one designed to address the continuation of a business and one designed to address the winding down of a business.

The Proposed Rule would require that the content of business continuity and transition plans be based upon the risks of the RIA's operations and include policies and procedures to minimize material service disruptions, including:

- Maintenance of critical operations and systems, including the backup, protection and recovery of investor and client data;
- Alternate physical office sites;
- Internal communications to employees and external communications with service providers, clients and regulators;
- Assessments of critical third-party service providers; and
- Planning for transition and the transfer of client accounts and data.

With respect to the final bullet, according to the Release, the plan of transition would have to include (i) policies and procedures intended to safeguard, transfer and/or distribute client assets during transition; (ii) information regarding the corporate governance of the RIA; (iii) the identification of any material financial resources available to the RIA; (iv) policies and procedures facilitating the prompt generation of any client-specific information necessary to transition each client account; and (v) an assessment of the applicable law and contractual obligations governing the RIA and its clients, including pooled investment vehicles, implicated by the RIA's transition.

The Proposed Rule would additionally require that RIAs review at least annually the adequacy of their business continuity and transition plans and the effectiveness of the implementation of each plan, as well as any revisions that may be necessary as a result of a change in the operations, service providers, business activities or clients. Furthermore, the Proposed Rule would require RIAs to make and retain copies of the plans that are or were in effect at any time during the last five years following the compliance date.

The SEC has requested comments regarding the Proposed Rule by September 6, 2016.

The Division of Investment Management also issued an IM Guidance Update (the "**Guidance**") on June 28, 2016 recommending that registered investment companies adopt similar policies and procedures. Please see ***SEC Division of Investment Management Published Business Continuity Guidance for Registered Investment Companies*** below for further detail on the Guidance.

- **See a copy of the Press Release**
- **See a copy of the Release and the Proposed Rule**

Industry Update

SEC Division of Investment Management Publishes Business Continuity Guidance for Registered Investment Companies

On June 28, 2016, the Division of Investment Management of the SEC (the "**Division**") issued an IM Guidance Update to underscore the importance of business continuity planning for registered investment companies.

Registered investment companies are generally required, pursuant to Rule 38a-1 under the Investment Company Act, to adopt written compliance policies and procedures reasonably designed to prevent violation of the federal securities laws. In the IM Guidance Update, the Division recommended that registered investment companies consider policies and procedures to address disruptions and business continuity planning and whether the registered investment companies' critical functions—such as processing shareholder transactions—are provided in-house or externally at a third-party service provider. Such policies and procedures should be, in the Division's view, tailored to the nature and scope of the registered investment company's business. If a registered investment company outsources its critical functions to third parties, the Division recommends that such registered investment company engage in thorough due diligence of the provider's business continuity and disaster recovery plans both at the outset of the relationship and on an ongoing basis.

Notable Practices. The IM Guidance Update expressed the Division staff's view that critical fund service providers would likely include each investment adviser, principal underwriter, administrator, transfer agent, custodian and pricing agent for a given registered investment company. The Division identified the following notable practices that it observed in its discussions with registered investment companies:

- Plans typically include in their scope the fund's facilities, systems, employees and the activities conducted by any affiliated entities, including the adviser, and any critical service providers.
- Firms generally involve a broad cross-section of employees in business continuity planning across functional areas of the business, including senior management, legal, technology and information security, operations, human resources, compliance and risk management.
- The Chief Compliance Officer typically participates in the oversight of third-party service providers, which is both conducted at the outset of an engagement and as an ongoing matter throughout the relationship.
- Oversight of third-party service providers can include on-site visits, questionnaires, independent reports of controls and program testing.
- Board presentations in respect of business continuity planning are typically annual and provided by the adviser to the registered investment company or the relevant service provider.
- Testing of business continuity plans typically occurs at least annually, and results may be shared with the board of the registered investment company.
- Outages triggering a business continuity plan are typically monitored by the Chief Compliance Officer and may be reported to the board of the registered investment company.

Service Provider Considerations. The IM Guidance Update also recommended that registered investment companies consider the following with respect to the oversight of third-party service providers:

- The effect of a disruption of their service providers' business on their operations and how to respond to such a disruption, as well as such service providers' backup systems and redundancies, contingency plans and plans to maintain operations in the event of a disruption;
- Methods to monitor a disruption at a service provider, its potential effects on the registered investment company's operations and communication protocols in the event of such a disruption (including internal communications within the registered investment company; external communications with the service provider, regulators, the press and investors; maintaining active contact information during such an event; and providing progress reports and updates in a timely and widely distributed manner, such as posting on websites);
- The interrelationships of service providers with other service providers and the way in which business disruptions at one such provider may affect those at another provider; and
- The various scenarios in which a business disruption could affect the operations and investors of the registered investment company and the associated responses to such a disruption.

According to the IM Guidance Update, boards of registered investment companies should discuss business continuity planning with the adviser and other critical service providers, whether in-house or third-party providers, including how to mitigate the impact of business disruptions and how to address the risks posed by an outage at a third-party service provider.

► **See a copy of the IM Guidance Update**

Financial Stability Board Releases Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities

On June 22, 2016, the Financial Stability Board ("**FSB**") published for public comment a consultative document entitled "Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities" (the "**Proposal**"). The FSB is an international body that monitors and makes recommendations about the global financial system, and was established in 2009 as a successor to the Financial Stability Forum. The Proposal contains revised policy recommendations intended to address four structural vulnerabilities associated with asset management activities that the FSB has identified as posing potential financial stability risks (with the first two being considered key vulnerabilities by the FSB):

- Liquidity mismatch between fund investments and redemption terms;
- Leverage within investment funds;
- Operational risk and challenges in transferring investment mandates in stressed conditions; and
- Securities lending activities of asset managers and funds.

Of the 14 recommendations within these four categories, more than half fall within the liquidity mismatch category, which focuses on open-ended funds, both public and private, including exchange-traded funds but excluding money-market funds. The leverage recommendations apply to all types of funds that employ leverage through borrowings or the use of derivatives. The recommendations for operational risk focus on asset managers that are large, complex and/or provide critical services, and the recommendations for securities lending activities center on asset managers' agent lender activities, in particular their provision of indemnities to clients. The FSB stated that the International Organization of Securities Commissions ("**IOSCO**") should review its existing guidance in many of these areas and, as appropriate, enhance it. The FSB is not currently recommending reforms for sovereign wealth funds or pension funds.

1. Liquidity Mismatch Recommendations

The recommendations associated with liquidity mismatch fall within the following four general categories: lack of information, gaps in liquidity management, adequacy of liquidity risk management tools to deal with exceptional circumstances and additional market liquidity considerations:

A. Lack of Information

- *Recommendation 1*: The FSB recommended that authorities collect information on the liquidity profile of open-ended funds in their jurisdiction proportionate to the risks such funds may pose from a financial stability perspective. Authorities should therefore, according to the FSB, review existing reporting requirements and enhance them as appropriate to ensure that they are adequate and that required reporting is sufficiently granular and frequent.
- *Recommendation 2*: The FSB advised that authorities review existing investor disclosure requirements and determine the degree to which additional disclosures should be provided by open-ended funds to investors regarding fund liquidity profiles, proportionate to the liquidity risks such funds may pose from a financial stability perspective. Authorities should also enhance existing investor disclosure requirements as appropriate to ensure that the required disclosures are of sufficient quality and frequency, according to the FSB.

B. Gaps in Liquidity Management

- *Recommendation 3*: In order to reduce the likelihood of material liquidity mismatches arising from an open-ended fund's structure, the FSB advised that authorities have requirements or guidance stating that funds' assets and investment strategies should be consistent with the terms and conditions governing fund unit redemptions both at fund inception and on an ongoing basis (for new and existing funds), taking into account the expected liquidity of the assets and investor behavior during normal and stressed market conditions.

- *Recommendation 4*: Where appropriate, the FSB recommended that authorities widen the availability of liquidity risk management tools to open-ended funds, and reduce barriers to the use of those tools, to increase the likelihood that redemptions are met even under stressed market conditions.
- *Recommendation 5*: Authorities should make liquidity risk management tools available to open-ended funds to reduce first-mover advantage, where it may exist, according to the FSB. Such tools may include swing pricing, redemption fees and other anti-dilution methods.
- *Recommendation 6*: The FSB recommended that authorities require and/or provide guidance on stress testing at the level of individual open-ended funds to support liquidity risk management to mitigate financial stability risk. The requirements and/or guidance should address the need for stress testing and how it could be done.

C. Adequacy of Liquidity Risk Management Tools to Deal with Exceptional Circumstances

- *Recommendation 7*: The FSB recommended that authorities promote (through regulatory requirements or guidance) clear decision-making processes for open-ended funds' use of extraordinary liquidity risk management tools and such processes should be made transparent to investors and the relevant authorities.
- *Recommendation 8*: The FSB advised that authorities provide guidance and, where appropriate and necessary, provide direction regarding open-ended funds' use of extraordinary liquidity risk management tools.

D. Additional Market Liquidity Considerations

- *Recommendation 9*: Where relevant, the FSB recommended that authorities give consideration to system-wide stress testing that could potentially capture the effects of collective selling by funds and other institutional investors on the resilience of financial markets and the financial system more generally. As with the other recommendations within the liquidity mismatch category, the FSB stated that this recommendation would apply to open-end funds.

2. **Leverage Recommendations**

The leverage recommendations are applicable to all funds that use leverage, either through borrowing or the use of derivatives.

- *Recommendation 10*: The FSB recommended that IOSCO develop simple and consistent measure(s) of leverage in funds with due consideration of appropriate netting and hedging assumptions. This would enhance authorities' understanding of risks that leverage in funds may create, facilitate more meaningful monitoring of leverage and help enable direct comparisons across funds and at a global level. IOSCO should also consider, according to the FSB, developing more risk-based measure(s) to complement the initial measure(s) and enhance the monitoring of leverage across funds at a global level.
- *Recommendation 11*: The FSB advised that authorities collect data on leverage in funds, monitor the use of leverage by funds not subject to leverage limits or which pose significant leverage-related risks to the financial system, and take action when appropriate.

- *Recommendation 12*: IOSCO should, according to the FSB, collect national/regional aggregated data on leverage across its member jurisdictions based on the simple and consistent measures(s) it develops.

3. **Operational Risk Recommendations**

- *Recommendation 13*: According to the FSB, authorities should have requirements or guidance for asset managers that are large, complex, and/or provide critical services to have comprehensive and robust risk management frameworks and practices, especially with regard to business continuity plans and transition plans, to enable orderly transfer of their clients' accounts and investment mandates in stressed conditions.

4. **Securities Lending Activities Recommendations**

- *Recommendation 14*: The FSB advised that authorities should monitor indemnities provided by agent lenders/asset managers to clients in relation to their securities lending activities. Where these monitoring efforts detect the development of material risks or regulatory arbitrage that may adversely affect financial stability, authorities should verify and confirm that asset managers adequately cover potential credit losses from the indemnification provided to their clients.

The FSB has requested comments on the recommendations included in the Proposal by September 21, 2016 by email to **fsb@gsb.org** or by mail to Secretariat of the Financial Stability Board, c/o Bank of International Settlements, CH-4002, Basel, Switzerland. All comments will be published on the FSB public website unless a commenter specifically requests confidential treatment.

- **See a copy of the Proposal**

SEC's Office of the Investor Advocate Releases Report on Objectives for Fiscal Year 2017

On June 30, 2016, the Office of the Investor Advocate (the "**Investor Advocate**") of the SEC filed its annual report on objectives (the "**Report**") with the Committee on Banking, Housing and Urban Affairs of the U.S. Senate and the Committee on Financial Services of the U.S. House of Representatives. The Report contains a summary of the Investor Advocate's primary objectives for fiscal year 2017, which begins on October 1, 2016. In the Report, the Investor Advocate added fund fees and expenses as one of the issues of focus during fiscal year 2017, with the objective to consider ways to improve investor understanding of those costs and their cumulative impact on fund holdings.

The Investor Advocate, established at the SEC on February 24, 2014 pursuant to Section 4(g) of the Securities and Exchange Act of 1934 (the "**Exchange Act**"), has a statutory mandate thereunder to (i) assist retail investors in resolving significant problems such investors may have with the SEC or with self-regulatory organizations ("**SROs**"); (ii) identify areas in which investors would benefit from changes in the regulations of the SEC or rules of SROs; (iii) identify problems that investors have with financial service providers and investment products; (iv) analyze the potential impact on investors of proposed regulations of the SEC and rules of SROs; and (v) to the extent practicable, propose to the SEC changes in the regulations or orders of the SEC and to Congress any legislative, administrative or personnel changes that may be appropriate to mitigate problems identified and to promote the interests of investors. For a discussion of the Senate and House legislation that established the Investor Advocate, please see the **June 10, 2010 Investment Management Regulatory Update** and the June 2, 2010 Client Memorandum, **Financial Reform Side by Side Comparison Chart – Key Senate and House Bill Issues**.

According to the Report, the Investor Advocate will take a closer look at fund fees and expenses in fiscal year 2017 and begin to consider whether investors understand the fees and expenses they pay for an array of products and service providers, including funds, investment advisers and broker-dealers. As an initial matter, the Investor Advocate recommended that the SEC should explore different approaches to further enhance mutual fund cost disclosures. The Report referred to recent staff guidance (the "**Staff Guidance**") from the SEC Division of Investment Management on mutual fund distribution and sub-accounting fees, and echoed its concerns regarding the possibility of potential mischaracterization of 12b-1 and other fund fees and potential misuse of fund assets to pay for distribution-related activities outside a permitted 12b-1 plan. For a discussion of the Staff Guidance, please see the **January 27, 2016 Investment Management Regulatory Update**. The Report also noted the recent recommendation to the SEC from the Investor Advisory Committee to improve mutual fund cost disclosures, including standardizing disclosure of actual dollar amount costs on customer account statements in the short term, and testing various approaches to determine which are the most effective in informing investors of the costs of their own funds, or funds they are considering purchasing, and the long-term impact of those costs. According to the Report, the Investor Advocate expects to be actively involved in investor testing of the various approaches to disclosing fund fees and expenses in fiscal year 2017.

The Investor Advocate also indicated in the Report that it will explore ways to improve disclosures surrounding fund-related financial intermediary fees, stating: "investors should be aware—or should be made aware—of the different types and layers of intermediary fees associated with the management, operation, and custody of their investment or retirement accounts." The Investor Advocate explained that such fees may include management fees, custodial fees, transactions fees and commissions, in addition to a whole spectrum of other potential expenses. In particular, the Report discussed the recent trend for broker-dealers and other financial intermediaries to use "omnibus" accounts, in contrast to individual "networked" accounts, each of which may generate fees not obvious to individual investors which should be more clearly disclosed. The Report also noted that financial intermediary compensation under various shareholder servicing arrangements, including networking arrangements with broker-dealers, sub-transfer agent agreements with financial institutions and record-keepers and third-party mutual fund supermarket arrangements, among others, should also be more fully and precisely disclosed.

In addition to its focus on fund fees and expenses, the Investor Advocate has stated that it will focus on certain other issues, including:

- **Public Company Disclosure**. The Investor Advocate will continue its multi-year focus on disclosure effectiveness for public companies, focusing more narrowly on the question of whether it is appropriate for disclosure requirements to be scaled based upon the size of the issuer providing the disclosure.
- **Equity Market Structure**. The Investor Advocate will focus on exchange access fees and rebates, as well as on disclosure that will help investors evaluate whether they are receiving best execution.
- **Municipal Market Reform**. The Investor Advocate will continue its engagement in reports related to the municipal securities markets, with a particular focus on markup disclosure, re-trade price transparency and curtailing certain problematic practices.
- **Accounting and Auditing**. The Investor Advocate will examine the duties and disclosures of audit committees, as well as issues related to accounting standards, such as a proposal by the Financial Accounting Standards Board to reinterpret the definition of materiality.
- **Corporate Governance**. The Investor Advocate will focus its efforts largely on the proxy voting process and continue to examine the listing standards of the national securities exchanges with respect to shareholder approval of certain corporate actions.

According to the Report, these issues of focus are not exhaustive, although the Investor Advocate expects to prioritize them on its policy agenda in fiscal year 2017.

- ► **See a copy of the Report**

Litigation

Private Fund Administrator Settles Charges for Gatekeeper Failures

On June 16, 2016, the SEC issued two related orders (the "**Orders**") instituting and settling administrative and cease-and-desist proceedings under Section 203(k) of the Advisers Act against Apex Fund Services (US) Inc. ("**Apex**"), a fund administrator providing accounting and fund administration services, relating to Apex's alleged failure to heed red flags and correct faulty accounting by two clients, ClearPath Wealth Management, LLC ("**ClearPath**") and EquityStar Capital Management, LLC ("**EquityStar**").

According to the Order relating to ClearPath, ClearPath, an investment adviser previously registered with the SEC, retained Apex in 2011 to administer four private funds managed by ClearPath. According to the SEC, Apex failed to set up the accounting system for the funds to ensure that it allocated the funds' assets and liabilities to specific series within each fund, which caused the capital account statements that Apex generated for ClearPath to provide to investors to not accurately reflect ClearPath's and its owner's use of series' assets and, as a result, made possible ClearPath and its owner's misappropriation and use of series assets for unauthorized investments. More specifically, the SEC alleged that Apex failed to act appropriately after detecting undisclosed brokerage and bank accounts, undisclosed margin and loan agreements and inter-series and inter-fund transfers made in violation of the fund offering documents. According to the SEC, Apex failed to properly account for the economic substance of the uncovered accounts and transactions or correct previously issued accounting reports and capital statements, and continued to provide materially false reports and statements to ClearPath and the funds' independent auditor, which enabled ClearPath to use Apex's false reports and statements to communicate financial positions and performance to the ClearPath funds' investors.

Similarly, according to the Order relating to EquityStar, Apex began serving as fund administrator for two private funds managed by EquityStar, an unregistered investment adviser, in 2012. According to the SEC, Apex learned in as early as May 2012 that the owner of EquityStar was withdrawing funds from one of the two funds, but Apex treated the amount of his withdrawals as a receivable due to the fund and thus as part of the fund's net asset value and, in the monthly account statements Apex sent to the fund's investors on behalf of EquityStar, did not disclose to investors that part of the net asset value was a receivable due from an affiliated party. The SEC noted that, over the next two years, Apex continued to account for undisclosed withdrawals by EquityStar's owner—which grew to more than half of the net asset value of one fund, and more than one quarter of the other—as receivables owed to the funds, despite no evidence that the owner was able or willing to repay the withdrawals. According to the SEC, Apex confronted the owner and concluded in August 2013 that he was unlikely to repay the funds; nevertheless, Apex did not properly account for the owner's withdrawals until March 2014. As such, the SEC found that Apex sent monthly account statements to investors that it knew or should have known materially overstated the investors' true holdings in the funds.

The SEC noted that under Section 203(k) of the Advisers Act, the SEC may impose a cease-and-desist order upon, among others, any person that is, was, or would be a cause of another's violation, due to an act or omission the person knew or should have known would contribute to such violation of any provision of the Advisers Act. Based on the conduct described above and in the Orders, the SEC found that while ClearPath and EquityStar and their respective owners directly violated Sections 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-8 thereunder, by making false and misleading statements to their respective clients, Apex was a cause of ClearPath and EquityStar's Advisers Act violations.

Apex consented to the Orders without admitting or denying the SEC's findings, and has undertaken to retain an independent consultant to conduct a comprehensive review of and recommend corrective measures concerning Apex's compliance and other policies, and to implement the independent consultant's recommendations within a year of the date of the Orders. The SEC also ordered Apex to cease and desist from further violations and to pay a total of $352,449, which included disgorgement of

$96,800 plus interest of $8,813 and a civil penalty of $75,000 for its role in the ClearPath fraud and disgorgement of $89,050 plus interest of $7,786 and a penalty of $75,000 for its role in the EquityStar fraud.

- **See a copy of the Press Release**
- **See a copy of the Order Relating to ClearPath**
- **See a copy of the Order Relating to EquityStar**

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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