2015 MMI Legal & Compliance Seminar

Regulatory Developments

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Regulatory Developments

- SEC Rulemaking Initiatives
- SEC Exam Priorities & Focus
- FINRA Developments
- Special Issues with Liquid Alts
- Recurring Questions

SEC Rulemaking Initiatives

- Data Gathering
- Portfolio Risks
  - Portfolio Risks from Derivatives
  - Portfolio Risks Associated with Liquidity
- Stress Testing
- Transition Plans

Data Gathering

- SEC Proposed Changes to Form ADV and Advisers Act Rules
  - Data Collection and Reporting of Separately Managed Accounts
    - Advisers with RAUM of up to $150 million attributable to SMAs -- Annually report approximate percentage of SMA assets invested in each of 10 broad asset categories
    - Advisers with RAUM of at least $150 million but less than $10 billion attributable to SMAs—Provide the information above, and identify the use of derivatives and borrowings in SMAs
    - Advisers with RAUM of $10 billion or more attributable to SMAs—Provide all of the same information required for advisers in the two categories described above, as well as the weighted average gross notional value of derivatives (as a percentage of the net asset value) in six different categories of derivatives

Data Gathering

- SEC Proposed Changes to Form ADV and Advisers Act Rules
  - Expanded Information about an Adviser's Business
    - Wrap Program Disclosure
    - Social Media
    - Offices
    - Adviser Assets
    - Types of Clients
    - Clients with no RAUM
    - Parallel Managed Accounts
    - Chief Compliance Officer Disclosure
    - Proposed Amendments to the Books and Records Rule Concerning Performance
    - Technical Amendments to Form ADV and Advisers Act Rules

Portfolio Risks

- Portfolio Risks from Derivatives
  - SEC staff concerned that use of derivatives creates excessive leverage, which can implicate Section 18 of the Investment Company Act
  - SEC issued a Concept Release in 2011 and has addressed derivatives issues on a case-by-case basis
  - SEC staff looking to take a more comprehensive and systematic approach to derivatives, including possibly requiring funds to establish broad risk management programs
- Portfolio Risks Associated with Liquidity
  - Mutual funds must satisfy redemption requests within seven days and, accordingly, the SEC has said that mutual funds should maintain a high degree of liquidity to honor redemptions
  - Liquidity risks are potentially significant for managers seeking to replicate strategies that hold illiquid assets
  - From 1969 through 1992, the SEC's view was that illiquid securities should not exceed 10% of a mutual fund, a position that was changed in 1992, when it increased the percentage to 15%
  - SEC staff is now considering recommending new comprehensive approach to management of liquidity risks, including updating liquidity standards and disclosures of liquidity risks

SEC Exam Priorities

- Fee Selection and Reverse Churning
  - Process for recommending advisory vs. brokerage accounts, including considerations of fees charged, services provided and disclosures
  - Focus on substantiating provision of investment advice (generally, in rep as portfolio manager programs)
    - Inactive accounts (reverse churning)
    - High-cash balance, concentrated positions, style drift, failure to adhere to asset allocation
    - Client meetings and communications (and documentation of meetings)
    - Analysis surrounding account conversions (brokerage to advisory and vice versa)
- Sales Practices and Suitability
  - Sales practices, due diligence, disclosure and suitability of recommendations for:
  - Retirement investments and IRA rollovers to higher-fee or higher-risk investments (higher yield and complex products such as leveraged ETFs and structured products)
  - Interest rate sensitive fixed income securities
  - “Alternative” mutual funds

SEC Exam Priorities

- Conflicts of Interest
  - Trading away and best execution in wrap programs
  - Mutual fund shares class selection (Class A vs. Class I shares)
  - Private Funds
    - Undisclosed fees, related-party transactions and use of friendly broker marks in valuation
    - Undisclosed and misallocated fee and expenses
- Internal Controls
  - Effectiveness of key control functions (liquidity, credit, and market risk management practices)
  - Valuation practices, particularly for infrequently traded securities
  - Branch office supervision
  - Overall compliance function

SEC Exam Priorities

- Trading
  - Best execution
  - Market access controls
  - Use of technology, with a focus on algorithmic and high-frequency trading
  - Market manipulation (practices such as marking-the-close, parking, spoofing, and excessive markups and markdowns)
  - Relationships between broker-dealers and ATSs
  - Application of the Market Access Rule (15c3-5) to proprietary trading

SEC Exam Priorities

- Fixed Income Market
  - The structure and transparency of the market and its effect on the quality of executions
  - Use of filters by market participants to control what is displayed by fixed income ATSs
  - Focus on transparency in the municipal securities market
- Cybersecurity
  - Focus to continue to investment advisers and broker-dealers and expand to include transfer agents
  - Cybersecurity Examination Sweep Summary (Feb. 3, 2015)

SEC Exam Focus

- "Alternative" Investment Companies
  - Leverage, liquidity, and valuation policies and practices
  - Adequacy of internal controls
  - Marketing of funds to investors
- Fixed-Income Investment Companies
  - Focus on whether funds have implemented procedures and investment and trading controls consistent with disclosures
  - Ensure that investment and liquidity profiles fit disclosures
- Never-Before-Examined Investment Companies

SEC Exam Focus

- Focus on Wrap Fee Programs
  - Suitability issues
  - Trade aways and best execution
  - Fee issues
  - Allocation of responsibility and oversight

FINRA Developments

- Retrospective Rule Review
  - Focus on advertising and Rule 2210
- Oversight of advisory activities of dual registrants
  - Access to information
  - Vagaries as to which FINRA rules apply

Special Issues with Liquid Alts

- Many liquid alt investment advisers that traditionally managed alternative strategies through private funds have little experience with the Investment Company Act
- Conversely, traditional mutual fund advisers seeking to add liquid alts have little experience with alternative investment strategies
- Extensive use of derivatives can raise complicated compliance questions and challenges in oversight
- Liquid alts are new product for retail investors for which redemption behavior is uncertain
- Managing daily liquidity, including daily NAV calculations, can be challenging to advisers who lack extensive experience

Special Issues with Liquid Alts

- Liquid alts present risk of overpromising because Investment Company Act restrictions may result in liquid alts being "watered down" versions of hedge funds
  - Leverage limits
  - Diversification requirements
  - Allocations of trades
- Retaining service providers with adequate expertise and resources may be difficult
- Evaluating performance may be difficult for liquid alts
  - Short performance track records
  - Challenges identifying appropriate peer groups
  - Identification of appropriate benchmark

Recurring Questions

- Does Rule 3a-4 make sense today?
- Allocation of responsibility among wrap fee program participants
- Structure and operation of model manager programs
- Line between solicitors and advisers

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