



INVESTMENT FUNDS, ADVISERS AND DERIVATIVES UPDATE

SEC Provides Important Guidance Regarding Investment Adviser Regulatory and Compliance Priorities

The Securities and Exchange Commission (the “SEC”) recently issued important regulatory and compliance guidance for registered investment advisers. This alert summarizes:

- Statement of 2013 Division of Investment Management priorities by Director Norm Champ;
- Statement of the SEC’s 2013 National Examination Program priorities; and
- SEC Risk Alert regarding compliance with custody rule under the Investment Advisers Act of 1940, as amended (the “Advisers Act”).

Division Director Identifies 2013 Investment Management Priorities

Norm Champ, Director of the Division of Investment Management (the “Division”), recently provided insights into the Division’s priorities for 2013. On March 7, at the Practising Law Institute’s “Investment Management Institute” program, David Grim, Deputy Director of the Division, speaking on behalf of Champ, outlined the following short term and long term priorities.¹ Short-term regulatory priorities include:

- *Potential Money Market Mutual Fund Reform*: In November 2012, after the SEC declined to adopt significant money market fund reform proposals, the Financial Stability Oversight Commission (“FSOC”) proposed controversial recommendations for money market fund reform.² Champ stated that the SEC staff is currently “engaged with the Commissioners and hard at work on developing a money market fund reform recommendation.”
- *Identity Theft Red Flags Rules*: In February 2012, the SEC proposed rules and guidelines jointly with the Commodity Futures Trading Commission (the “CFTC”) requiring identity theft detection and prevention programs. According to Champ, the Division is working on final identity theft red flags rules to recommend to the SEC.
- *Valuation Guidance*: Champ indicated that the staff is developing long-awaited guidance designed to “level set requirements and make sure funds and their directors are aware of prudent practices that will lead to fair and accurate valuations.”

¹ Norm Champ (as delivered by David W. Grim), “Remarks to the Investment Management Institute 2013” (March 7, 2013), available at <http://www.sec.gov/news/speech/2013/spch030713nc.htm>.

² For information regarding the FSOC proposals, see “Sidley Update: Financial Stability Oversight Council Issues Proposed Money Market Fund Reform Recommendations” (November 16, 2012), available at <http://www.sidley.com/Financial-Stability-Oversight-Council-Issues-Proposed-Money-Market-Fund-Reform-Recommendations-11-16-2012/>.

Champ also listed five longer-term regulatory initiatives:

- *Variable Annuity Summary Prospectus*: rulemaking to provide a short-form prospectus, similar to the format used by mutual funds, for variable annuities.
- *ETF Rule*: renewed efforts to adopt a rule to codify routinely granted exemptive relief for “plain vanilla” exchange-traded funds (“ETFs”).
- *Enhancements to Fund Disclosures about Operations and Portfolio Holdings*: initiative to explore more structured data reporting for mutual funds and other investment companies along the lines of money market reporting reforms adopted by the SEC in 2010.
- *Review of Advisers Act Rules Applicable to Private Fund Advisers*: initiative to review Advisers Act rules “for aspects that should be updated to address investor protection concerns and the business models of private fund advisers” (which now comprise nearly 40% of SEC registered advisers).
- *Derivatives Concept Release*: analysis of feedback on the SEC’s 2011 concept release on funds’ use of derivatives, focusing on, among other things, “valuation, diversification and leverage limitations.”

OCIE Issues National Exam Program Priorities

The SEC’s Office of Compliance Inspections and Examinations (“OCIE”) recently published the National Examination Program’s (the “NEP’s”) examination priorities “to communicate with investors and registrants about areas that are perceived by the staff to have heightened risk, and to support the SEC’s mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”³ The NEP Investment Adviser-Investment Company Program (“IA-IC”) has primary examination authority for approximately 11,000 registered investment advisers and 800 registered investment company complexes which, collectively, manage nearly \$50 trillion.

The stated 2013 IA-IC priorities include several recent NEP areas of focus for investment advisers, including:

- *“Presence Exams” for New Registrants*: coordinated exam initiative designed to establish “meaningful presence” with the approximately 2,000 advisers newly registered as a result of the Dodd-Frank Act reforms.⁴
- *Conflicts of Interest*: examine steps registrants have taken to mitigate conflicts and the sufficiency of disclosure – particularly with respect to affiliate relationships.
- *Custody and Safety of Assets*: risk-based asset verification process to confirm the safety of client assets and compliance with custody requirements (see “SEC Issues Custody Rule Risk Alert,” below).
- *Compensation Arrangements*: review of conflicts of interest and disclosure surrounding fee arrangements, including solicitation arrangements, referral arrangements and receipt of payment for services provided to third parties.
- *Marketing/Performance*: review of aberrational performance as an indicator of fraudulent or weak valuation procedures or practices, as well as accuracy of advertised performance, including hypothetical and back-tested performance, the assumptions or methodology utilized and related disclosures and compliance with record keeping requirements. The staff indicated it also intends to review changes in advertising practices related to the Jumpstart Our Business Startups (“JOBS”) Act, which requires modification of the rules restricting general solicitations.

³ “Examination Priorities for 2013” (February 21, 2013), available at <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf>.

⁴ For additional information regarding this initiative, see “Sidley Update: SEC Launches ‘Presence Exams’ Initiative for Newly-Registered Investment Advisers” (October 16, 2012), available at <http://www.sidley.com/SEC-Launches-Presence-Exams-Initiative-for-Newly-Registered-Investment-Advisers-10-16-2012/>.

- *Allocation of Investment Opportunities*: review of policies and procedures to address conflicts of interest relating to side-by-side management of clients – particularly clients with different fee arrangements or other circumstances that may incentivize the adviser to favor one client over another.
- *Fund Governance*: review disclosures to fund boards and confirm that fund directors are conducting reasonable reviews of such information in connection with contract approvals, oversight of service providers, valuation of fund assets and assessment of expenses or viability.
- *Compliance with Pay-to-Play Rule*: review for compliance and practical application.

Other 2013 NEP IA-IC priorities include:

- *Coordinated and Joint Exams of Dually-Registered Investment Advisers and Broker-Dealers*: examine conflicts of interest relating to recommendations made in brokerage and advisory accounts and related policies, procedures and disclosure.
- *“Alternative” Investment Companies*: examine use of alternative and hedge fund investment strategies in open-end funds, ETFs and variable annuity structures, focusing on, among other things, (i) leverage, liquidity and valuation; (ii) board, compliance personnel and back-office qualification and resources; and (iii) fund marketing.
- *Payments for Distribution*: focus on payments made by advisers and funds to distributors and intermediaries, related disclosure and board oversight.
- *Money Market Fund Issues*: review operation and results of stress testing in compliance with Rule 2a-7 under the Investment Company Act of 1940, as amended, to ascertain ability to maintain a stable share price based on hypothetical events, including changes in short-term interest rates, increased redemptions, downgrades and defaults, and changes in spreads from selected benchmarks.
- *Compliance with Exemptive Orders*: review compliance with orders related to, e.g., closed-end funds and managed distribution plans, employee securities companies, ETFs and the use of custom baskets, and co-investment opportunities between funds and advisers.
- *Fraud Detection and Prevention*: utilize and enhance the NEP’s quantitative and qualitative tools and analyses – and review of tips, complaints and referrals (“TCRs”) – to identify market participants engaged in fraudulent or unethical behavior.
- *Corporate Governance and Enterprise Risk Management*: consultation with senior management and boards of registered entities and their affiliates regarding enterprise risk, and in particular, financial, legal, compliance, operational, and reputational risks.
- *Technology*: examine governance and supervision of information technology systems for operational capability, market access and information security, including risks of system outages and data integrity compromises.

SEC Issues Custody Rule Risk Alert

On March 4, OCIE issued a Risk Alert focused on investment adviser compliance with the SEC’s custody rule. The Alert stated that of more than 400 recent examinations that contained significant deficiencies, approximately one-third (over 140) included custody-related issues.⁵ The Risk Alert underscores the critical importance of both understanding the custody rule and diligent compliance with all of its requirements.

In the Risk Alert, OCIE identified four categories of deficiencies (with selected examples listed below):

⁵ “Significant Deficiencies Involving Adviser Custody and Safety of Client Assets” (March 4, 2013), available at <http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf>.

1. Failure by advisers to recognize that they have custody under the rule and comply accordingly.

- *Role of Employees or Related Persons:* adviser's personnel or a "related person" serves as trustee or has power of attorney for client accounts.
- *Bill-Paying Services:* adviser provides bill-paying services for clients and, therefore, is authorized to withdraw funds or securities from the client's account.
- *Online Access to Client Accounts:* adviser has clients' personal usernames and passwords without restrictions and, therefore, has the ability to withdraw funds and securities from the clients' accounts.
- *Adviser Acts as a General Partner:* adviser serves as the general partner of a limited partnership or holds a comparable position.
- *Physical Possession of Assets:* adviser has physical possession of client assets.
- *Check-Writing Authority:* adviser or a related person has signatory and checkwriting authority for client accounts.
- *Receipt of Checks Made to Clients:* adviser received checks made out to clients and failed to return them promptly to the sender.

2. Failure to comply with surprise examination requirements.

- *Form ADV-E:* independent accountant failed to file Form ADV-E with the SEC within 120 days after a surprise examination.
- *No Surprise:* evidence suggested accountant did not conduct examinations on a surprise basis (*e.g.*, exam conducted at the same time each year).

3. Failure to comply with qualified custodian requirements.

- *Separate Account:* adviser held client assets in adviser's name, but not in an account that was under the adviser's name as agent or trustee for the client and that held only client assets.
- *Commingled Account:* adviser commingled client, proprietary and employee assets into one account.
- *Safe Deposit Box:* adviser held certificates of securities owned by a fund that it advised in a safe deposit box under the adviser's control at a local bank.
- *Quarterly Account Statements:* adviser did not have a reasonable basis, after due inquiry, for believing that a qualified custodian was sending quarterly account statements to the client.
- *Adviser Account Statements:* adviser opened a custodial account on behalf of a client and, as permitted by the rule, sent its own account statements to the client but did not notify the client to compare the adviser statements to the custodian statements.

4. Failure to comply with audit approach requirements by advisers to pooled investment vehicles.

- *Independence:* accountant that conducted the audit was not "independent" under applicable SEC regulations or was not PCAOB-registered and subject to PCAOB inspection.
- *GAAP:* audited financial statements were not prepared in accordance with U.S. Generally Accepted Auditing Procedures for various reasons (*e.g.*, (i) organizational expenses were improperly amortized rather than expensed as incurred, resulting in a qualified audit opinion; (ii) financial statements were prepared on a federal income tax basis; (iii) adviser could not substantiate fair valuations and the accountant therefore could not issue an unqualified opinion).
- *Distribution by Deadline:* adviser failed to demonstrate that financial statements were distributed to all fund investors or failed to send financial statements to investors within 120 days of the private fund's fiscal year end (or 180 days for a fund of funds).

- *Liquidation Audit:* final audit was not performed on liquidated funds.
- *Waiver of audit:* adviser obtained investor approval to waive the annual financial audit of a fund, but did not obtain a surprise examination; therefore, according to OCIE, adviser failed to comply, because it neither had a surprise exam nor complied with the audit approach.

OCIE also noted that in addition to the deficiencies noted in recent examinations, its staff previously had observed advisers to non-U.S. funds relying on financial statements that were not satisfactory because either:

- the accountant did not conduct the audit in accordance with U.S. Generally Accepted Auditing Standards (“GAAS”), and/or
- the accountant prepared the financial statements in accordance with International Financial Reporting Standards, and they did not contain information substantially similar to financial statements prepared in accordance with U.S. GAAP.

Deficiencies resulted in actions ranging from immediate remediation efforts by advisers (*e.g.*, new or amended compliance procedures, policies or processes; revised business practices; or more attention and resources dedicated to custody) to referrals by OCIE to the SEC’s Division of Enforcement.

* * *

Investment advisers should review their current policies, procedures and practices in light of the SEC guidance outlined herein. Please contact a Sidley attorney with whom you work if you would like our assistance in doing so.

The Investment Funds, Advisers and Derivatives Practice of Sidley Austin LLP

Sidley has a premier, global practice in structuring and advising investment funds and advisers. We advise clients in the formation and operation of all types of alternative investment vehicles, including hedge funds, fund-of-funds, commodity pools, venture capital and private equity funds, private real estate funds and other public and private pooled investment vehicles. We also represent clients with respect to more traditional investment funds, such as closed-end and open-end registered investment companies (*i.e.*, mutual funds) and exchange-traded funds (ETFs). Our advice covers the broad scope of legal and compliance issues that are faced by funds and their boards, as well as investment advisers to funds and other investment products and accounts, under the laws and regulations of the various jurisdictions in which they may operate. In particular, we advise our clients regarding complex federal and state laws and regulations governing securities, commodities, funds and advisers, including the Dodd-Frank Act, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933, the Securities Exchange Act of 1934, the Commodity Exchange Act, the USA PATRIOT Act and comparable laws in non-U.S. jurisdictions. Our practice group consists of approximately 120 lawyers in New York, Chicago, London, Hong Kong, Singapore, Shanghai, Tokyo, Los Angeles and San Francisco.

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