Issue 19, May 2014

REGULATORY ADMINISTRATION DIGEST

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The following is a summary of select developments in investment management regulation during the first quarter of 2014.

REGULATORY AND ENFORCEMENT DEVELOPMENTS

EXAMINATION PRIORITIES FOR 2014 ANNOUNCED

The Securities and Exchange Commission (the "SEC") recently released its *Examination Priorities for 2014,* and in a related Press Release stated that it was "publishing these priorities to highlight areas [it] perceives to have heightened risk" and "to increase transparency, strengthen compliance, and inform the public and the financial services industry about key risks that [the SEC is] monitoring and examining." The examination priorities cover issues that affect a wide range of financial institutions, including investment advisers and investment companies, hedge funds, private equity funds, and transfer agents.

The SEC divides the examination priorities into two categories, market-wide issues and program-specific issues. Market-wide examination priorities identified include: fraud detection and prevention; corporate governance and enterprise risk management; technology controls; issues posed by the convergence of broker-dealer and investment adviser businesses and by new rules and regulations; and retirement investments and rollovers. Enforcement priorities designated as program-specific are further divided into three sub-categories: Core Risks; New and Emerging Issues and Initiatives; and Policy Topics. The priorities identified with respect to registered investment advisers and investment companies by category include:

- Core Risks: safety of assets and custody; conflicts of interest inherent in certain investment adviser business models; marketing and performance.
- New and Emerging Issues and Initiatives: never-before examined advisers; wrap fee programs; quantitative trading models; presence exams; payments for distribution in guise; and fixed income investment companies.
- Policy Topics: money-market funds; "alternative" investment companies; and securities lending arrangements. The SEC stated that the priorities listed for 2014 are not exhaustive and may be adjusted throughout the year.

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AUDIT FIRM CHARGED WITH FAILURE TO COMPLY WITH INDEPENDENCE RULES

The SEC announced settled administrative proceedings charging public accounting firm KPMG with violating auditor independence rules. Without admitting or denying the charges, KPMG agreed to pay $8.2 million and to undertake certain remedial actions outlined in the SEC's Order Instituting Administrative and Cease and Desist Proceedings (the "Order").

The independence rules cited by the SEC require that auditors be independent from the companies that they audit. According to the Order, those rules were violated when KPMG provided prohibited non-audit services to affiliates of three companies that were also KPMG audit clients, and by KPMG employee ownership of stock in companies or affiliates of companies that were KPMG audit clients. The SEC concluded that KPMG's conduct resulted in the firm committing multiple violations of the Securities Exchange Act of 1934 (the "Exchange Act"), SEC Regulation S-X ("Regulation S-X") and the SEC Rules of Practice. In addition, the SEC found that KPMG's conduct caused three of its audit clients to violate the Exchange Act.

The SEC contemporaneously published a *Report of Investigation* (the "Report") in which it considered whether KPMG's independence was impaired when the firm engaged in the practice of "loaned staff engagements" - loaning non-manager tax professionals to assist audit clients on-site with tax compliance work. Although the SEC elected not to bring an enforcement action against KPMG relating to such practice, the Report notes that "[l]oaned staff arrangements, by their nature, appear inconsistent" with the Regulation S-X prohibition against auditors acting as employees of their audit clients. In addition, the Report emphasized, among other things, that "[a]udit firms and audit committees must carefully consider whether any proposed service may cause the auditors to resemble employees of the audit client in function or appearance even on a temporary basis."

SEC GUIDANCE AND INITIATIVES

Risk Alert Discusses Adviser Alternative Investment Due Diligence Practices

Citing an increase in advisers making alternative investment recommendations to their clients, the SEC's Office of Compliance Inspections and Examinations (the "OCIE") issued *Risk Alert: Investment Adviser Due Diligence Processes For Selecting Alternative Investments And Their Respective Managers* (the "Risk Alert"), which focuses on due diligence practices used by investment advisers when considering alternative investments. The Risk Alert identifies trends and deficiencies in adviser

alternative investment due diligence practices based on the OCIE's observations during its examination of advisers that provide advisory services to pension plans and funds of private funds. During the examinations, the OCIE evaluated how those advisers: "(i) performed their due diligence; (ii) identified, disclosed, and mitigated conflicts of interest (e.g., benefits to the adviser or its employees for allocations made to private funds); and (iii) utilized experienced investment teams when evaluating complex investment strategies and fund structures." For purposes of the Risk Alert, "alternative investments" include private funds such as hedge funds, private equity, venture capital, real estate, and funds of private funds.

Trends in adviser due diligence processes observed by the OCIE include:

- Seeking more information and data directly from the managers of alternative investments.
- Using third parties to supplement and validate information provided by managers of alternative investments.
- Performing additional quantitative analysis and risk assessment of alternative investments and their managers.

In addition, the OCIE observed certain deficiencies in adviser processes, including:

- Omitting alternative investment due diligence policies and procedures from their annual reviews, even though these investments comprised a large portion of certain advisers' investments on behalf of clients.
- Providing potentially misleading information in marketing materials about the scope and depth of due diligence conducted.
- Having due diligence practices that differed from those described in the advisers' disclosures to clients.

The OCIE also observed that: (i) advisers were more likely to have due diligence processes that were consistently applied if they adopted detailed written policies and procedures that required adequate documentation; and (ii) advisers that delegated certain responsibilities to third-party service provider, but did not conduct periodic reviews of those service providers, were more likely to have deficiencies in meeting compliance responsibilities.

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Guidance Releases Address Proxy Proposals and Risk Management in Changing Market

Unbundling Proxy Proposals. The SEC's Division of Investment Management (the "IM Division") published *IM Guidance Update: Unbundling of Proxy Proposals-Investment Company Charter Amendments* in response to inquiries from registrants with respect to the application of the SEC's "unbundling rules," Rule 14a-4(a)(3) and 14a-4(b)(1) under the Exchange Act, to proposals for amendments to investment company charters. The IM Division restated its position that proposed amendments to the fund charters should be "unbundled," providing separate votes for each proposed material amendment. The IM Division added that funds should consider whether a given matter substantively affects shareholder rights. Noting that there is no "bright line" for materiality, the IM Division listed examples of charter amendments that the IM Division previously reviewed and determined should be presented separately, including proposals to: (i) amend voting rights from one vote per share to one vote per dollar of net asset value; (ii) authorize a fund to involuntarily redeem small account balances; (iii) authorize a fund to invest in other investment companies; (iv) change supermajority voting requirements; (v) authorize the board to terminate a fund or merge with another.

Managing Changing Market Conditions. In response to developing trends in the fixed income market, the IM Division published *IM Guidance Update: Risk Management in Changing Fixed Income Market Conditions* in which it suggests certain steps that fund advisers may consider with respect to risk management and disclosure regarding changing market conditions. The IM Division also suggests that fund boards consider discussing with fund advisers the steps the advisers are taking in this area.

In general, the IM Division suggests that fund advisers:

- Assess and stress test liquidity
- Conduct more general stress-tests/scenario analyses
- Evaluate the appropriateness of risk management strategies and actions
- Provided fund directors with information on the fund's risk exposures and liquidity position, and the fund's ability to manage through changing interest rate conditions and potentially increased fixed income market volatility.

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OTHER NEWS

IM Division Highlights 2013 Accomplishments and Previews 2014 Agenda

The IM Division has summarized its 2013 regulatory achievements in *IM Information Update: 2013 Division of Investment Management Year in Review* (the "Information Update"). Accomplishments highlighted in the Information Update include:

- Rulemaking intensity with respect to the SEC's money market fund reform proposals, regulations implementing the Volker Rule and the Jumpstart Our Business Startups Act, removal of credit rating references in certain SEC rules and forms and regulations requiring the adoption of identity theft programs by investment advisers, broker-dealers and certain other entities.
- Identifying new and emerging issues through enhanced dialogue with senior management and board members of the largest most complex asset management firms and insight into portfolio management of money market funds through analysis of fund data.
- Providing timely guidance with the launch of Guidance Updates in 2013 and the issuance of no-action and interpretive letters.

Also in the Information Update, the IM Division previewed its 2014 agenda, including plans to:

- Consider possible rules on disclosure by funds.
- Finalize rulemakings to implement the JOBS Act and the Dodd-Frank Act.
- Advance toward final rules to strengthen the resilience of money market funds and reduce the risk of runs.
- Continue next steps in the SEC's investment adviser/broker-dealer initiative.
- Enhance disclosure about variable annuities, an investment product often sold to seniors and others seeking ways to fund their retirement.

CYBERSECURITY ROUNDTABLE

The SEC assembled the *Cybersecurity Roundtable* to discuss the issues and challenges cybersecurity presents for market participants and public companies. The roundtable was divided into four panels, each comprised of market experts and regulators. During the final panel, *Broker-Dealers, Investment Advisers, and Transfer Agents,* panel participants discussed how broker-dealers, investment advisers, and transfer agents address cybersecurity issues, including those involving identity theft and data protection. Key investment adviser cyber risks identified by panelists

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included hacking/client account takeover, insider attacks and denial of service. James Burns, Deputy Director, Division of Trading and Markets, summarized the "bottom line" takeaways from the discussion as generally including a need to: (i) foster the sharing of information and best practices; (ii) tailor regulatory requirements so that they can be adapted to firms of various profiles; and (iii) encourage good planning, testing and communications, including the development of playbooks and recovery plans.

DRAFT SEC STRATEGIC PLAN RELEASED

The SEC has released its *Draft Strategic Plan for 2014-2018* for public comment. The draft includes descriptions of the SEC's mission, vision, values, strategic goals, major initiatives, and performance metrics for fiscal years 2014 through 2018. Among other things, the draft identifies the following initiatives with a focus on investment advisers and investment companies: analyzing regulatory structures for investment advisers and broker-dealers that provided personalized investment advice; and modernizing the regulatory treatment and valuation of certain portfolio holdings of registered investment companies.

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