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The following is a summary of select developments in investment management regulation during the first quarter of 2016.

SEC Announces 2016 Examination Priorities

On January 11, 2016, the Securities and Exchange Commission ("SEC") announced the examination priorities of its Office of Compliance Inspections and Examinations ("OCIE") for 2016. Carrying over the themes from 2015, OCIE examinations will continue to prioritize the following: (i) matters important to retail investors, particularly investors saving for retirement; (ii) issues related to market-wide risk; and (iii) use of data by the SEC to identify illegal activity.

More specifically, OCIE examinations will include a focus in the following areas:

Retirement Accounts: registered investment advisors and broker-dealers and the services they offer to investors with retirement accounts.

Exchange-Traded Funds ("ETFs"): regulatory requirements, sales strategies, trading practices, and disclosures involving ETFs.

Variable Annuities: sales of variable annuities to investors as well as the adequacy of disclosure and supervision of such sales.

Cybersecurity: testing and assessment of broker-dealers' and investment advisers' cybersecurity procedures and controls.

Liquidity Controls: exposure to potentially illiquid fixed income securities, and controls over market risk management, valuation, liquidity management, trading activity and regulatory capital of advisers to mutual funds, ETFs, private funds and broker-dealers.

Data Analytics to Identify Signals of Potential Illegal Activity: continuing use of data analytics to identify registrants with elevated risk profiles, including: (i) individuals with a track record of misconduct; (ii) broker-dealers with inadequate Anti-Money Laundering programs; (iii) broker-dealers and transfer agents participating in market manipulation schemes; (iv) firms engaged in excessive or otherwise potentially inappropriate trading; and (v) parties promoting new, complex and high risk products.

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Additionally, the SEC will allocate examination resources to municipal advisors, private placements, never-before-examined investment advisers and investment companies, private fund advisors and transfer agents. "We hope that registrants will use this information to inform the evaluation of their own compliance programs in these key areas," says OCIE Director Marc Wyatt.

SEC Issues Guidance on Mutual Fund Distribution and Sub-Accounting Fees

In January 2016, the SEC's Division of Investment Management ("IM Division") released guidance regarding mutual fund distribution and sub-accounting fees. The SEC last provided guidance on this subject in 1998. The recent SEC sweep examinations focused on fee payments to financial intermediaries prompted the SEC to release the updated guidance. According to the SEC, these sweep exams raised concerns regarding mischaracterizations of distribution-related payments as sub-transfer agent, administrative, sub-accounting and other shareholder servicing fees.

The guidance provides recommendations to mutual fund complexes and their boards to ensure that distribution payments from fund assets comply with the requirements of Rule 12b-1 under the Investment Company Act of 1940, as amended ("Rule 12b-1"). Rule 12b-1 prohibits mutual funds from making distribution-related payments outside a Rule 12b-1 plan to help avoid conflicts of interest between investment advisers and other service providers. Regardless of whether a fund complex has adopted a Rule 12b-1 plan, the guidance recommends that mutual fund boards have in place, and incorporated into their Rule 38a-1 compliance programs, policies and procedures "reasonably designed to evaluate whether a portion of sub-accounting fees is being used to pay directly or indirectly for distribution." These policies and procedures should include a process for advisers and other service providers to: (1) provide the board with an "overall picture of intermediary distribution and servicing arrangements for the mutual fund, including how the level of sub-accounting fees may affect other payment flows (such as Rule 12b-1 fees and revenue sharing) that are intended for distribution"; and (2) inform the board of the existence of potential distribution-related arrangements in connection with sub-accounting fees, which the board should carefully scrutinize.

The guidance provides the following non-exhaustive list of factors that mutual fund boards should consider in their evaluation of fund-paid sub-accounting fees:

- information about the specific services provided under the mutual fund's sub-accounting agreements;
- the amounts being paid;
- whether the adviser and other service providers are recommending any changes to the fee structure and whether any of the services provided have materially changed;

- whether any of the services could have direct or indirect distribution benefits;
- how the adviser and other service providers ensure that the fees are reasonable; and
- how the board evaluates the quality of services being delivered to beneficial owners (to the extent of its ability to do so).

Moreover, the guidance provides examples of activities or arrangements that could raise concerns that fund-paid fees may be utilized to pay for distribution-related activities in violation of Rule 12b-1, including:

- distribution-related activities conditioned on the payment of sub-accounting fees;
- lack of a Rule 12b-1 plan;
- tiered payment structures covering a number of services, which may include distribution-related activities;
- lack of specificity regarding services covered or bundling of services;
- adviser or other service provider takes into account distribution benefits when recommending, instituting, or raising sub-accounting fees;
- large disparities in sub-accounting fees paid to intermediaries; and
- purchase of additional "strategic sales data" from intermediaries.

SEC ISSUES GUIDANCE ON FUND RISK DISCLOSURE

In March 2016, the IM Division released guidance regarding fund risk disclosures, recommending that funds review their risk disclosures on a continuing basis in light of changes in market conditions to determine whether those disclosures adequately communicate the fund's susceptibility to risk to investors. In issuing this guidance, the SEC stressed the importance of clear and accurate risk disclosure to investor protection.

The guidance explained that because a fund's susceptibility to risk can change as a result of changes in market conditions, funds should evaluate and update their risk disclosures on an ongoing basis. The SEC states, "[m]onitoring market conditions for their impact on the fund is, of course, a part of prudent portfolio management by the adviser, so we would expect that funds would routinely engage in this practice as a normal part of day-to-day operations." Consequently, funds should assess whether changes in market conditions have affected a fund's susceptibility to risk in a way that would be material to investors. If so, the fund should determine whether its current risk disclosures remain adequate in light of this material change. If a fund determines that its current risk disclosures are no longer sufficient, it should update its risk disclosures and communicate the change to investors through appropriate channels such as the fund's prospectus, shareholder reports, fund websites and marketing materials. Furthermore, the SEC urged advisers to consider providing information regarding the steps they took to evaluate fund risk disclosures and the need for changes thereto.

By way of example, the SEC noted two areas where funds have appropriately revised their risk disclosures in response to changes in market conditions:

(i) fixed income funds; and

(ii) funds invested in Puerto Rico debt securities.

The SEC reported that the current low interest rate environment, along with the Federal Reserve's rate increase in December 2015, has led some funds to modify their risk disclosures. Specifically, funds have informed investors that current conditions may lead to future interest rate increases, which could in turn decrease the value of fixed income funds. Some funds have also disclosed that increased interest rates may lead to increased redemptions, which could result in the liquidation of portfolio securities at unfavorable prices and times and reduce the returns of the fund. Additionally, according to the SEC, many funds have noted that an increase in interest rates could have a greater impact on longer-term securities.

The guidance also discussed some funds' response to concerns surrounding Puerto Rico's ability to fulfill its debt obligations. The SEC noted that some funds have added disclosures addressing the current factors impacting the value of Puerto Rico debt, such as budget deficits and ratings downgrades, as well as the impact those factors have on market values and liquidity. Accordingly, the SEC urged fund complexes to review and update their risk disclosures in a similar fashion to account for the effects of changed market conditions.

KEYNOTE SPEECH TAKEAWAYS FROM THE ICI'S 2016 MUTUAL FUNDS AND INVESTMENT MANAGEMENT CONFERENCE

In the keynote address for the Investment Company Institute's ("ICI's") *2016 Mutual Funds and Investment Management Conference*, David W. Grim, Director of the IM Division, discussed key events of the past year impacting the investment management industry and aspects of the industry that may be subject to future SEC rulemaking efforts. Among other things, he shared notable insights into the IM Division's thinking across a range of topics, including:

Liquidity Risk Management and Swing Pricing Proposal: The SEC is closely reviewing the various alternatives to the proposal's liquidity classification framework and the three-day minimum liquidity requirement.

Reporting Modernization Proposal: The SEC has adopted robust cybersecurity protocols to ensure that data collected by the SEC is not compromised by cybersecurity attacks, including fund portfolio data that would be collected under the reporting modernization proposal.

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Third Avenue Case: The IM Division continues to carefully analyze Third Avenue Management's decision to wind down its Focused Credit Fund. Based on lessons learned from the case to date, Mr. Grim recommended that:

- Funds contemplating suspending redemptions should approach the IM Division as soon as possible, noting a belief that investors fare best when a fund facing acute liquidity pressures brings the IM Division into the conversation as soon as possible.

- Funds should consider implementing robust policies and procedures to ensure that their investment strategies are appropriate for an open-end structure and revisit the adequacy of their protocols for vetting new funds that will be subject to daily redemptions.

IM Guidance on Risk Disclosure: Because risk has a fluid quality, whenever market conditions begin to shift materially, funds should consider whether their funds' risk disclosures need to be revised to warn of a changing risk profile. To help ensure that funds provide adequate disclosure, funds should consult recent IM Division Guidance, *Fund Disclosure Reflecting Risks Related to Current Market Conditions*, which included the recommendations that (i) funds routinely monitor market conditions and gauge the impact of changing conditions on the fund and its investments; and (ii) funds consider all appropriate avenues for communicating to investors any updates to risk disclosures such as posting updates to the fund's website or sending letters directly to shareholders in addition to communicating with prospectuses and shareholder reports. (See related discussion here.)

Developing IM Division Initiatives: Future IM Division rulemaking initiatives include:

- requiring registered investment advisers to create and implement transition plans; and

- requiring stress testing by large investment advisers and investment companies in accordance with the Dodd-Frank Act.

Other Observations: Funds that outsource critical functions to third party service providers should:

- conduct thorough initial and ongoing due diligence of those third parties which includes exploring the service providers' business continuity and disaster recovery protocols, and understanding how the fund's own business continuity plan addresses the risk that a key service provider could suffer a significant business disruption; and

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- consider how funds can best monitor whether a service provider has experienced a significant disruption (such as a cybersecurity breach or other continuity event) that could impair its ability to provide uninterrupted services, the potential impacts such events may have on fund operations and investors, and the communication protocols and steps that may be necessary to successfully navigate such events.

In addition, funds should consider having a detailed playbook for responding to various scenarios, whether those disruptions occur internally or at a key service provider.

ICI COMMENTS ON SEC DERIVATIVES RULE PROPOSAL

On March 28, 2016, the ICI issued a comment letter on the recent rule proposed by the SEC regarding the use of derivatives by registered investment companies and business development companies. While the ICI agreed with the SEC's stated goals of modernizing guidance for funds' use of derivatives and ensuring that funds are not unduly speculative, the ICI did not agree with all of the SEC's proposed methodologies. Noting that derivatives have many beneficial functions, such as achieving efficiencies, enhancing liquidity and lowering costs, the ICI stated that derivatives are a "critically important tool of asset management" that must be preserved.

One facet of the rule proposal with which the ICI strongly disagreed was the proposed implementation of portfolio limits on funds' exposure to derivatives. Specifically, the ICI argued that the SEC's proposed reliance on notional exposure to derivatives was misplaced, because notional exposure was not an accurate barometer for measuring risk. The ICI also opposed the proposed "value-at-risk" ("VaR") metric that would be used for an alternative, risk-based portfolio limit, contending that its usefulness was similarly limited. Additionally, the ICI asserted that the proposed portfolio limitations were established based on inadequate data, as the SEC relied on a study of only 10 percent of the funds and assets in the mutual fund industry in concluding that only a limited number of funds would be affected. Drawing on what it considered to be a more comprehensive ICI study, the ICI stated that the number of affected funds would actually be much larger. Should the SEC determine that portfolio limits are necessary, the ICI recommended that the notional exposure limit be increased from 150% to 200% and alternative VaR metrics be provided.

The ICI was much more supportive of the asset segregation requirement included in the rule proposal, suggesting only that qualifying coverage assets be more broadly construed and calculated. The ICI was also amenable to the proposed risk management program. It suggested a few changes, including the establishment of a cure period for funds that inadvertently cross derivative exposure limits, and questioned whether the oversight responsibilities imposed on fund boards were reasonable and appropriate. Overall, the ICI suggested that a robust asset segregation requirement, combined with an effective risk management program, would be sufficient to accomplish the SEC's stated goals. Once the rule is finalized, the ICI recommended that a 30-month transition period be set aside for implementation. The comment period for the rule proposal ended on March 28, 2016.

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Northern Trust

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