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

## SEC Provides Guidance for Auditor Independence Implications of the Loan Rule

On June 20, 2016, the Securities and Exchange Commission's ("SEC's") Division of Investment Management issued a temporary no action letter (the "Letter") to Fidelity Management and Research Company et al. ("Fidelity"), applicable to registered investment companies ("Fidelity Funds") and other entities ("Fidelity Entities") within Fidelity whose financial statements are audited by a public accounting firm ("Audit Firm") that is not independent from the Funds due to non-compliance with Rule 2-01(c)(1)(ii)(A) of Regulation S-X (the "Loan Rule"). The Letter provides that the SEC would not recommend enforcement action against any Fund or Entity that continues to rely on financial statements audited by an Audit Firm that is not independent from the Funds due to Rule 2-01(c)(1)(ii)(A), so long as (i) the Audit Firm is compliant with PCAOB Rule 3526(b)(1) and (2) or has been provided equivalent communications, (ii) the non-compliance of the Audit Firm is with respect to the Loan Rule, and (iii) notwithstanding its non-compliance, the Audit Firm has concluded that it is objective and impartial with respect to the issues encompassed within its engagement. This no action letter comes after funds from multiple fund families disclosed that their audit firm had informed their audit committee that the audit firm had a loan from an entity in possible violation of the Loan Rule. The Letter will expire 18 months from the date of issuance.

The first of the funds to disclose this issue was Invesco Ltd. ("Invesco"). In May 2016, Invesco disclosed in a Form 8-K filing that its public accounting firm, PricewaterhouseCoopers LLP ("PwC"), had informed them that it was in discussions with the SEC regarding the interpretation and application of the Loan Rule with respect to certain of PwC's lenders who own interests in open-end and closed-end mutual funds managed by Invesco. The Loan Rule specifies, in relevant part, that an audit firm is not independent if it receives a loan from an entity that is a record or beneficial owner of more than ten percent of the audit client's equity securities. Additionally, under the Loan Rule, if an audit firm's lender owns more than ten percent of any entity within the investment company complex of an audit client, that audit firm's independence is jeopardized with regard to the entire complex. At issue was whether shares owned by broker-dealers, which list the broker-dealer as the owner of record but are ultimately held for the benefit of the underlying advisory client, count as ownership by the broker-dealers towards the ten percent threshold of the Loan Rule. PwC and other audit firms appear to have been interpreting the Loan Rule in such a manner that did not count broker-dealers' ownership of funds via omnibus accounts for purposes of the ten percent Loan Rule threshold. However, the SEC's Office of the Chief Accountant indicated that broker-dealers' ownership of funds through omnibus accounts could in fact count towards the ten percent threshold of the Loan Rule for auditor independence purposes.

In the Letter, the SEC noted the Audit Firm's assertion that notwithstanding its noncompliance with the Loan Rule, the entity with which it had these non-compliant lending relationships was not able to impact the impartiality of the Audit Firm or assert any influence over the Fidelity Fund that it owned, or its investment adviser, and as such the concerns underlying the Loan Rule were not implicated in that instance. The SEC further noted Fidelity's assertion that in regards to those non-compliant Audit Firm lending relationships, if a matter arose that could potentially affect the Audit Firm's objectivity and impartiality, the Fidelity Entity in question would make a reasonable inquiry into the matter, and if it found that the lender did in fact exercise discretionary voting authority with respect to at least ten percent of the Fidelity Entity's shares in violation of the Loan Rule, the Fidelity Entity would not rely on the relief granted by the Letter, but instead would take action as appropriate under federal securities laws. As such, the SEC stated in the Letter that it would not recommend enforcement action against a Fidelity Entity if that Fidelity Entity continued to rely on audit services performed by an Audit Firm that is not compliant with the Loan Rule in the above circumstances, if the following conditions are met:

1. The Audit Firm has complied with PCAOB Rule 3526(b)(1) and (2) or, with respect to a Fidelity Entity to which Rule 3526 does not apply, has provided substantially equivalent communications;
2. The non-compliance of the Audit Firm is with respect to the lending relationships described above; and
3. Notwithstanding such non-compliance, the Audit Firm has concluded that it is objective and impartial with respect to the issues encompassed within its engagement.

Given the 18 month timeframe of the Letter's effectiveness, it is likely that the SEC is working towards a more permanent solution. In the meantime, the Letter provides relief for registered investment companies whose audit firm's independence was implicated in this particular manner.

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## SEC PROPOSES RULE REQUIRING INVESTMENT ADVISERS TO ADOPT BUSINESS CONTINUITY AND TRANSITION PLANS

On June 28, 2016, the SEC proposed a new rule that would require investment advisers to create and implement business continuity and transition plans. In an effort to minimize client and investor harm, the proposed rule would require registered investment advisers to adopt plans to address potential material service disruptions such as natural disasters, cyber-attacks, technology failures, changes to key personnel, or other similar events. Under the proposed rule, advisers would be able to customize their business continuity and transition plans to fit their business needs, according to the complexity of and specific risks associated with their own operations.

An investment adviser's plan would need to include individualized policies and procedures addressing the following areas:

(i) Maintenance of critical operations and systems, and the protection, backup, and recovery of data;
(ii) Pre-arranged alternate physical location(s) of the adviser's office(s) and/or employees;
(iii) Communications with clients, employees, service providers, and regulators;
(iv) Identification and assessment of third-party services critical to the operation of the adviser; and
(v) Plan of transition that accounts for the possible winding down of the adviser's business or the transition of the adviser's business to others in the event the adviser is unable to continue providing advisory services.

The proposed rule would further require that advisers review their business and continuity plans on at least an annual basis and to retain various related records.

The SEC believes that under the proposed rule, investment advisers would increase their effectiveness by addressing both business disruptions and transition events, and therefore contribute to enhanced client and investor servicing. As SEC Chair Mary Jo White explains, "[w]hile an adviser may not always be able to prevent significant disruptions to its operations, advance planning and preparation can help mitigate the effects of such disruptions and in some cases, minimize the likelihood of their occurrence, which is an objective of this rule. This is the latest action in the Commission's efforts to modernize and enhance regulatory safeguards for the asset management industry, which includes rules previously proposed that would modernize the information reported to the Commission and investors, enhance fund liquidity management, and strengthen the regulation of funds' use of derivatives."

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## SEC CHAIR'S SPEECH SIGNALS PLANS TO FINALIZE LIQUIDITY AND DERIVATIVES REGULATIONS IN 2016 AND IDENTIFIES FUTURE SEC PRIORITIES

In the keynote address for the Investment Company Institute's *2016 General Meeting*, Mary Jo White, Chair of the SEC, focused on the SEC's regulation of investment companies, including initiatives currently being implemented and areas targeted for future regulation. With respect to current initiatives, she highlighted the SEC's efforts to adopt new rules governing liquidity and derivatives, noting that it is the SEC's "responsibility to promptly finalize [the] rules" and that she "expect[s] to move forward on [them] this year." Turning to future SEC initiatives, she predicted "dynamic and robust regulation...that adapts and evolves to meet all of the current and future risks and challenges, while preserving the features that have served investors so well over more than seven decades."

Chair White recognized feedback received from commentators on the proposed rules in the areas of liquidity and derivatives, stating that the SEC "appreciated receiving comments from the industry and other interested parties that provided constructive suggestions" and that the SEC will "continue to welcome your input as staff works toward finalizing recommendations for these reforms this year." Looking forward, she cited initiatives that focus on disclosure effectiveness and regulation of exchange traded funds ("ETFs").

> **Disclosure Effectiveness.** While discussing effective disclosure, Chair White stated that she had instructed the staff of the SEC Investment Management Division "to undertake a disclosure effectiveness initiative . . . to consider ways to improve the form, content, and delivery of funds' disclosures." Chair White also stated that the staff was "in the early stages of prioritizing areas of focus," but that she "expect[s] they will include ways to leverage advances in technology to improve the presentation and delivery of disclosures and ways to enhance disclosure about fund strategies, investments, risks, and fees." She reminded the audience that disclosure is the responsibility of the investment manager, noting that investment managers should ask themselves on a regular basis -- "[w]hat can I do to improve investors' understanding of the fund's strategies, risks, and costs?"
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> **ETF Regulation.** Chair White cited ETFs as an example of a particular type of fund on which the SEC will be focusing more closely. She stated that the staff was analyzing recent market volatility events involving ETFs and a range of other challenging aspects, including: (i) the role that authorized participants and market makers play in the operation and trading of ETFs; (ii) the interconnectedness of the prices of ETF shares and their portfolio holdings; (iii)

the impact on investors when the ETF's arbitrage mechanism does not function efficiently; and (iv) sales practices of broker-dealers in the market.

Chair White also identified two emerging challenges that are SEC priorities – use of technology and service providers, and portfolio pricing.

**Use of Technology and Service Providers.** Citing a recent event during which a service provider was unable to provide funds with pricing information due to a software failure, Chair White explained that "[i]t is important that a fund is adequately prepared to promptly and effectively respond to risks that may be triggered by service providers and its own use of technology, including implementing alternative and reliable means to satisfy the fund's regulatory requirements." Chair White then addressed the importance of cybersecurity, stating that investment managers should "consider the full range of cybersecurity risks to [their] funds and consider appropriate tools and procedures to prevent breaches, detect attacks and limit harm."

**Portfolio Pricing.** Noting the increase in portfolio holdings that are difficult to value, Chair White stated that "it is essential that the accurate pricing of the portfolio holdings and NAV calculations are carefully considered" and that "[i]t is also important that the services used to assist funds with pricing do so accurately, in the manner disclosed in the fund's prospectus and consistent with the law."

In closing, Chair White reminded asset management executives of their responsibility to "foster a culture in [their] organizations that prioritizes responsibility and fairness and asks first – and last – what is in the best interest of investors."

## OCIE Director Wyatt Addresses Results of High-yield Bond Fund Sweep Exams

In an interview with the *Wall Street Journal* published on April 14, 2016, Marc Wyatt, Director of the SEC's Office of Compliance, Investigations and Examinations ("OCIE"), stated that the SEC's examination of high-yield bond funds conducted in December of 2015 did not reveal any systemic issues that would place similar funds at risk. This sweep exam was triggered by the sudden collapse of the $789 million Third Avenue Focused Credit Fund, which was forced to take the unusual step of suspending withdrawals and placing its assets into a liquidating trust when it could no longer meet redemption requests without selling assets at fire sale prices.

According to Director Wyatt, "[w]e haven't seen anything that would warrant us going out and trying to pre-emptively" raise alarms. He stated that an industry-wide risk alert was not necessary, noting that "[i]f we saw something that would have been systemic or widespread, we certainly would have gotten that out." However,

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even though a risk alert was not issued in response to the Third Avenue sweep exams, it should be noted that liquidity controls for mutual funds was identified by OCIE as one of its 2016 examination priorities. In an SEC advisory committee meeting, Director Wyatt stated that the Third Avenue sweep exams were an example of the SEC's commitment to respond to emerging risk factors and potential risk factors in a timely fashion.



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