Issue 22, February 2015

REGULATORY ADMINISTRATION DIGEST

TOPICS IN THIS ISSUE:

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

SEC Chair Discusses New Fund Initiatives

In a speech on December 11, 2014, at a conference organized by The New York Times/DealBook, Securities and Exchange Commission ("SEC") Chairwoman Mary Jo White discussed developments of new SEC initiatives affecting the mutual fund and exchange-trade fund ("ETF") sectors. The initiatives are part of a broader risk management assessment undertaken by the SEC to address issues involving liquidity and derivative markets.

In her speech, Ms. White outlined three core initiatives: (1) improvements to data and other information used to analyze risks in the asset management industry; (2) enhancements to a registered fund's ability to identify and address risks related to portfolio compositions; and (3) measures to ensure that investment advisers have a plan for transitioning client assets when circumstances require.

The first initiative entails the development of regulatory responses, and the expansion and updating of existing data requirements that would apply to both mutual funds and their investment advisers. For instance standardized reporting may be required for many types of derivatives. The second initiative focuses on the ability of a mutual fund or ETF to identify and address risks with a focus on the use of derivatives. Potential actions include requiring updated liquidity standards, disclosures of liquidity risks, and measures to limit leverage created by the use of derivatives. The third initiative would require the investment to implement procedures to test and plan for major disruptions in their advisers business. Examples that would warrant such an action include market stress events or when an adviser is no longer able to serve its clients due to a dissolution or departure of key personnel. SEC staff are also considering implementation of new requirements aimed at large investment advisers and large funds for annual stress testing.

Once implemented, these new initiatives would update the rules on liquidity standards that have been in place for more than 20 years. No announcement has been made yet on when proposed rules would be released. In response to inquiries

by reporters after her speech, Chairwoman White stated that "2015 will be a very active year for those rules."

Recent Guidance Update Focuses on Consolidated Financial Statements

In the Guidance Update, No. 2014-11, published by the Investment Management Division ("IM") of the SEC, staff outlined their position on the meaningfulness of consolidated financial statements as applied to feeder funds, funds of funds, and business development companies ("BDCs"). Such financial statements come under Regulation S-X, which govern the form and content of financial statements. Staff recommendations can be summarized as follows for each type of fund.

Feeder Funds: Generally, unconsolidated financial statements are deemed most meaningful provided that, among other things:

- The feeder fund attaches the financial statements of the master fund to its financial statements;
- If the master fund is organized as a partnership, the feeder fund also:
    - Separately discloses on its statement of operations the net investment income, the net realized gain/loss, and the net change in unrealized gain/loss allocated from the master fund; and
    - Includes the net investment income and expenses allocated from the master fund in its net investment income and expense ratios in its financial highlights.

An exception to the above applies where the design and purpose of the master-feeder structure is for the master fund to be wholly owned by a sole feeder fund, in which case, the registrant should consult with SEC staff on whether a consolidated financial statement is appropriate.

Fund of Funds: Generally, unconsolidated financial statements are deemed most meaningful. With investments in multiple underlying funds, the level of controlling and non-controlling interests might fluctuate, and the SEC staff views that presentment of financials in a consolidated format may be confusing to investors. SEC staff also noted that fund of funds should consider whether an investment in a single underlying fund is so significant as to warrant presentation of financial statements in a manner similar to a master-feeder fund.

BDCs: Generally consolidated financial statements are deemed most meaningful for BDCs that have wholly owned subsidiaries. Because the design and purpose of a subsidiary may be to act as an extension of the BDC's investment operations and to facilitate the execution of the BDC's investment strategy, SEC staff believes that consolidation provides investors with the most meaningful financial presentation.

Director Champ Reviews SEC 2014 Successes and Future Goals

In remarks before the Investment Company Institute's 2014 Securities Law Developments Conference, the Director of the SEC's Division of Investment Management, Norm Champ, highlighted his "Top 10 Lessons Learned and Points to Remember from 2014." He reviewed key operational successes of 2014 and future goals.

The SEC accomplishments during the past year cited by Mr. Champ included:

- Enhancement of the staff's ability to monitor and better understand the investment management industry
- Innovative use of data and analytical tools that enable the staff to make "better and more informed policy recommendations" based on "real-world, contemporary data and information"
- Continued use of Guidance Updates to provide transparency into the staff's work processes and to "decrease ambiguity and improve the public's understanding of the staff's view on critical issues"

SEC goals for the future identified by Mr. Champ included:

- Doing more to inform SEC policy initiatives with real-world, contemporary data and information
- Refocusing the efforts of the Disclosure Review and Accounting Office on assessing the consistency and effectiveness of staff comments on disclosure documents reviewed each year, as part of an effort to identify emerging disclosure issues, promote consistency in staff comments, inform policy decisions, and provide improved guidance to registrants concerning disclosures to investors

Mr. Champ also noted the tenth anniversary of Rule 38a-1 under the Investment Company Act, which codified the required compliance policies and procedures for registered funds, including the designation of a chief compliance officer. He

commented that in the decade since the rule's adoption, these concepts had become "a defining characteristic of the fund industry." He highlighted the importance of individual compliance professionals in ensuring a strong culture of compliance, citing a recent enforcement action against a portfolio manager for "misleading and obstructing a chief compliance officer" as an example of the seriousness with which the SEC intended to address threats to the integrity of a fund's compliance program.

Mr. Champ discussed additional focus areas for the Division, including "thoughtful joint action" with other divisions of the SEC and outside stakeholders, enhanced risk monitoring, increased communication with senior leaders in the fund industry, proactive regulation to protect investors, and the role of the exemptive relief review process in fostering appropriate innovation. He noted that 2015 would mark the 75th anniversary of the Investment Company Act and the Investment Advisers Act, and reiterated his view that the lessons and goals of the previous year formed a foundation for the SEC to "meet the new challenges faced by investors in the twenty-first century."

TOPICS IN THIS ISSUE:

Northern Trust

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