Key Takeaways for Updating your Compliance Program in 2017: Investment Advisers, Hedge Funds and Private Equity Funds

January 6, 2017

By: Jaqueline M. Hummel, Partner and Managing Director

Based on the regulatory developments from 2016 (see our blog post), here’s our suggestions for updates for your compliance manual for 2017.

DOL Conflict of Interest Rule

Effect on Investment Advisers

The Department of Labor’s ("DOL") Conflict of Interest Rule (the “Rule”), also known as the Fiduciary Rule, was issued in final form on April 6, 2016. The Rule goes into effect April 10, 2017 and compliance with the exemptive relief (best interest contract and principal transactions) is extended until January 1, 2018. The Rule imposes fiduciary obligations on large segment of the financial services industry, including broker-dealers and insurance agents. The biggest impact will be on advisers that serve retirement investors and that offer additional services.

Advisers that recommend IRA rollovers and provide additional services and products to retirement investors, such as brokerage and insurance products, will now have to meet the specific conditions of the Best Interest Contract Exemption ("BICE") or another exemption in order to receive third-party compensation like commissions and 12b-1 payments. Advisers that typically receive flat fees or a fee based on a fixed percentage of assets under management need to comply with this new Rule and BICE, to the extent they provide advice with respect to rollovers from employer-sponsored retirements plans to IRAs, and rollovers from one IRA account to another. Compliance with the Rule and BICE is less stringent for these “Level Fee Fiduciaries”.

Key takeaways: By April 7, 2017, investment advisers that provide advice to retirement investors should meet the following conditions:

1. Adopt “Impartial Conduct Standards” (provide prudent investment advice, charge only reasonable compensation, and avoid misleading statements);
2. Prepare and distribute a written statement of fiduciary status and conflict disclosures (either electronically or via email), the “Transition Disclosure”; and
3. Designate a Chief Conflicts Office (or BICE Compliance Officer) or a conflicts committee.
The Transition Disclosure will require firm to identify conflicts of interest. This process should include:
  • Identifying any affiliated service providers, such as broker-dealers, custodians, consultants, or administrators;
  • Listing payments made and received by the firm and its affiliates, including referral fees, revenue sharing, 12b-1 payments, shareholder servicing fees, and recordkeeping fees;
  • Identifying other benefits received, such as access to educational seminars related to current products and industry issues;
  • Determining whether “free” services or products offered by service providers, such as custodians, are based on the amount of business brought in by an adviser; and
  • Considering sales events, conferences, and programs held by mutual fund distributors.

See our blog post for more information on how to comply.

Effect on Advisers to Private Funds

The DOL did not provide a specific exemption for investments in private funds. It could be argued that offering an investment in a private fund is not “a recommendation” as contemplated under the Rule, since it is not based on meeting the particular investment needs of a client.

**Key takeaway:** Private fund managers should consider including representations in the subscription agreement stating:

  • The owner understands and agrees that the fund manager is not offering impartial fiduciary advice;
  • The owner has sufficient financial expertise to make the decision to invest; and
  • The owner understands and agrees that fund manager is not providing specific advice or a recommendation as to whether the owner should invest in the fund.

The DOL Rule is complex and additional guidance continues to be issued on how firms can comply with it. See our blog post and webinar for more details on this Rule.

Rule Amendments Requiring Changes to the Compliance Manual

1. Form ADV Amendments

On August 25, 2016, the Securities and Exchange Commission (“SEC”) finalized its amendments to Form ADV and the books and records rule (Rule 204-2 of the Advisers Act) that require additional reporting and disclosure from investment advisers. See our blog post for more details. In a nutshell, the SEC wants advisers to report certain aggregated information about their separately managed accounts (SMAs), identify key custodians, provide disclosure about the firm’s use of social media, and identify outsourced CCOs. The amendments also establish a more efficient method for the registration of multiple private fund adviser entities operating as a single advisory business (“Umbrella Registration”).

**Key Takeaways:** Investment advisers, including private fund managers, should review the new Form ADV Part 1A and its instructions and begin planning how to produce the required information. For most advisers, the amendments will not have an impact until they update Form ADV in the first quarter of 2018. Investment advisers filing an initial form ADV on or after October 1, 2017, however, will be required to use the revised form.
2. Recordkeeping Rule Amendments

The SEC amended its books and recordkeeping requirements under Rule 204-2 of the Advisers Act. Rule 204-2(a)(16) under the Advisers Act, relating to records regarding performance calculations was changed to require that advisers maintain records demonstrating the calculation of the performance or rate of return in any communication circulated to “any person.” The rule previously applied to communications to “ten or more persons.” The SEC also amended Rule 204-2(a)(7) to require advisers to maintain originals of all written communications received and copies of written communications that relate to the performance or rate of return of any or all managed accounts or securities recommendations. See our blog post for more details.

*Key takeaways:* Investment advisers, including private fund managers, should revise their recordkeeping policies relating to performance information and investor communications. Communications distributed to investors after October 1, 2017, will be subject to the new recordkeeping requirements.

3. Qualified Clients – New High Net Worth Threshold Adopted

Effective August 15, 2016, the SEC amended Rule 205-3 of the Advisers Act to raise the net worth threshold for a registered investment adviser to charge performance-based compensation to its advisory clients or investors in 3(c)(1) private funds from $2 million to $2.1 million.

*Key Takeaway:* Private fund advisers should update the investor questionnaires to reflect this new net worth threshold.

Regulatory Hot Buttons That Could Impact your Compliance Program

1. Increased Supervision Procedures required for Supervised Persons with Regulatory Baggage

In a recent [risk alert](#), the SEC appears to be stating what’s been obvious to compliance officers for years: advisory firms should be careful when hiring individuals with regulatory baggage. The SEC will expect more from your firm if you hire individuals with a history of disciplinary events.

*Key Takeaways:* Advisers with employees or investment adviser representatives with blemished records should have a written due diligence process for hiring, policies for employee oversight, and procedures for handling complaints. Additionally, examiners are going to review disclosures of regulatory, disciplinary or other actions in the Form ADV with a magnifying glass. Advisers should have a process to periodically review and update these disclosures.

2. Best Execution Process for Recommending Mutual Fund Share Classes

OCIE published a [Risk Alert](#) announcing that it will be looking at whether investment advisers are meeting their best execution obligations when recommending or selecting mutual fund and 529 Plan investment to clients. Examiners will be reviewing advisers’ books and records to identify share classes held and purchased in client accounts and any compensation received by the adviser or its affiliates related to such investments.
Key Takeaway: Advisers that are dually registered as broker-dealers, or that have an affiliated broker-dealer, should have written procedures for selection of mutual fund share classes. These procedures should address how the recommendations or selections are made in the best interest in the client. Additionally, advisers should review Form ADV Part 2A to ensure that it discusses whether the adviser or its supervised persons accepts compensation for the sale of securities or other investment products, including asset-based sales charges or service fees from the sale of mutual funds. Form ADV Part 2A should also explain the conflict of interest such compensation creates and how the adviser addresses the conflict, including the adviser’s procedures for disclosing the conflict to its clients.

3. Whistleblower Act Compliance

OCIE released a risk alert warning advisers and broker-dealers that it will be focusing on compliance with key whistleblower regulations during exams. OCIE will be reviewing compliance manuals, code of ethics, employee agreements and severance agreements for any provisions that might discourage or impede employees from whistleblowing, since such actions could violate Securities Exchange Act Rule 21F-17.

Key Takeaway: Investment advisers and broker-dealers should review their employment and severance agreements, and compliance policies and procedures, to ensure that they do not contain any provisions that:

- Limit the types of information an employee can disclose to the SEC or other authorities;
- Require an employee to represent that he or she has not assisted in any investigation;
- Require an employee to get consent from his or her employer prior to disclosing confidential information, without any exception for voluntary communications to the SEC concerning potential securities laws violations.
- Require departing employees to waive their rights to any individual monetary recovery for reporting information to the government.

Advisers should also have a process in place to allow employees to report potential legal or compliance violations in a confidential manner. Setting up an anonymous tip line or online form will give employees the freedom to report issues, preferably before going to the SEC with their concerns. Advisers should investigate the tips and document the results. Letting employees know that their concerns will be taken seriously will help promote a “culture of compliance”.

4. Multi-Branch Adviser Initiative

The latest OCIE Risk Alert, issued on December 12, 2016, deals with investment advisers that provide advisory services through multiple offices. Examiners will be evaluating the effectiveness of firm oversight of branch offices.

Key takeaways: Investment advisers with multiple branch offices should take a critical look at how they supervise the activities taking place away from the home office. Consider routine audits of remote offices to review client files, marketing materials, financial records (including the general ledger), other business activities taking place in that location, and computer programs and/or services being used to run the business. Investment adviser representatives at remote locations should also be required to show compliance with standard account opening procedures, maintenance of client files with fully executed advisory agreements and evidence of periodic review of client accounts.

Lessons for Advisers from SEC Enforcement Actions
SEC Announces Enforcement Results for FY 2016 with a Record Number of Cases against Investment Advisers and Investment Companies

The SEC announced that in fiscal year 2016 it filed 868 enforcement actions. The SEC brought the most cases involving investment advisers and investment companies (160) in its history, including 98 standalone cases against investment advisers and investment companies. I have highlighted the more significant issues below:

1. **Verify Performance of outside Asset Managers**: The SEC brought action against 13 investment advisers for relying on claims by F-Squared Investments that its AlphaSector strategy for investing in exchange-traded funds (ETFs) had outperformed the S&P Index for several years. F-Squared admitted that the track record it presented as its own was actually back-tested performance that was substantially inflated. The firms repeated many of F-Squared's claims and recommended the investment to their own clients, without performing due diligence to substantiate the performance being advertised. The penalties assessed ranged from $100,000 to a half-million dollars based upon the fees each firm earned from AlphaSector-related strategies.

   **Takeaways**: First, develop a due diligence process for evaluating data from third-party advisers, such as requesting an independent audit of the performance. Second, do not expect to disclose your way out of this due diligence with statements that the data is provided by third parties and we take no responsibility for ensuring its accuracy.

2. **Avoid Back-Tested Performance**: This case makes it abundantly clear that the SEC hates the use of back-tested performance, and disclaimers won’t save an adviser if the Commission finds the presentation misleading overall.

   **Key takeaways**:
   - Back-tested performance is defined as performance calculated using historical data, not hypothetical assumptions (even reasonable assumptions that do not result in misleading performance numbers);
   - Calculate back-tested performance consistent with the strategy you are advertising;
   - Be able to substantiate the performance claims in advertisements, even those based on information provided by third parties; and
   - Include substantial and prominent disclosures when using back-tested or hypothetical performance.

3. **How NOT to do a Cross Trade**: Although many advisers know that cross trading can raise compliance issues, not everyone understands the legal nuances that make certain types of cross trades illegal. The case involving Aviva Investors Americas, LLC provides some valuable lessons for compliance and trading staff.

   **Key takeaways**:
   - Just because a broker is involved doesn’t mean it is NOT a cross trade. If the firm has an agreement with the broker regarding price, mark-up and an understanding that the adviser will be purchasing the security, this can be considered a cross trade.
• A one-day delay between the sale and purchase does not mean it is NOT a cross trade. The broker must take on market risk.
• The type of client accounts involved in the transaction makes a HUGE difference. ERISA accounts cannot participate in cross trades (unless an exemption applies) and mutual fund accounts can only participate in cross trades in compliance with Rule 17a-7 of the Investment Company Act.
• If the adviser or an affiliate has an ownership interest in the accounts involved in the trading activity, then you may have a principal transaction, which would require disclosure and prior consent of the clients involved.
• If cross trades are prohibited by the firm’s policies and procedures, then the SEC could find a violation of the Compliance Program Rule (Rule 206(4)-7 of the Advisers Act) if the firm engages in cross trading activity.
• The trade blotter should be reviewed for cross trading activity in violation of the firm’s policies and procedures.

4. Don’t Turn a Blind Eye to Potential Insider Trading: In a recent action, the SEC settled charges against a hedge fund adviser and a senior research analyst related to their failure to detect insider trading by one of their employees. Artis Capital Management had to disgorge more than $5 million in profits, plus interests and penalties of more than $3.5 million. The supervisor ended up paying a fine of $140,000 and was suspended from the industry for 12 months.

Key takeaways:

• An adviser that hires an analyst because of his or her relationships with industry insiders needs to have procedures to monitor that analyst’s interactions with employees of public companies.
• If an analyst does provide written materials or research data to back up his recommendations, questions should be asked by his/her supervisor regarding the sources of information.
• If an adviser’s employees are frequently talking to others that may be in possession of material nonpublic information, the adviser should periodically evaluate that information. Relying on self-reporting is not sufficient.

5. Best Execution for Wrap Accounts: Since 2014, wrap fee programs have been on the agenda for the SEC’s National Exam Program. In 2016, the SEC brought three separate enforcement actions and accompanying settlement agreements relating to wrap programs. Actions against program sponsors Robert W. Baird & Co., Inc. and Raymond James & Associates, Inc., focused on the oversight and disclosure of “trading away” activity. The third case, Riverfront Investment Group, LLC, involved a finding that wrap program sponsor failed to adequately disclose the frequency of “trading away” in its wrap program.

Key Takeaways:

• Wrap program sponsors should collect information from sub-advisers regarding the costs and frequency of “trading away”. This can be accomplished with annual questionnaires;
• Wrap program sponsors should review the trading away policies and practices of the sub-advisers involved in the program;
• Include disclosures of costs and the frequency of “trading away” in Form ADV Part 2A and any disclosure statements provided to wrap program clients. Clients should be provided with disclosure stating that they will pay additional costs when a sub-adviser “trades away” and the likelihood that the sub-advisers will engage in “trading away;” and
• Review and analyze the wrap fee programs sub-advisors’ trading away practices and costs, and assess whether the use of a particular sub-adviser in the wrap fee program is suitable.

Lessons for Private Fund Advisers from SEC Enforcement

In 2016, the SEC continued its scrutiny of private fund advisers, focusing intently on allocation of fees and expenses, and conflicts of interest. In many ways, it’s a repeat of 2015, but I’ve highlighted a few significant cases.

• **Misallocation of Fees**: Private equity fund documents stated that management fees would be offset by transaction fees received from portfolio companies. Co-investors received a share of the transaction fees, which reduced the amount of management fee offset to investors.
• **Failure to Disclose and Failure to Supervise**: Private equity firm disclosed the fact that it would receive fees for monitoring portfolio companies, but did not disclose that these fees would be accelerated upon sale or IPO. The SEC also found one of the firms failed to adequate supervise a senior partner at the firm for improperly charging personal items and services to the firm’s private funds and their portfolio companies.
• **Failure to allocate expenses consistent with disclosures and failure to share volume discounts with the private funds**: An adviser to 20 private funds allocated expenses to some of these funds to pay fees and expenses incurred in the creation of certain advisory affiliates, and to pay more than their proportional share of liability insurance. The SEC also hammered the adviser for not passing along discounts for legal fees that resulted from the large amount of work generated by firm’s funds.
• **Favoring insiders and favored clients**: The SEC charged a fund-of-funds manager with fraud for paying out redemptions and disbursements of the fund he managed to himself, his family and certain favored investors, while telling other investors that redemptions were suspended.
• **Unregistered adviser held accountable for breach of fiduciary duty**: SEC found that an unregistered investment adviser lied to investors and took additional profits by engaging in deals with affiliates.

As noted last year, SEC seems focused on the issues of disclosure, fairness and fulfilling fiduciary obligations. Even in situations where fees were disclosed to investors, the SEC still finds fault with advisers for not providing more explicit disclosure, specifically in those situations where the adviser seems to be getting extra benefits.

**Key takeaways:**

• Develop policies and procedures for allocating fees and expenses;
• Consider adopting the [Institutional Limited Partners Association reporting template](#), which provides a list of various categories of fees and expenses and common definitions;
• Itemize and document portfolio monitoring fees, directors’ fees, and transactional fees that are offset against the management fee;
• Perform a comprehensive review of fees and expenses earned and charged by the private fund manager to the funds to determine whether disclosure to investors is required and/or adequate;
• Compare actual allocation of fees and expenses to the practices described in disclosures provided to investors and in partnership documents;
• Review fund documents to ensure that they accurately disclose the firm’s actual practices with respect to fee and expense allocation;
• Develop a protocol for identifying and resolving fee and expense allocation issues and conflicts of interest;
• Consider use of the limited partner advisory committee (LPAC) to resolve fee and expense allocation and conflict issues; and
• Consider an external review of fee and expense allocation.

I hope you have found these recommendations helpful. I welcome your feedback.