HARDIN COMPLIANCE CONSULTING LLC

COMPLIANCE INFORMER®

Eleven Key Takeaways for Updating your Compliance Program in 2019: Investment Advisers, Mutual Funds, Hedge Funds and Private Equity Funds

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Based on regulatory developments from 2018, here are our suggestions for updates to your compliance program for 2019.

1. BE READY FOR THE SEC'S SCRUTINY OF CONFLICTS OF INTEREST.

Conflict of the Year: Receiving 12b-1 Fees without Sufficient Disclosure
In 2018, the SEC became increasingly aggressive against advisers for failing to disclose, or to adequately disclose, conflicts of interest. Attention-grabbing cases have involved advisers and their affiliates receiving 12b-1 fees, revenue sharing, and payments from other advisers and service providers. In a press release, the SEC said these advisers "failed to disclose conflicts of interest and violated their duty to seek best execution by investing advisory clients in higher-cost mutual fund shares when lower-cost shares of the same funds were available." (See Additional Resources, Conflicts of Interest and Best Execution at the end of this article for references to these cases.) As former Director of SEC's Division of Enforcement, Stephen M. Cutler, said back in 2003:

> Shed the blinders of 'industry practice' that may have made it possible for you not to see the conflicts that surround you daily. Just because the industry has always done something 'that way', don't assume it's acceptable.

Undisclosed conflicts of all types were highlights of SEC enforcement actions in 2018. For example, an investment adviser agreed to pay an $8 million penalty for failing to disclose conflicts of interest to its clients. In this case, deVere USA (DVU) recommended and assisted clients in rolling over their U.K. pension assets to retirement plans that would receive favorable tax treatment under U.K. tax laws. DVU would then provide investment advice for the transferred assets. DVU's dirty little secret was that the firm's investment adviser representatives (IARs) received payments from various service providers the firm recommended, such as custodians, trustees, and foreign exchange providers, and received front-end sales loads from European investments. None of these payments were disclosed on the Firm's Form ADV Part 2A. In addition to the $8 million penalty, the SEC ordered DVU to notify clients of the proceeding, provide four hours of training each year for the next two years to all employees on fiduciaries duties, and retain an independent compliance consultant to review the firm's compliance program. Separate charges were filed against former DVU CEO, Benjamin Alderson and Bradley Hamilton, both of whom were IARs of the firm.

In addition to undisclosed referral arrangements, the SEC also brought cases revisiting advisory practices that commonly result in conflicts: cross trading and valuations.

Cross trading can be appropriate when the adviser can ensure that it is in the best interest of buying and selling clients and when the firm appropriately and accurately discloses the practice. The adviser also has a fiduciary duty to ensure that both sides of the deal are traded fairly. This tends to be the most common downfall of traders and portfolio managers doing the trading, as two advisory firms discovered. In both cases (In the Matter of Hamlin Capital Management, LLC and In the Matter of Putnam Investment Management, LLC and Zachary Harrison), the firms favored the buying clients at the expense of the selling clients, in violation of firm procedures and their fiduciary duties. In both situations, the firms failed to accurately disclose how the cross-trading price was set. (Hamlin got a $900,000 fine and had to reimburse clients. Putnam's penalties totaled $1,050,000.)

Valuation is often an area where advisers fail to meet regulators' expectations. Even large organizations with sophisticated supervisory processes can make mistakes, as evidenced by the SEC's action against Citigroup Global Markets, Inc. In this case, Citigroup, a dually registered broker-dealer and investment adviser, settled charges that it failed to supervise its traders. The case involved undetected mismarking of illiquid securities by three different traders at different trading desks, as well as some unauthorized speculative trading. Citigroup's traders dealt with securities that did not have a readily available market value. At the same time, the traders were responsible for marking the value of these securities and had discretion in determining the values. At least two of the traders also received performance-based bonuses. The lure of a large bonus and the ability to manipulate performance numbers provided an irresistible temptation to cheat. Moreover, front line supervisors were not held accountable for the traders' valuations, making it easier for the traders to evade detection. Finally, corporate programs aimed at cost management eroded the ability of the last line of defense, the valuation control group, to catch the mispricing. The firm was fined $5.75 million.

There are two other valuation cases from 2018 worth mentioning. In Premium Point Investments LP ("Premium Point"), the firm was charged with a scheme that involved getting fake quotes from friendly brokers to pump up the value of the firm's portfolio. In Visium Asset Management, L.P., portfolio managers were also found to have manipulated portfolio values using inflated quotes from brokers.

Recommendation #1
An adviser that receives 12b-1 fees (whether directly as a dually registered broker-dealer or indirectly through an affiliated broker-dealer) as a result of using mutual fund share classes with 12b-1 fees for its clients should include specific disclosure on its Form ADV Part 2A. The disclosure should state that the firm [or its affiliate(s)] receives payments from third parties, such as 12b-1 fees, revenue sharing payments, and marketing support payments. This disclosure should identify the source of these payments, such as mutual funds, broker-dealers, custodians, etc. The firm should also state that the payments present a conflict of interest between the firm and its clients' best interests. Simply put, the firm has a financial incentive to invest client assets in mutual funds where the firm or its affiliates receive payments from outside parties. Finally, the disclosure should also address whether the firm and its IARs select mutual fund share classes that charge 12b-1 fees, even in situations where clients may be eligible for lower cost share classes of the same fund. This disclosure should also state whether the firm

has a specific process for selecting mutual fund share classes, and what factors are taken into consideration when making that decision.

Recommendation #2:
Advisers should conduct a review of conflicts of interest periodically (at least once a year). A conflict of interest is an activity or relationship that might provide an incentive for an adviser to act in a way that is not consistent with the client's best interest.

Another way to find conflicts is to follow the money. CFO's may balk at a CCO's request to review firm financials, including employee expenses, general ledgers, etc., but the benefit of this additional pair of eyes is that the CCO views the information through a different lens. This review can be critical in detecting undisclosed conflicts and other compliance matters. And it is better to find an issue before the SEC raises the question during an examination.

Recommendation #3: Take the lessons from the above cases to heart and review policies and procedures related to conflicted activities, such as valuation and cross trading, to ensure that they are robust and include sufficient controls to prevent similar issues.

Valuation:

- Address conflicts using oversight and governance. While a portfolio manager should participate in the valuation process, firms should consider establishing a valuation committee or de-facto valuation team with representation by senior firm managers to mitigate the impact of the portfolio manager's conflicted position. Recommended participants include the Chief Compliance Officer, head of operations/COO, CFO, internal legal counsel, and senior trading personnel.
- Procedures should include standard workflows to handle stale prices, subsequent events, and price challenges. Decisions made to address these issues should be carefully documented and reviewed by compliance.
- Where harder to value securities (referred to under GAAP as level 2 and 3) are used, firms should consider implementing look-back testing by comparing the actual sale prices to the fair value determined by the adviser and then analyzing any significant discrepancies. This can be a useful tool for advisers in refining their valuation processes.

Cross trading:

- Cross trading policies and procedures should be reviewed to ensure an appropriate level of oversight, testing, and consistency with disclosure documents.
- Suggested procedures could include: CCO pre-approval of cross-trading activity, establishment of a process to determine the price at which any approved cross is executed, and a review of that price against current market conditions. Similar to the valuation process, the portfolio manager should not be empowered to determine the price; firms should incorporate oversight and controls into these procedures.

2. CONFIRM YOUR COMPLIANCE PROGRAM ADDRESSES THE MOST FREQUENT ADVISORY FEE AND EXPENSE COMPLIANCE ISSUES IDENTIFIED IN EXAMINATIONS OF INVESTMENT ADVISERS IDENTIFIED IN THE SEC'S RISK ALERT

As part of its efforts to provide more information to registrants about its findings and concerns, OCIE issued this Risk Alert identifying the six most frequent deficiencies relating to advisory fees and expenses which include:

- Fee-billing based on inaccurate account valuations
- Billing fees in advance when a contract states arrears or with improper frequency
- Applying incorrect fee rates
- Omitting rebates and applying discounts incorrectly
- Inconsistent or inaccurate disclosures involving advisory fees
- Misallocation of expenses for private and registered investment funds.

Recommendations

Our experience at Hardin Compliance Consulting is consistent with these findings. We recommend that compliance officers test the billing process for accuracy and consistency with the advisory contract, Form ADV disclosures, and fund offering documents, as applicable. Review the Risk Alert closely and consider whether your firm has the appropriate processes in place to address the issues discussed. Testing the accuracy of these processes is essential. Consider the following practices to enhance the accuracy of the billing process:

1. Adopt a robust account onboarding process that includes a check and balance on the initial entry of the information in the firm's billing system to confirm that the fee schedule entered is consistent with the terms of the investment management agreement (IMA) and the disclosures related to fees in the Form ADV. If the firm offers breakpoints or prorates fee calculations for intra-period client cash flows, consider adding a review of these items as part of your firm's quality control process. It is important that the individual setting up the fee terms in the billing system should not be the same person checking them for accuracy.
2. Customized terms should be memorialized in the agreement and addressed in the review process.
3. Institute periodic transactional and forensic testing of fee terms and calculations to ensure that they are being calculated in accordance with the IMA's terms. For example, transactional testing could be performed by operations or accounting as an additional check and balance during the invoicing process. Forensic testing could be performed by compliance during the course of the annual compliance program review.
4. Review fee calculations made by intermediaries in situations where you, as the adviser, do not calculate the fee (such as in a subadvisory or wrap arrangement).
5. Confirm that the account values used to calculate the fees are consistent with the disclosure in the Form ADV and the IMA.
6. For firms that collect management fees in advance, ensure there is a process in place to determine when accounts are closed or transferred out, and that any unearned fees are refunded to clients. Include disclosure in Form ADV Part 2A so that clients know what to expect. For example, do not say unearned fees are returned "promptly" if that is not the case.
7. Review Form ADV Part 2A disclosures periodically to ensure that fee billing and fee calculation practices, including billing error correction, are accurately disclosed (including avoiding the use of "may" when a practice "is" occurring). Operations and on-boarding personnel should be involved in this review.
8. For private and mutual fund advisers, implement controls and compliance testing of fund expense processing to ensure that fund expenses are paid as stated in fund documents and

related disclosures. Firms should implement guidelines for determining when an expense is eligible for payment by the fund and for allocating expenses between a fund and its adviser, or across multiple funds.

9. Correct any billing or expense processing errors pro-actively and promptly. Similar to trade error procedures, maintain documentation related to any corrections and review the circumstances surrounding an error to prevent reoccurrence.

3. REVIEW OCIE'S RISK ALERT: MOST FREQUENT BEST EXECUTION ISSUES CITED IN ADVISER EXAMS AND CONFIRM YOUR POLICIES, PROCEDURES AND PRACTICES ADDRESS THE DEFICIENCIES CITED.

Best execution is always on the SEC's exam hit list for investment advisers, so this risk alert provides great information about what the examiners are finding. The common deficiencies cited were:

- Not performing best execution reviews
- Not considering materially relevant factors during best execution reviews
- Not seeking comparisons from other broker-dealers
- Not fully disclosing best execution practices
- Not disclosing soft dollar arrangements
- Not making a reasonable allocation of mixed-use products or services
- Inadequate policies and procedures related to best execution, and
- Not following best execution policies and procedures.

Recommendations

These deficiencies boil down to failure in the process, the documentation and the disclosure. Advisers that engage in equity and fixed income trading for their clients and have the discretion to select broker-dealers to execute trades should consider having the following processes in place and documentation that demonstrates their execution. Remember – if it isn't documented, it didn't happen.

1. Broker-dealer selection, including appropriate criteria to support using that firm to execute trades;
2. Evaluation of execution quality, including both quantitative and qualitative factors and taking into consideration feedback from traders and portfolio managers;
3. Soft dollar arrangement reviews, including determining whether products and services meet the criteria of Section 28(e) of the Securities Exchange Act safe harbor, formal approval of arrangements, allocation of mixed-use products; and
4. Review of commission payments.

Investment advisers that serve retail clients and use a limited number of broker-dealers to provide execution and custody services should consider having the following processes in place:

1. Documentation of the due diligence process involved in selecting the broker-dealer, such as a memo presented to firm management that compares the quality and costs of broker-dealers considered, including a discussion of the deciding factors;

2. Documentation of a review of the policies and procedures of the selected broker-dealer to confirm that regulatory requirements will be met;
3. Perform due diligence periodically (e.g., every three years) on the current and other potential broker-dealers to determine whether the clients are still receiving quality service at competitive prices; and
4. Documentation of discussions with their custodial broker-dealer regarding the reduction of fees and commissions (even if unsuccessful).

All advisers should consider developing a review process to make sure that the disclosures in Form ADV Part 2A are consistent with their practices. Consider requiring best execution or brokerage committees, traders and portfolio managers to review and approve the disclosure before Form ADV is filed. Although a compliance officer may do the drafting, those responsible for trading activity should own this disclosure. The cases brought by the SEC on best execution revolve around disclosure, so making sure it's accurate should be a firm-wide obligation.

4. REVIEW THE RISK ALERT: INVESTMENT ADVISER COMPLIANCE ISSUES RELATED TO THE CASH SOLICITATION RULE AND MAKE SURE YOUR FIRM HAS A PROCESS IN PLACE TO COMPLY WITH THE REQUIREMENTS OF RULE 206(4)-3.

OCIE also shared its list of compliance issues related to the Cash Solicitation Rule in a risk alert. It's not surprising that OCIE decided to highlight referral arrangements, since it has been our experience that advisers often neglect to comply with the Rule's requirements.

Recommendations:
Advisers should read this alert carefully and consider whether their current referral arrangements comply with Advisers Act Rule 206(4)-3. If your firm pays for referrals, then consider having a process in place for your compliance officer to review any referral arrangements ***before*** any referrals or payments are made. The process should include:

- Performing due diligence on the solicitor before entering into an agreement;
- Using a written agreement between the firm and the solicitor that meets the requirements of Rule 206(4)-3;
- Providing referred clients with disclosure that meets the requirements of Rule 206(4)-3;
- Receiving signed acknowledgements from referred clients confirming that disclosure document and Form ADV Part 2A has been received;
- Requiring certifications from solicitors periodically attesting to compliance with the agreement and the Cash Solicitation Rule; and
- Updating the Form ADV Parts 1 and 2A to disclose the solicitation arrangements.

I also recommend reviewing our blog post, 12 Things You Need to Know about Adviser Referral Arrangements and the Cash Solicitation Rule, which highlights additional regulatory issues to be considered when entering into referral arrangements under state law. For example, in many states, the act of recommending an investment adviser is considered providing investment advice, so a person receiving a solicitation fee has to register as an investment adviser representative. Some states also limit the ability of accountants and lawyers to receive referral fees.

Referral arrangements carry additional compliance burdens, so make sure you have a plan to address them.

5. ADDRESS HOW ELECTRONIC MESSAGING IS BEING USED FOR BUSINESS COMMUNICATIONS AND CONFIRM WHETHER YOUR FIRM IS RETAINING THE REQUIRED RECORDS.

Check out OCIE's Risk Alert: Observations from Investment Adviser Examinations Relating to Electronic Messaging, which identifies practices that can help advisers meet their recordkeeping obligations under Advisers Act Rule 204-2, the Books and Records Rule.

This Risk Alert recommends an incredibly broad range of actions for advisers to consider, including recommending that firms regularly review "popular social media sites to identify if employees are using the media in a way not permitted by the adviser's policies." Firms are also encouraged to run regular Internet searches or set up automated alerts "to notify the adviser when an employee's name or the adviser's name appears on a website to identify potentially unauthorized advisory business being conducted online." The alert also recommends that advisers establish a confidential reporting program "where employees can report concerns about a colleague's electronic messaging, website, or use of social media for business communications. Particularly with respect to social media, colleagues may be "connected" or "friends" with each other and see questionable or impermissible posts before compliance staff notes them during any monitoring."

Recommendation
The SEC dropped this risk alert like a bomb just before the holidays, and with the government shut down, the industry hasn't had a chance to voice its concerns or ask questions. The Pandora's Box of electronic messaging apps has been opened, however, so advisers need to address the use of these new venues of communication in their compliance programs, both from a policy and systems perspective.

There are a lot of good recommendations in this risk alert that can be used by advisers to augment their current supervisory process. Others seem overly intrusive (like asking employees to report about their colleagues' questionable posts on social media) or impractical (such as requiring employees to move messages received on an unapproved platform to one being captured and monitored by the firm). Before pulling your hair out trying to incorporate all of them in your compliance program, we recommend that advisers first understand how their employees and investment advisory representatives are using messaging apps and social media to communicate with clients outside the firm's email system. Are they texting, using instant messaging, personal email, or other forms of private messaging? Which communication platforms are they using, and which devices, e.g., firm computers, personal computers, tablets, websites, and mobile devices do they use? Management should use this information to evaluate the record-keeping costs and opportunities associated with the venues and apps the firm wants to use to communicate with clients.

Advisers have limited resources, so management should consider restricting the forms of electronic communications to be used to those that best support its business model and can be used in compliance with the Advisers Act Rule 204-2 (the "Books and Records Rule"). In addition to retaining client communications, the SEC also expects firms to supervise communications. The SEC has left it to investment advisers to use a risk-based approach in setting up monitoring programs; it encourages the use of compliance testing and device control mechanisms. Retaining and monitoring electronic communications takes time and resources, such as software programs and personnel to administer the software and review the communications. Advisers should consider the "value add" of a particular mode of communication before using firm resources to retain, administer, and supervise its use.

6. BE PREPARED FOR EXAMINERS CONTINUED SCRUTINY OF CUSTODY ISSUES.

The SEC's scrutiny of standard custody arrangements that retail investment advisers have with major custodians continues to be an exam focus. Compliance officers should consider reviewing the SEC's Guidance Update on Inadvertent Custody and the Investment Advisers Association (IAA) No-Action Letter and make sure they have addressed issues raised by Standing Letters of Authorization (SLOAs). For help determining whether your advisory firm has custody, check out our Custody SLOA Flow Chart here.

At least one state securities department has followed the SEC's lead in focusing on potential custody violations. The Pennsylvania Department of Banking and Securities issued a position letter on September 25, 2018 telling state-registered investment advisers and their investment adviser representatives to stop using client usernames and passwords to access client custody accounts. (The SEC issued a similar warning in an OCIE Risk Alert in 2017.) The Department Staff stated that accessing a client's custodial account using the client's password or username will be considered a "dishonest and unethical business practice" in Pennsylvania and a potential custody violation. Federally registered investment advisers should also pay attention, since the states can go after them for violations of state securities laws that amount to fraud.

Recommendations
Given all the attention given to this issue in 2017, advisers should have identified accounts with SLOAs and determined whether they would need to comply with the Custody Rule's surprise exam requirement or follow the seven steps set forth in the IAA No-Action letter to avoid custody. This year advisers should review and test the policies and procedures adopted to deal with the issues raised by SLOAs. Finally, because it may only occur infrequently, remind employees and provide training to reinforce the process for handling inadvertent custody.

7. WATCH YOUR BACK.

In 2018, there were at least three cases targeting Chief Compliance Officers ("CCOs"), and at least one other case brought by FINRA punishing a CEO for failing to provide adequate support to a CCO. The SEC will hold individuals accountable for wrongdoing, including those at the top of the corporate hierarchy.[1] As outlined in a speech, former director of the SEC's Division of Enforcement, Andrew Ceresney, the SEC will bring cases against CCOs where they have:

- directly engaged in misconduct unrelated to the compliance function,
- attempted to obstruct or mislead the SEC staff, or
- exhibited a wholesale failure to carry out their responsibilities as CCOs.

[1] See page 2, Division of Enforcement Annual Report 2018; and page 11, Division of Enforcement Annual Report 2017.

In 2018, there were at least four significant cases where regulators found CCOs and other corporate officers personally liable. The first case illustrates how CCOs can get into trouble when they directly engage in the misconduct. In its complaint against Ameratex Energy, Inc., et al, the SEC charged three oil and gas companies and their executives for engaging in a fraudulent scheme to raise $11.7 million for drilling projects. The SEC charged the corporate compliance officer personally, alleging that he knew what was going on and assisted in the sales efforts by drafting and reviewing communications to investors and filing Forms D with incorrect information. The CCO played a key role in the scheme, according to the complaint, by "adding an aura of legitimacy."

There were two other cases involving chief compliance officers that illustrated the "wholesale failure" to carry out the responsibilities of a CCO. In the first case, the SEC upheld a FINRA disciplinary against CCO Thaddeus J. North, former chief compliance officer for FINRA member with Southridge Investment Group LLC. Mr. North was fined $40,000 and suspended from all principal and supervisory capacities for two months for failing to perform some basic compliance blocking and tackling, including correspondence review. He also missed a significant regulatory issue completely, despite the presence of a large red flag. The second case involved a chief compliance officer who had notice, help, and resources to fix known issues and completely dropped the ball. The SEC banned the CCO from acting in a supervisory or compliance capacity in the financial services industry. The firm's president was also sanctioned because he was aware of the issues, but did nothing to fix them.

In the final case, FINRA suspended the president of the broker-dealer for his failure to supervise an inexperienced chief compliance officer. The case boiled down to the president's failure to address two compliance issues. First, the CCO was unable to perform adequate trade monitoring, even with the help of a consultant. The CCO asked for help, but the president apparently failed to follow up to confirm that she could perform the task. The president also failed to take any action after the CCO told him that a registered representative was engaging in excessive trading of Class A mutual fund shares.

Recommendations

The lessons here are simple. Chief compliance officers have to take the job seriously. Failure to understand your obligations can result in being barred from the industry. Another important takeaway is that CCOs should ask for help when they need it, preferably in writing. A compliance officer is not expected to know everything, nor is he or she expected to expend super-herculean efforts to get the job done. Like any other employee, a CCO should have the tools and resources necessary to do the job. Firm management is responsible for providing these resources.

The CCO cannot implement an effective compliance program or demonstrate a strong culture of compliance without the support and assistance of the firm's management. While it is a balancing act in any department to find the right level of resources, firm management should understand that ignoring requests for additional resources could result in personal fines and sanctions.

8. ADOPT POLICIES AND PROCEDURES TO PROTECT SENIOR AND VULNERABLE INVESTORS.

More than 20 states have adopted laws addressing financial exploitation of seniors and vulnerable clients. Some require investment advisers to report suspected or actual financial exploitation of seniors and vulnerable clients to state adult protective services agencies. FINRA has already adopted rule changes aimed at protecting senior investors, and the SEC has included protection of senior investors in its exam priorities since 2017.

Recommendations:
Understand your client base and what portion is represented by individuals 62 and over (both in terms of the number of clients and associated AUM). Review or consider developing policies and procedures that address issues associated with senior clients including (but not limited to):

- when the adviser feels a senior client may have possible diminished capacity or competence,
- handling of client requests to change beneficiaries, powers of attorney or trustee on accounts,
- requesting a trusted contact from senior clients,
- assisting clients in their transition from employment to retired status,
- handling of client accounts upon a client's death,
- frequency of client communication, and
- training on topics impacting senior clients.

Review adult protective services statutes in the states where you do business. Some states require broker-dealers and investment advisers to report suspected abuse, and impose misdemeanor penalties for failure to report. Check out this 50 state survey of laws governing senior and vulnerable investors prepared by Bressler Amery Ross.

9. SHORE UP YOUR CYBERSECURITY POLICIES AND PROCEDURES.

With the constant media reports of cyber-attacks and security breaches, including an EDGAR breach announced in late 2017, it's no wonder that OCIE's examination priorities for 2019 include cybersecurity protection. OCIE will be focusing on cybersecurity practices at investment advisers with multiple branch offices, including those that have recently merged with other investment advisers. OCIE will also be looking at access rights and controls, data loss prevention, vendor management, training, and incident response.

Recommendations
Review the SEC's case against Voya Financial Advisors, Inc. ("VFA") and learn from VFA's mistakes. Over a six-day period in 2016, fraudsters impersonating VFA representatives were able to get VFA's technical support staff to reset their passwords. According to the SEC, the intruders were then able to access the personal information of at least 5,600 of VFA's customers and account information for three customers. Although no unauthorized transfers resulted from the attack, VFA still had to pay a $1 million fine and retain an independent compliance consultant to review its policies and procedures to ensure compliance with Regulation S-P and Regulation S-ID. Show this case to your IT experts and ask whether your firm might have similar vulnerabilities.

This case serves as a reminder to advisers to update their policies and procedures in light of material changes to the business. In this case, VFA had not substantively updated its Identity Theft Protection Program since 2009, despite material changes in its business model, including the use of contractors. The SEC also found that VFA's cybersecurity procedures were not designed to apply to the systems used by the independent contractors, leaving gaps that were exploited by the intruders. A full discussion of all the "do's and don'ts" is beyond the scope of this article, so check out the Recommended Resources listed at the end of this article under "Cybersecurity."

10. MUTUAL FUND AND ETF ADVISERS, AND THEIR SUB-ADVISERS, SHOULD REVIEW THE RISK ALERT: RISK-BASED EXAMINATION INITIATIVES FOCUSED ON REGISTERED INVESTMENT COMPANIES AND PREPARE TO BE EXAMINED.

OCIE is interested in index funds that track custom-built indexes; smaller, low trading volume ETFs; mutual funds with underperformance relative to peer groups; and funds with high allocations to securitized assets (such as certain securitized loans, credit card receivables, or mortgage-backed securities). OCIE is also looking at advisers that are either new to mutual funds or that provide 'side-by-side' advice to mutual funds and private funds. Review the Risk Alert for the specific focus areas for the funds and advisers.

OCIE wants to better understand how risks and conflicts are reviewed by advisers to investment companies, how they are disclosed to the board and shareholders, and how policies, procedures and controls are developed to address them. The risk alert also identifies key areas examiners plan to address within each category:

- Index funds with custom indexes have unique relationships with index providers and OCIE plans to explore these arrangements, associated conflicts, and potential disclosure issues. OCIE will also be looking at the portfolio management process.
- Advisers to low trading volume ETFs should expect questions about the market risks associated with low trading volume, how those risks are managed and the depth of the disclosures provided to a fund's shareholders and the board. This includes board monitoring of the fund as a going concern, as well as ensuring that any liquidation and/or delisting procedures receive proper oversight.
- Advisers with underperforming funds relative to peers will likely receive requests for detailed information about portfolio management and allocation decisions. They will also likely be asked whether the investments comply with disclosures in the fund documents, and whether fund marketing materials accurately portray the fund's objectives, policies, risks, and/or restrictions, and use of leverage.
- Funds heavily invested in securitized assets should expect questions related to risk disclosures, portfolio management, and valuation processes. OCIE will also be scrutinizing ongoing monitoring and board oversight of these activities.
- Side-by-side management is of perennial interest in examinations given the conflicts – especially those associated with allocation and brokerage decisions when fee schedules between the vehicles differ.

This risk alert provides advisers with advance notice of OCIE's focus areas, instead of issuing guidance after the fact of commonly identified deficiencies. We recommend that advisers be proactive in reviewing their compliance programs (including their risk assessment and testing program). While the SEC's decision to share this insight in advance of this exam initiative should be welcomed by advisers as a planning resource, it also seems reasonable that the SEC will also expect more of them.

11. ADVISERS TO MUTUAL FUNDS AND ETFS SHOULD BE WORKING ON THEIR LIQUIDITY RISK MANAGEMENT PROGRAMS TO COMPLY WITH INVESTMENT COMPANY ACT RULE 22E-4.

The SEC has revised the compliance date for classification, highly liquid investment minimum, and board approval, as well as related reporting requirements of Part D on Form N-LIQUID and liquidity disclosures on Form N-PORT under the Investment Company Act of 1940. The revised compliance date is now June 1, 2019 for larger entities (extended from December 1, 2018), and December 1, 2019 for smaller entities (extended from June 1, 2019).

Recommendations

- Advisers to funds should check out the SEC FAQ site (listed in the Resources section below) while developing their LRMPs.
- Boilerplate LRMPs will not be effective, practical or in the spirit of the regulation. Firms should spend the time to tailor their programs to reflect the types of securities traded by their funds and typical shareholder flow patterns. Taking a thoughtful approach on the front end should result in a more effective and practical LRMP.
- Fund managers should consider:
    - whether to assign liquidity categories on a security-level basis, or to assign them by asset class. Firms considering the latter will need to define and apply "asset class" consistently and meaningfully to ensure the definition established rings true to the investment strategy, including the size of positions typically taken by the fund. They will also be required to monitor securities for "reasonable exceptions" and potentially to classify or reclassify securities that fall outside the definition of its asset class.[2]
    - the impact that any shareholder cash flow patterns or trends when establishing the minimum percent of highly liquid securities permitted.
    - Fund of funds should consider the look through related requirements in the rule so that they are prepared to determine when they will (or will not) look through the liquidity of underlying fund holdings vs. liquidity of the fund investment as a whole.
- Advisers should consider other sources of fund liquidity when evaluating liquidity management, including standard overdraft provisions and/or lines of credit.
- Firms should consider whether to implement a pre-trade review of liquidity. Although there is no requirement to assign a holding to a liquidity bucket ahead of trading, the rule requires firms to implement reasonable policies and procedures to avoid investing more than 15% of the portfolio in illiquid securities. Check out the FAQ for procedures suggested by the SEC to assist in this determination.
- RIA operations will need to be able to generate sufficient data to monitor the liquidity characteristics of its holdings and satisfy new regulatory reporting requirements. For example, firms assigning liquidity buckets by "asset class" may systematically refresh these liquidity buckets in a monthly batch process. Firms will still need procedures to monitor for "reasonable exceptions" (described in the Interim Release[3]) and firms are encouraged to develop a list of the types of events that would prompt a mid-month reclassification. Advisers will also need a way to monitor the 15% illiquid level and the selected highly liquid investment minimum on a regular

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[2] See Interim Release at page 6.
[3] *Id.*

basis because they will be required to quickly report breaches to the board and the SEC using Form N-LIQUID.

Takeaways for Private Fund Advisers: Cayman Island Funds & Changes from CIMA

Beneficial Ownership Register Compliance: Private equity and hedge funds in the Cayman Islands should confirm with their administrators whether they are subject to the Cayman Islands Monetary Authority ("CIMA") new beneficial ownership register rule. The Cayman Islands government passed two laws outlining this new beneficial ownership regime, The Beneficial Ownership (Companies) (Amendment) Regulations, 2018, and The Beneficial Ownership (Limited Liability Companies) (Amendment) Regulations, 2018 (the "'Amending Laws"). Companies and limited liability companies incorporated or registered in the Cayman Islands are required to maintain a beneficial ownership register at their Cayman Islands-registered offices (or appointed service provider), unless an exemption applies.

CIMA AML Regulations. Cayman Island fund managers should confirm that their policies are in compliance with the Cayman Islands Monetary Authority's ("CIMA's") anti-money laundering regulations. CIMA made a number of key changes in 2018 to expand the reach of its AML regulations to unregulated entities, including private equity, venture capital and real estate funds, insurance entities, and finance vehicles like collateralized loan obligations ("CLOs").

We hope you found these recommendations helpful. We welcome your feedback!

Recommended resources:

- Retail, Remedies, Resources and Results: Observations From the SEC Enforcement Division 2018 Annual Report
- Investment Adviser "To Do" list for 2019

Conflicts of Interest and Best Execution

- Conflicts of Interest Facing Investment Advisers, presentation by Morgan Lewis from 2003.
- Why the SEC is Obsessed with Mutual Fund Share Class Selection and Disclosure (and why you should be too)
- The Real Nightmare before Christmas: SEC Gets Tough on Firms that Did Not Self-Report during SCSD Initiative
- BD/IA pays $2.2 million to Compensate Investors for Recommending More Expensive Mutual Fund Share Classes
- SEC Nails Three Advisors for Fiduciary Failures when Selecting Mutual Fund Share Classes
- In the Matter of deVere USA, Inc.
- SEC vs. Benjamin Alderson and Bradley Hamilton
- SEC Slams Firm For Failing to Disclose Payments From Outside Managers
- SEC fines RIA $8 million for Failure to Disclose Kickbacks

Cross Trading Cases

- In the Matter of Hamlin Capital Management, LLC
- In the Matter of Putnam Investment Management, LLC and Zachary Harrison),

Valuation Cases

- Citigroup Global Markets, Inc.
- In the Matter of Premium Point Investments LP
- In the Matter of Visium Asset Management, L.P.

Cash Solicitation Rule

- 12 Things You Need to Know about Adviser Referral Arrangements and the Cash Solicitation Rule
- The CPA's Guide to Investment Advisory Business Models

Electronic Communications

- Electronic Communications in SEC Examinations and Investigations
- SEC Sweep on Electronic Communications Document List

Custody Rule

- Custody Rule Refresher: Review of Most Recent SEC Guidance

CCO and Executive Liability

- Case regarding Thaddeus J. North, CCO, appeal from FINRA Disciplinary Action
- Southwind Associates of NJ Inc. (D/B/A Villafranco Wealth Management), William Scott Villafranco, and Anthony Laperuta
- Financial Industry Regulatory Authority Letter of Acceptance, Waiver and Consent re: Wayne Ivan Miller
- Cautionary tale: SEC goes after CCO for Aiding and Abetting Fraud Scheme

Protecting Seniors and Vulnerable Investors

- SEC's white paper: Elder Financial Exploitation: Why it is a concern, what regulators are doing about it, and looking ahead.
- SIFMA's Senior Investor Protection Toolkit
- Bressler Amery Ross's Senior and Vulnerable Investors Laws 50-State Survey.

Cybersecurity

- In the Matter of Voya Financial Advisors, Inc.
- North American Securities Administrators Association Cybersecurity Checklist for Investment Advisers
- FINRA Small Firm Cybersecurity Checklist
- FINRA Report on Cybersecurity Practices

- OCIE Risk Alert: Observations from Cybersecurity Examinations

Mutual Fund and ETF Advisers

- Risk Alert: Risk-Based Examination Initiatives Focused on Registered Investment Companies

Liquidity Rule Compliance

- SEC Amends Liquidity Rule Reporting and Disclosure Requirements
- SEC Requires Mutual Funds to Adopt Liquidity Risk Management Programs
- Investment Company Liquidity Risk Management Programs Frequently Asked Questions
- Investment Company Liquidity Risk Management Program Rules – Small Entity Compliance Guide

CIMA

- Cayman Islands Requires Companies to Maintain Beneficial Ownership Register; Is Your Fund In or Out (of Scope)?
- Cayman Islands Fund Managers Face New Anti-Money Laundering Requirements
- Cayman Islands - The Anti-Money Laundering Regulations 2017

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