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"Each fund or adviser should determine whether these or other measures need to be considered in … addressing cybersecurity."

SEC Offers Cybersecurity Guidance with Specific Recommendations

The SEC's Division of Investment Management doesn't go so far as to say "do this" or "do that" in its latest cybersecurity warning. But it comes a lot closer than it did before.

The Division on April 28 issued a cybersecurity guidance update, suggesting specific "measures" that advisers and funds "may wish to consider" in addressing cybersecurity risk. The suggested measures are fairly detailed. A February risk alert from the agency's Office of Compliance Inspections and Examinations provided results of a cybersecurity survey of advisers it performed last year, but offered few recommendations for action.

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OCIE Turns Its Attention to Never-Before-Examined Investment Companies

Mutual funds, open-end funds and other investment companies that have never been examined should start getting a bit nervous: Examiners may be coming.

The SEC's Office of Compliance Inspections and Examinations created some buzz last year with its examinations of never-before-examined advisers. Apparently considering that program a success, the agency in January announced that in 2015 it would do the same with never-before-examined investment companies. In an April 20 National Exam Program risk alert, OCIE put some detail behind that announcement, letting

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Valuation: What Examiners Want to Know

Examiners follow the money.

Valuation is where the money starts. After all, valuation "impacts performance, which impacts marketing, which impacts how assets under management grow, which impacts fees," said **Mayer Brown** partner **Rory Cohen**. In short, it involves issues of investor fairness and conflicts of interest – both major red flags to SEC examiners.

Private funds in particular need to be concerned about examiner inquiries into valuation, said **Zaccaro Morgan** partner **Nicolas Morgan**. Hedge fund managers, for instance, have part of their compensation tied to the value of their portfolio. Private

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SEC Offers Cybersecurity Guidance

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The new guidance update "is more specific because the agency's earlier risk alert was basically 'survey says,'" said **Sutherland** partner **Brian Rubin**. But similar recommendations are available from other quarters. For instance, he said, when FINRA provided its cybersecurity report in February, it provided specific guidance.

K&L Gates partner **Sean Mahoney** noted that the alert is the first time the SEC, which he said has referred to cybersecurity measures before, has explicitly suggested them in one document. "The tone of this alert is that, 'We think it would be a good idea for you to do x, y and z,' whereas up to this point the SEC has been implicit about its expectations with regard to cybersecurity."

The guidance alert also means that "every adviser should now expect that every examiner will ask how they are addressing cybersecurity," he said.

The issue has been an SEC priority since April 2014, when OCIE issued a risk alert outlining the launch of its "cybersecurity initiative," following a Commission cybersecurity roundtable held the month before. "Cybersecurity threats know no boundaries," said SEC chair **Mary Jo White**. "Through our engagement with other government agencies as well as with the industry and educating the investing public, we can all work together to reduce the risk of cyber attacks."

"Cyber attacks on a wide range of financial services firms highlight the need for firms to review their cybersecurity measures," the new guidance update says. Those SEC staff concerns were also influenced by discussions the staff had with fund boards and senior management advisers.

One size does not fit all

Advisers and funds will be glad to see that the SEC staff "recognizes that it is not possible for a fund or adviser to anticipate and prevent every cyber attack." Nonetheless, it uses the guidance alert to state that "appropriate planning ... and a rapid response capability may ... assist funds and advisers in mitigating the impact of any such attack and any related effects on fund advisers and advisory clients, as well as complying with the federal securities laws."

Mahoney interprets this to mean that the SEC is leaning toward a risk-based approach to cybersecurity, rather than a checklist-based approach requiring advisers to take specific actions. Under a risk-based approach, risks are assessed, controls and systems are put in place to mitigate risks, activities are then monitored, events are responded to, then corrections to controls and systems are made if needed, with the process continuously repeated. It's all part of business continuity, he said, something the SEC has also taken a strong interest in for some time.

The guidance suggests three categories of action, with each broken down into specific actions.

Periodic assessments

The first category of action suggested by the SEC staff is to conduct periodic assessments in five areas:

- The nature, sensitivity and location of information the firm collects, processes and/or stores, and the technology systems it uses;
- Internal and external cybersecurity threats to and vulnerabilities of the firm's information and technology systems;
- Security controls and processes currently in place;
- The impact should the information or technology systems become compromised; and
- The effectiveness of the governance structure for the management of cybersecurity risk.

"An effective assessment would also assist in identifying potential cybersecurity threats and vulnerabilities so as to better prioritize and mitigate risk," the guidance alert said.

The right strategy

The second action category suggested was to "create a strategy that is designed to prevent, detect and respond to cybersecurity threats." The strategy would address the following five areas:

- Controlling access to various systems and data via management of user credentials, authentication and authorization methods, firewalls and/or perimeter defenses, tiered access to sensitive information and network resources, network segregation, and system hardening;
- Data encryption;
- Protecting against the loss of exfiltration of sensitive data by restricting the use of removable storage media and deploying software that monitors technology systems for unauthorized intrusions, the loss or exfiltration of sensitive data, or other unusual events;
- Data backup and retrieval; and
- The development of an incident response plan.

"Routine testing of strategies could also enhance the effectiveness of any strategy," the staff said.

Policies and procedures

The third action category is implementing the strategy. This should be done through written policies and procedures, as well as training, "that provide guidance to officers and employees concerning applicable threats and measures to prevent, detect and respond to such threats, and that monitor compliance with cybersecurity policies and procedures," the guidance update said. It added that firms may also wish to educate investors and clients about how to reduce their exposure to cybersecurity threats concerning their accounts.

Tailor your programs to fit your operations

The guidance alert recognizes that funds and advisers are "varied in their operations." For that reason, it said, "they should tailor their compliance programs based on the nature and scope of their businesses."

The measures suggested in the guidance alert "are not intended to be comprehensive," the alert says. "Other measures may be better suited depending on the operations of a particular fund or adviser. Each fund or adviser should determine whether these or other measures need to be considered in connection with addressing cybersecurity attacks."

Tying cybersecurity risk to compliance risk

Cybersecurity risks may also have an effect on overall securities law compliance. Funds and advisers should identify their respective compliance obligations under federal securities laws and take into account these obligations when assessing their ability to prevent, detect and respond to cyber attacks, the staff said. Doing so will allow them to mitigate exposure to any compliance risk associated with cyber threats through compliance policies and procedures reasonably designed to prevent violations of securities laws.

"For example," the guidance alert says, "the compliance program of a fund or an adviser could address cybersecurity risk as it relates to identity theft and data protection, fraud and business continuity, as well as other disruptions in service that could affect, for instance, a fund's ability to process shareholder transactions." To this end, the alert suggests that funds and advisers might want to "consider reviewing their operations and compliance programs and assess whether they have measures in place that are designed to mitigate their exposure to cybersecurity risk."

Vendors and networks

Vendors are also a concern, with the guidance noting that because funds and advisers rely on a number of service providers, they "may also wish to consider assessing whether protective cybersecurity measures are in place at relevant service providers." But it does not specify which cybersecurity measures might be relevant to each type of service provider.

Funds and advisers affiliated with other entities that share common networks should consider whether it may be appropriate to conduct an assessment of the entire corporate network, the staff said.

Finally, the guidance update suggests that funds and advisers consider implementing a mechanism "to monitor for ongoing and new cyber threats." They can do that, it said, by gathering information from outside resources, such as vendors, third-party contractors specializing in cybersecurity and technical standards, and topic-specific publications and conferences.

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OCIE Turns Its Attention

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the investment fund community know just what areas would be covered by the examinations.

In recent years, OCIE has been plagued by a shortage of examiners – something the SEC is seeking to address in its 2016 budget request (*ACA Insight*, 4/27/15). In order to get the most bang from its examination buck, it has developed innovative methods of determining just which advisers and funds should be examined. Many of these methods are based on risk, often determined by computer models. Other examinations are based on new developments that call for attention, such as cybersecurity.

"The primary focus is on the following types of funds: open-end funds (i.e., mutual funds); closed-end funds; and underlying insurance funds," OCIE said in the new risk alert. "The emphasis will be on registered investment company complexes that were launched one or more years ago." It did not state just when in 2015 such examinations would start or if they have, in fact, already started.

"We welcome OCIE publishing information regarding its planned areas of focus for targeted exams, as this information enables other registrants that may not be visited as part of a review to assess their own operations, with a focus on those areas that are of interest to the SEC," said an Investment Company Institute spokesperson.

The initiative will probably make investment companies who have never been examined "a bit nervous," said **Wilmer Hale** partner **Douglas Davison**. "Those that are small shops may have the same person in charge of compliance and in charge of other responsibilities, and now they will need to prepare for an exam and handle document requests."

Investment companies should consider the following, he said, to make the preparation somewhat smoother:

- **Identify who will be the lead person when the examiners arrive.** This could be the person currently in charge of compliance, but does not have to be. The ideal person will be someone with a patient temperament, articulate, and who is up to speed on the subject matter, or can quickly find appropriate answers to examiner questions.
- **Get the paperwork in order.** Funds should be able to determine from the given topic areas listed below just what types of documents will probably be asked for. "Funds should not wait. They should get the right documents in order now," Davison said.
- **Conduct a mock exam.** This involves having a consulting firm or law firm play the role of SEC examiners and conducting an exam just as the real examiners would.

What examiners will examine

What the risk alert did reveal, in some detail, were the "higher-risk areas" that examiners will focus on, and listed five specific ones. Each examination will focus on two or more of the following areas:

- **Compliance programs.** Examiners will look at both fund and adviser compliance programs in regard to four specific areas: proxy voting policies and procedures for portfolio securities, proxy voting policies and procedures for fund shares, timeliness and accuracy of registration statements and other periodic report filings, and codes of ethics for identifying and mitigating conflicts of interest. "Rule 38a-1 under the Investment Company Act requires each fund to adopt and implement policies and procedures reasonably designed to prevent the fund from violating the federal securities laws," OCIE said. "The policies and procedures must provide for the oversight of compliance by the fund's investment advisers, principal underwriters, administrators and transfer agents … through which the fund conducts its activities."
- **Annual advisory contract review.** Examiners will scrutinize fund advisory contracts, including sub-advisory contracts, to determine "the adequacy of the basis for the board's determination of whether the advisory fee is fair and reasonable; and … the management of any adviser's conflicts of interest with respect to its obligations to the fund and the fees it receives."

- **Advertising and distribution of fund shares.** Examiners will assess a fund's policies, procedures and controls in regard to the review and approval of advertising materials. They will also "review fund disclosure of breakpoints and the practical application of any procedures in place to assess whether and to what extent breakpoints are correctly applied and monitored," OCIE said. Fund marketing materials are subject to statutory and regulatory restrictions, unless eligible for an exemption or exception.
- **Valuation of portfolio assets and NAV calculation.** Examiners will review fund valuation and NAV calculation methodology policies and procedures and practices, as well as the board's processes for carrying out valuation oversight. A fund's NAV is required to be calculated using, for portfolio securities with readily available market quotations, the current market value of those securities. For securities and assets for which market quotations are not readily available, fair value must be determined in good faith by the fund's board.
- **Leverage and use of derivatives.** Examiners will look at three areas here: compliance with asset coverage requirements under Section 18 of the Investment Company Act, asset segregation in relation to SEC staff-issued guidance, and whether funds' disclosures "appropriately convey the funds' use of derivatives and the associated risks with such investments," OCIE said. Section 18 restricts the amount of borrowing by open-end and closed-end funds in order to protect fund investors from "excessive borrowing by funds that would increase the speculative character of fund shares and to ensure that funds operate with adequate reserves."

OCIE cautioned that "examiners may select additional topics based on operational and other risks identified by the staff during the course of the examination."

Valuation

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equity fund managers may want the NAV of their funds to be as high as possible when raising additional capital. The agency's Asset Management Unit in the Division of Enforcement focuses on hedge fund activities, with its Aberrational Performance Inquiry zeroing in on improbable returns from hedge funds. The unit has brought a number of cases in recent years. Improper valuation may be a contributing factor when it finds such returns, said Morgan.

Expect examiners to ask these questions:

- **Does your firm have an independent process designed to derive a fair value?** "Your firm should consider having a formal process for valuation," said Morgan, and it should be spelled out in your firm's policies and procedures. Valuation of particular securities may change over a quarter because of market circumstances or other reasons. Your firm should revaluate at least often enough to match a private fund's publication of its performance results with the timing of subscriptions and withdrawals, which often will mean monthly.
- **Does your firm's actual valuation process follow its policies and procedures?** This goes to the heart of examiners determining if what your firm says it is doing is, in fact, what it is doing, said Cohen. You don't want your firm's policies and procedures stating that it is following methodology A when, in practice, it is following methodology B. Morgan suggested that a two-column chart comparing and contrasting how your firm is matching its policies and procedures in this regard would be helpful, with one column showing the particulars of your firm's stated valuation methodology and the other showing the actual practice.
- **Are there any conflicts of interest that may impede fair valuation?** These typically involve compensation or performance issues, said Cohen. For instance, a conflict of interest would exist if a portfolio manager participated or otherwise had influence on the valuation committee, because he or she has a direct interest in the valuation. The existence of such conflicts of interest may warrant disclosure to the full committee, investors and potential investors, Morgan said. It can be mitigated by making sure there are enough other committee members who would not so benefit,

thereby ensuring that committee members with the conflict could not, by themselves, make a final valuation decision.

- **How does your firm valuate illiquid assets?** Assets that are not liquid, such as mortgage backed securities or collateralized debt obligations, are particularly difficult to value because, Morgan said, unlike liquid securities, a firm cannot simply check what an illiquid security was last publicly traded for. Determining a fair value in such cases will require research into the company issuing the illiquid security; broker quotes, if available; and more. Make sure you have documentation showing the steps you took to properly value such assets.

- **Do your firm's disclosures to investors accurately describe the valuation process?** Expect examiners to scrutinize your Forms ADV, offering documents, limited partnership agreements and operating agreements to see if there is adequate disclosure. Any conflict of interest, such as a compensatory one, should be evaluated for possible disclosure, said Morgan. "The SEC will almost always view more disclosure more favorably than less disclosure."

- **Is your firm's valuation process monitored and updated?** Examiners do not want to see a static, never-changing valuation process that doesn't take market shifts or better valuation techniques into account. You should be able to demonstrate to examiners that your firm's valuation process is regularly reviewed and, when necessary, updated, Morgan said. Cohen suggested that one good way to do this is by periodically testing your valuation processes, checking everything from whether calculations were correct to whether your policies and procedures were followed (*see above*). "Sit in on valuation committee meetings, pay attention to detail, evaluate efforts to override or seek exceptions, determine whether similar securities are valued in a similar manner, and seek to identify stale pricing," he suggested.

- **Is your firm getting "binding marks" or "indicative marks" when getting quotes from brokers?** Firms often seek multiple broker quotes when pricing illiquid assets, said Cohen. Make sure those marks are true estimates of an asset's worth, and not just initial suggestions used to start the conversation to help determine the value ballpark. In weighing the value of quotes, place greater value on binding marks and those that may reflect actual market transactions, he said, adding that you should "be consistent in selecting brokers for quotes." SEC Asset Management Unit co-chief **Julie Riewe**, in a February 26 speech, noted that "friendly broker marks" were an upcoming agency target.

- **Is your firm using a third-party valuation service?** Using qualified independent third-party valuation firms for illiquid and hard-to-value securities would be "seen as a good thing" in the eyes of examiners, said Cohen. But that does not mean that firms not using an independent third-party service will necessarily run into trouble, he said.

Advisory Agreement Case: SEC Files New Charges After $55M Court Win

Watch out for those old active advisory contracts. They can come back and bite you.

The SEC on April 28 instituted administrative proceedings against adviser **Charles Kokesh**. The Commission action followed a March 30 final judgment by the U.S. District Court for the District of New Mexico, in which Kokesh was ordered to pay more than $55 million in disgorgement, interest and civil money penalties. The final judgment was the result of a November 2014 five-day trial that led to the adviser's conviction of misappropriating almost $35 million in client funds from 1995 through July 2007 at two registered advisers he controlled (*ACA Insight*, 11/17/14).

Now, with the SEC order of administrative proceedings, Kokesh faces the prospect of additional sanctions.

What Kokesh did was receive prohibited reimbursements, distributions and performance fees from four business development companies he managed, said the SEC, which filed the original complaint against him in October 2009. The payments were not allowed by the firm's advisory agreements with the four BDCs, according to the complaint.

The alleged crimes occurred well after the advisory agreements were signed. While the improper expense reimbursements began in 1995, the business development companies had raised funds from investors from 1987 to 1993 pursuant to agreements that were signed "in the 1980s and 1990s,"according to the SEC.

One lesson that advisers can take away from this case is that the SEC "will carefully scrutinize the fees and expenses that they charge their clients and look to see whether expenses charged separately are for items that should be covered by the management fee," said **Mayer Brown** attorney **Matthew Rossi**.

"The final judgment in this case shows the importance the SEC places on investment adviser representations to investors about the use of their funds," said **Zaccaro Morgan** partner **Nicolas Morgan**. "The SEC scrutinizes any discrepancies between distributions, performance fees, and expenses and representations to investors about those topics in documents such as proxy statements and reports filed with the SEC. In this case, both the judge and jury appeared to strongly agree with the SEC's view."

Of the approximately $55 million judgment, about $53 million was for disgorgement and interest, and approximately $2.35 million was a civil money penalty. The SEC charged Kokesh with violating Section 57 of the Investment Company Act for stealing funds; Section 13(a) of the Exchange Act and several of its rules for filing false and misleading annual and quarterly reports; Section 14(a) of the Exchange Act and its Rule 14a-9 for issuing false and misleading proxy statements; Section 205 of the Investment Company Act for misuse of the mails and interstate commerce to commit fraud; and Sections 206(1) and (2) of the Advisers Act for aiding and abetting his advisory firms in committing fraud. An attorney representing Kokesh, reached by telephone, did not comment on the final judgment or the case.

The BDCs and the agreements

Just how did the payments received by the advisory firms from the business development companies differ from what the SEC said the advisory agreements allowed? According to the agency, here are some of the ways:

- **Reimbursement.** The advisory agreements said that the advisory firms would be reimbursed by the business development companies for operational costs, which were defined as expenses related to

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the selection of portfolio companies or to proposed investments. Specifically prohibited was reimbursement for rent, salaries and fringe benefits incurred by any controlling persons of the Kokesh advisory firms. *What the SEC said happened:* The advisers caused the four business development companies to reimburse the Kokesh Advisers at least $15 million for rent, salary and fringe benefits in violation of the advisory agreements.

- **Distribution.** The advisory agreements called for the business development companies to pay 99 percent of any distribution to investors and 1 percent to the Kokesh advisory firms until the investors received a complete return of their initial investment. Afterwards, each business development company was to receive 80 percent of the distributions, with the advisory firms receiving the remaining 20 percent. The only exception to this arrangement was for distributions to cover tax liabilities associated with the sale of business development company assets. *What the SEC said happened:* From 1995 through 1999, the advisers caused three of the four business development companies to pay the advisory firms $760,000 in distributions without corresponding distributions to investors. There were no tax liabilities that would have allowed such distributions.

- **Performance fees.** Under the advisory agreements, the advisers would receive a performance fee of 20 percent of each business development company's portfolio gains, calculated as no more than 20 percent of the net profit of the partnership after taking into account all cumulative net loss. *What the SEC said happened:* The advisory firms calculated net profit "by combining both realized and unrealized gains in each [business development company's] portfolio," the agency said. "Because the calculation included unrealized capital gains, the Kokesh Advisers charged the BDCs higher performance fees than they were allowed to charge under Section 205(b)(3) of the Advisers Act," not to mention their advisory agreements.

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