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ACA Insight

The weekly news source for investment management legal and compliance professionals

"In a perfect world, this is what you would want. But it's a lot to put on one human being, the chief compliance officer."

Inside Insights

7 SEC Will No Longer Seek Certain Retroactive Collateral Bars

SEC's Donohue: If I Were a Chief Compliance Officer …

Andrew "Buddy" Donohue, now back at the SEC as chief of staff, has some sage advice to compliance professionals: the nine categories in which he would focus his time if he were a chief compliance officer. Given his history at the agency and his current role, it might be wise to pay attention.

Donohue's return to the SEC was announced this past May. He left in 2011 after serving approximately five years as director of the Division of Investment Management. He was also responsible for compliance and legal functions at several large financial institutions, including **Goldman Sachs**, **Merrill Lynch** and **Oppenheimer Funds**, so he

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Private Funds: Low Systemic Risk, High Operational and Management Risk

The SEC has delivered a private fund one-two punch: systemic risks from private funds due to high leverage and too much reliance on derivatives are not as great as some feared, but risks from operational and management issues within advisory firms and the private funds they manage are significant and need to be policed.

The message was delivered October 16 via the release of Form PF aggregate data, and in a speech SEC chair **Mary Jo White** delivered to the **Managed Funds Association** in New York City the same day.

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SEC Commissioner Nominees Face Key Votes

Lisa Fairfax and **Hester Peirce** are going to have an interesting few months ahead of them.

The two, nominated last week by president **Barack Obama** as SEC commissioners, will first face the sometimes-grueling process of Senate confirmation. Once confirmed, they are likely to be called upon to support SEC chair **Mary Jo White's** agenda on issues such as the proposed data reporting rules for advisers and funds, the proposed liquidity risk management rules for mutual funds, and expected upcoming proposed rules on derivatives, transition planning, and stress testing.

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SEC's Donohue

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has some credentials to speak, which he did🖰 October 14 at the **National Regulatory Services** 30th Annual Fall Investment Adviser and Broker-Dealer Compliance Conference.

At the conference, Donohue addressed a variety of compliance topics, including CCO fear of liability, how the SEC's Office of Compliance Inspections and Examinations identifies risk, and the SEC's use of data and technology to collect information.

Varied reactions

Industry professionals took differing views on what Donohue had to say.

"CCOs and others involved in supporting the culture of compliance in investment advisory firms will want to pay careful attention to Donohue's observations and guidance," said **Sidley Austin** partner **Jonathan Miller**. "He speaks not only with the authority of his current position as chief of staff, but also from long experience as a regulator and in the private sector of the investment management industry."

"It's a tall order," said **Investment Adviser Association** president **Karen Barr**. "In a perfect world, this is what you would want. But it's a lot to put on one human being, the chief compliance officer."

"The speech is a nice starting point for compliance professionals," said **Mayer Brown** partner **Richard Rosenfeld**. "The list of considerations Donohue offers is useful, but in the current atmosphere where 'broken windows' technical cases are an ever increasing part of the regulatory enforcement landscape, his final bullet, asking CCOs to learn what they don't know, is increasingly the argument that securities regulators use to extract settlements from market participants."

"Regulators are increasingly bringing enforcement actions in cases where there is no knowledge or intent of wrongdoing," Rosenfeld said. "In these increasingly common cases, there is often, at most, a technical unintended misstep by a good, well-meaning market participant. The problem is not that inadvertent technical faults can never be violations, but rather that the enforcement climate has moved from addressing these issues through a telephone call to bringing the full weight of a public settlement down upon a market participant 'for the good of the market.'"

What Donohue would do

"If I were a chief compliance officer, I would consider my role in terms of the following categories," Donohue told the attendees, adding that the list was "non-exhaustive," meaning that the categories listed are just some of the areas CCOs should address:

- **Laws, regulations and other requirements.** "I would need to have first-hand knowledge of the various laws and regulations that apply to my firm and its activities as well as any particular conditions or requirements of exemptive orders or other compliance requirements," Donohue said. Included in this knowledge, he said, would have to be an understanding of the "interplay of the requirements of the various regulatory regimes applicable to the firm based on its business model and the jurisdictions in which the firm operates." Certainly it's important for CCOs to know applicable domestic laws and regulations, said Barr, but it may not be realistic for them to know "the intricacies of foreign regulations in jurisdictions around the globe." The answer, she said, is for Donohue and others at the SEC to say that "you are allowed to rely on others," such as in-house counsel and external law firms. "It's not a one-man or one-woman show."
- **Organization and operations of the firm.** A deep understanding of the firm, its structure, and internal operations would be necessary, Donohue said. "I would also need to develop a working knowledge or roadmap of how the different areas of the firm interacted with, or were dependent upon, other areas of the firm." Finally, he said that a detailed knowledge of the supervisory structure of the firm would be "essential."
- **Conflicts of interest.** "I would need to have a clear understanding of how the firm identifies all of the conflicts of interest that might exist; how frequently potential conflicts are reviewed; and, when conflicts

are identified, how they are resolved and by whom," Donohue said. In a situation where resolution requires disclosure, he said, "I would want to understand who drafts the disclosure and how and when it is effectively communicated to clients/customers."

- **Clients of the firm.** Donohue said that in order to effectively discharge his responsibilities, a detailed understanding of who the clients of the firm are and the products and services that are being provided to them would be necessary. "I would also need an understanding of the profitability of these products and services for the firm and the firm's registered representatives" in order to conduct "a robust analysis of potential conflicts," he said. "Reviewing offering and sales materials and related documents on a regular basis would help inform this view."
- **Compliance and other systems.** A deep understanding of the compliance and other technology platforms utilized by the firm and an appreciation of the implications they pose for developing and implementing a robust compliance program would be something to learn, Donohue said. "After all, you can develop great procedures, but they need to be able to be implemented within the constraints of the compliance and other systems of the firm. An understanding and appreciation for key dependencies of your program and of the firm is very important."
- **Policies and procedures.** "I would need to have a detailed knowledge of the policies and procedures of the firm and an appreciation of how they are applied and monitored," he said. In addition, Donohue said he would also need to develop "an understanding of how they interacted with each other and the intended goal for each."
- **Markets and business practices.** An understanding of the various markets in which the firm operates is something he would need to develop, Donohue said. Such an understanding would need to include any specific practices in those markets and areas that might raise concerns. "A detailed understanding of the types of investment products and strategies involved and their potential issues would also be essential," he said.
- **Culture of the firm.** This is something that Donohue said he "would absolutely need to grasp. I would insist that the customer/client comes first and that the firm will endeavor to 'do the right thing.'" CCOs, he said, instead of fostering a culture of "can I do this?" should want to develop a culture of "should I do this?" "The firm would also need to devote sufficient resources to compliance and empower the CCO to provide the proper stature to the compliance area and its critical mission," he said. Barr noted that while this goal is important, "the chief compliance officer alone cannot develop the culture. The entire ownership and management team must do so."
- **Learn what I don't know.** "It is very important that, as a CCO, I have an appreciation for what I don't know or recognize when I am relying on the knowledge or expertise of others," Donohue said. "This involves constantly challenging yourself and your colleagues to identify potential risks." CCOs, he said, need to create an environment of open communication and freedom to ask the tough questions: "What is going on of which I am unaware? What aspects of the markets, financial products or strategies am I not well versed in? Where are there gaps in what I am covering, in my knowledge or in our programs?"

"Donohue's speech emphasizes the importance of the CCO ensuring that the compliance function not be a silo within the firm," Miller said, "although it is, of course, at least as important that the CCO operate with the independence and authority necessary for a robust culture of compliance from the top down."

CCO liability

Donohue sought to calm CCO concerns that the SEC might hold them personally liable if they take more of a pro-active role in their compliance activities. "Some of you may be wondering whether this elevated role could expose you to increased personal liability. In my opinion, the answer to this question is no," he said.

Some of this concern came from action the Commission took earlier this year against three CCOs for not meeting Advisers Act Rule 206(4)-7, the Compliance Program Rule, which requires advisers to adopt and implement

written compliance policies and procedures.

"Following these cases, there was a lot of discussion about whether the Commission was targeting CCOs," he said. "From my point of view, the Commission is not targeting – and has not targeted – compliance personnel." He quoted SEC chair **Mary Jo White** as saying that it is not the SEC's intention to use its enforcement program to target compliance professionals and that the SEC does not bring cases based on second guessing compliance officers' good faith judgments.

Nonetheless, he did note that White said that "being a CCO obviously does not provide immunity from liability," and that Division of Enforcement director Andrew Ceresney outlined three situations in which action may be taken against a CCO. These are when a CCO affirmatively participated in misconduct, helped mislead regulators, or had clear responsibility to implement compliance programs and policies and failed to do so.

That third condition – when a CCO failed to implement compliance programs and policies – raised a concern from Barr, who said that CCOs "are concerned that the SEC will look back in hindsight" after it finds some violations and blame the violations on a failure on the part of the CCO. "It's one thing to say that the firm didn't follow the policies and procedures. It's another to turn it all on the chief compliance officer." ☙

Private Funds

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The data release and the speech appeared to be targeting to two groups. The first group is comprised of advocates of prudential regulation, who have sounded alarms about the dangers of too much leverage and too much reliance on derivatives among private funds. The message was that the SEC has a handle on what is happening in the private fund world and that, in any event, leveraging, reliance on derivatives and high-frequency trading are not as great as many have feared.

The second group is comprised of the private fund advisers and funds themselves. The message to them was that the agency has concerns about significant operational risks relating to client transitioning, cybersecurity and market stress, as well as firm-specific risks involving marketing, conflicts-of-interest disclosure, and fees and expenses – all of which White made clear the SEC would be actively looking at.

"If I were a private fund manager and read White's speech, the good news I'd take away would be that the SEC is using data to better understand the footprint occupied by the private fund space, which should lead to a more informed approach to regulation than has been threatened by prudential regulators," said **Willkie Farr** partner **James Burns**. "The more challenging news for private funds is that she still talks about aggressively continuing the type of broken-window policing that we have seen in connection with recent cases."

The data

Since gaining regulatory authority over approximately 1,500 new private fund advisers with the passage of the Dodd-Frank Act five years ago, the SEC has been gathering data, both through Form ADV and through Form PF (for private fund advisers managing more than $150 million in private fund assets), on those advisers and the private funds they manage. In addition, the agency's Office of Compliance Inspections and Examinations has conducted presence exams of some private fund advisers.

The data, White said, allows the SEC to monitor trends in the industry. For instance, while the number of private fund advisers reported on Form PF has "not changed appreciably since 2013, the number of large hedge fund advisers with at least $1.5 billion in hedge fund assets has increased by approximately 15 percent in the same period," she said. "We have also observed an 8 percent increase in the number of private funds reported from 2013 to 2014, and their total gross assets have increased by nearly $1 trillion, now totaling just shy of $10 trillion." Of that $10 trillion, about $6.1 trillion was reported by hedge funds. In terms of net assets, private funds had $6.7 trillion, while hedge funds had $3.4 trillion, at the end of 2014.

Form PF data provides the SEC with a wealth of information on private fund advisers. It also "allows the staff to monitor investment strategies among private funds and

to understand the potential effect of certain markets or global events," White said. "We have used it to assess funds' reliance on derivatives and leverage, their exposure to certain international markets, and their use of high frequency trading strategies."

Systemic risk

The statistics issued by the SEC include a wide variety of measurements, including some related to leverage, reliance on derivatives, and high-frequency trading, all of which have been concerns from organizations like the Financial Stability Oversight Council (FSOC) and the Financial Stability Board (FSB), said Burns. These two organizations, which are concerned with systemic risk, are seen by some as threats to SEC regulation of asset managers. White and others have made clear their view that the SEC is the right organization to regulate any systemic risks in the securities industry.

To that end, the decision to make public the Form PF aggregate data demonstrates that the agency is on top of any and all risks, systemic or firm-specific, that private advisers and their funds face. "The financial crisis re-focused financial regulators, including the Commission, on addressing risks that could have a systemic impact," White said, noting that doing so is "fundamental" to the SEC's core mission.

"White is essentially saying to that agency's critics, 'The SEC knows what's going on, we're in charge here, and we're taking steps to protect the financial system,'" said **Mayer Brown** attorney **Adam Kanter**.

As for what the aggregate data from Form PF specifically shows about private funds and systemic risk, White noted the following:

- **Derivatives.** Although the total notional value of derivatives reported on Form PF increased from about $13.6 trillion in the first quarter of 2013 to about $14.8 trillion in the fourth quarter of 2014, the value has decreased relative to total net assets during the same time period, from about 256 percent of net asset value to about 221 percent of net asset value.
- **Leverage.** More than half of all large hedge fund advisers report aggregate economic leverage less than two and a half times their total reported hedge fund net assets. That is a relatively small leverage ratio, said Burns, something he said should help allay the concerns of organizations like FSOC and the FSB.
- **High-frequency trading.** Fewer than 100 reporting hedge funds – representing less than $70 billion in combined net assets – manage some portion of their funds using high-frequency trading. "That is a relatively small incidence of high-frequency trading," said Burns.

"The public availability of aggregated information should help to address persistent questions, and to some degree misconceptions, about the practices and size of the private fund industry," said White.

"The numbers put things in perspective with those critics who are scaremongering that use of leverage, derivatives and high-frequency trading are at high levels," said Kanter. "For instance, with those critics who say that the SEC is not doing a good job with high-frequency trading by private funds, White is saying, in effect, 'We've got the figures and it's not as prevalent as you seem to think it is.'"

Operational risks

On the other hand, private funds face three specific operational risks that White said "merit close attention" by advisers:

- **Transition of client accounts from one adviser to another.** This occurs when there is an abrupt change in the management of a private fund, or when a fund is liquidated. Private funds may be invested in asset classes that are difficult to sell and where there are fewer alternative advisers, investors in private funds are more likely to have special contractual rights that other advisers may not be willing to accept or that may limit the adviser's ability to transfer management, and investors in private funds tend to have confidentiality concerns that may affect the ability to find an alternate adviser. "A clear, well-defined transition plan" is a good way to address this, White said.
- **Cybersecurity.** This, of course, is a challenge for all advisers, not just those managing private funds, but

White nonetheless listed it. She urged advisers to pay attention to recent staff guidance (*ACA Insight*, 9/21/15), as well as to a settled enforcement case (*ACA Insight*, 9/28/15) involving an adviser charged with not having written policies and procedures to protect customer records and information.

- **Market stress.** White noted that while the SEC staff is currently considering ways to implement Dodd-Frank requirements for annual stress testing by large advisers and funds, "there are important questions about how to address this issue for other registered funds and their advisers that meet the Dodd-Frank asset threshold, including private fund advisers." Doing so is challenging, she said, as the stress tests need to be tailored to the specific risks and business models of diverse assets managers. "The traditional models of stress testing for banks and broker-dealers may not be transferable. Indeed, since the financial distress of an investment adviser may affect only the assets of the adviser, rather than the finances of the likely much larger funds in manages, there are real questions about precisely what the goal of stress testing should be for advisers."

Firm-specific risks

The main risk White named was fiduciary duty, under which investment managers must serve the best interests of their clients, which she identified as "the bulwark of investor protection." She then noted that examiners conducting private fund presence exams "identified several areas where cracks in this bulwark were found," including:

- **Marketing.** "Some hedge fund advisers may have used marketing materials that included back-tested performance numbers, portable performance numbers, and benchmark comparisons without key disclosures," she said.
- **Disclosure of conflicts of interest.** Some hedge fund advisers may not be adequately disclosing conflicts related to advisers' proprietary funds and the personal accounts of their portfolio managers, White said. "Examiners saw, for instance, advisers allocating profitable trades and investment opportunities to proprietary funds rather than client accounts in contravention of existing policies and procedures."
- **Conflicts involving fees and expenses.** Examiners were concerned that some advisers "may have been improperly shifting expenses away from the adviser and to the funds or portfolio companies by, for example, charging a fund for the salaries of the adviser's employees or hiring the adviser's former employees as 'consultants' paid by the funds," she said. In addition, she said that examiners observed advisers collecting "millions of dollars" in accelerated monitoring fees without disclosing this to clients.

SEC Commissioner Nominees

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The two will also be part of a Commission precedent once on board. The SEC, for the first time in its history, will have women as four of its five commissioners. Obama, in nominating Fairfax and Peirce, filled vacancies left by the departures of two male commissioners, **Daniel Gallagher** and **Luis Aguilar**. The two women already on the Commission are White and existing commissioner **Kara Stein**. Commissioner **Michael Piwowar** would be the sole remaining male member.

Traditionally, aside from the Commission chair, the other Commission members are split between Democrats and Republicans. Obama's nominations continue in this tradition:

- Fairfax is a **Georgetown University** law professor who has studied shareholder activism. Her name was reportedly on a list of possible nominees circulated by senator **Elizabeth Warren** (D-Mass.), generally considered a liberal in the area of financial regulation. She would also be the third African-American commissioner in the SEC's history. She would replace Aguilar, whose term expired.
- Hester is a former aide to Senate Banking Committee chair **Richard Shelby** (R-Ala.). She is a senior research fellow at the **George Mason University's** Mercatus Center, described as a free-market-oriented think tank, and is a critic of the Dodd-Frank Act, and was the editor of a book called, "Dodd-Frank: What It Does

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and Why It's Flawed." She would replace Gallagher, who resigned his seat earlier this month.

"The SEC has a lot of important work to do and it is critically important that the agency have a full complement of Commissioners," said **Investment Adviser Association** president **Karen Barr**. "We look forward to working with them at the SEC."

"Everyone would like to know how Peirce and Fairfax will vote on various issues," said **Ropes & Gray** counsel **David Tittsworth**. Referring to the issues on White's agenda such as the proposed data reporting rules and proposed liquidity rules mentioned above, he said that they all "are driven by the SEC's desire to retain its jurisdiction of asset managers and funds and to prevent an incursion by the Financial Stability Oversight Council or banking regulators."

"At least in concept, both Democratic and Republican Commissioners have found common ground on the broad notion of ceding SEC authority of the asset management profession to the banking regulators," he said. "Whether this translates to broad support by the Commissioners on all of these pending or anticipated rules remains to be seen."

"I suspect that the two candidates will bring very different world views to the Commission, and it will be interesting to watch how that plays out in terms of White's agenda," said **Stroock** partner and SEC former Division of Investment Management deputy director **Robert Plaze.**

SEC Will No Longer Seek Certain Retroactive Collateral Bars

The SEC this month decided not to challenge a unanimous July 14 ruling of the U.S. District Court of Appeals for the District of Columbia that found the agency erred in imposing certain retroactive collateral bars against an adviser, **Koch Asset Management**. Those retroactive collateral bans would have prevented the adviser from associating with municipal advisers or nationally recognized statistical rating organizations.

At issue was whether the SEC was overstepping its authority by retroactively banning advisers from associating with entities that the agency did not have the authority to ban prior to passage of the Dodd-Frank Act. It was only with passage of Dodd-Frank that the SEC gained the authority to ban advisers from association with municipal advisers or nationally recognized SROs.

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Since the alleged conduct in the Koch Asset Management case pre-dated the enactment of Dodd-Frank, the appellate court held that applying the ban in such a case would be "impermissibly retroactive."

"The Commission has determined not to seek further review of that decision," the SEC said in its statement.

Further, the agency offered to consider vacating collateral bars already enacted against entities in regard to association with municipal advisers or nationally recognized SROs, and provided a link to a form to make that request. The key factor in successfully having such a ban vacated is that the conduct in such cases must have occurred before July 22, 2010, Dodd-Frank's effective date, the SEC said. The process is available only to bans against associating with municipal advisers or nationally recognized SROs.

"What else were they going to do?" asked **Stroock** partner and former SEC Division of Investment Management deputy director **Robert Plaze**, in regard to steps the Commission could have taken following the D.C. appeals court's unanimous verdict. "I'm sure they concluded that the Supreme Court would not have been likely to take the case," he said, and, in any event, the issue of retroactive collateral bars is "small potatoes" compared to larger issues the SEC is now facing, including the definition of insider trading (*ACA Insight*, 10/12/15) and its use of administrative proceedings over federal courts (*ACA Insight*, 9/28/15). "This is an issue that will go away with the passage of time."

The agency's decision not to challenge the appellate court no doubt was welcomed by SEC commissioner **Michael Piwowar** and former commissioner **Daniel Gallagher.** The two had issued a joint statement following the appellate ruling, calling on the Commission to "promptly take appropriate action to address all impermissibly retroactive collateral bars that have been misapplied since the enactment of Dodd-Frank."

"The Commission's apparent willingness to consider vacating bars that were impermissibly applied retroactively is clearly a positive development," said **Mayer Brown** partner **Matthew Rossi**.

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ACA Compliance Group
(301) 495-7850
(301) 495-7857 (fax)
service@acainsight.com

Publisher/Editor:
Robert Sperber
(301) 502-8718
rsperber@acainsight.com

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subscribe@acainsight.com
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