

Wells Fargo Prime Services Business Consulting Industry and Regulatory Updates

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The Three “Cs” for Fund Managers’ Compliance Attention in 2019

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As chief compliance officers prepare for their annual compliance reviews, they should familiarize themselves with the SEC’s examination priorities letter¹ and other recent OCIE guidance to ensure their firms are satisfying regulatory expectations. In particular, these materials emphasize the importance of addressing three Cs—cybersecurity, conflicts of interest, and cryptocurrencies.

Cybersecurity

Over the past few years, cybersecurity has been one of OCIE’s top priorities. It will remain at the forefront of examinations this year to ensure that fund managers are properly assessing and addressing risks associated with operating an interconnected business with sensitive information. Among other things, OCIE indicated in its priorities letter that it will focus on fund managers that operate multiple branch offices and those that have recently merged with other managers to vet their governance and risk assessment, access rights and controls, data loss prevention, vendor management, training, and incident response.

While OCIE has emphasized that it will work cooperatively with firms to identify and manage cybersecurity risks, recent enforcement actions for violations of Regulations S-P and S-ID as well as the Custody Rule illustrate the perils of not adequately addressing these risks.

The priorities letter also referenced a recent OCIE risk alert that cautioned how electronic messaging may present cybersecurity and other risks.² That alert advised fund managers to account for text, SMS, or instant messaging, personal email, and social networking in their compliance programs and how their use may affect the managers’ recordkeeping and compliance obligations. Among other things, the alert included a sweeping recommendation that managers monitor social networking posts to verify whether the firms’ policies on permitted use are being followed and to archive posts that qualify as business communications. The alert also recommended that firms perform regular Internet searches or set up automated alerts to identify unauthorized business being conducted online.

These materials and other SEC guidance urge managers to appreciate the ubiquity of cybersecurity risks and take appropriate steps to protect their firms from both external and internal threats.

Conflicts of Interest

As it has in the past, OCIE will continue to scrutinize the disclosures and business operations of fund managers to

identify the existence of any potential conflict of interest. For example, the priorities letter referenced another risk alert that noted how OCIE has observed that some fund managers erroneously value assets based on original cost rather than fair market value, while other fund managers wrongly include certain assets in the fee calculation that the advisory agreement excluded.³ That risk alert also cautioned fund managers to disclose any markups for third-party services or fee-sharing arrangements with affiliates and avoid any misallocation of expenses to clients where they should be borne by the manager.

Another recent risk alert referenced in the letter similarly warned about proper disclosure relating to solicitor relationships.⁴ Under the “Cash Solicitation Rule” investment advisers are generally prohibited from paying a cash fee directly or indirectly to any person who solicits clients for the advisor (a “solicitor”) unless the arrangement complies with the conditions of the Cash Solicitation Rule. In particular, that alert observed that some fund managers do not adequately disclose the nature of the relationship with their solicitors or the terms of the compensation arrangement and any costs to the client.

And a third risk alert referenced in the letter encouraged fund managers to ensure that they maximize client value when executing trades by reviewing the services performed by their executing brokers and documenting their best execution compliance on a periodic basis.⁵ That alert noted that, as part of this review, fund managers should consider various quantitative and qualitative factors, including: (i) commission rates; (ii) liquidity of traded securities; and (iii) research quality, execution capability, and responsiveness of the brokers as measured by traders and portfolio managers.

As a stark warning for fund managers, each risk alert identified various SEC enforcement actions that have been brought for failing to fulfill these fiduciary obligations.

Cryptocurrencies

OCIE recognized in its priorities letter that fund managers are increasingly active in the burgeoning digital asset market. Given this trend and the nascent regulations surrounding this emerging asset class, OCIE indicated it will continue to evaluate the trading and management of digital assets by fund managers to evaluate regulatory compliance where digital assets qualify as securities. OCIE also indicated it will continue to monitor this market to otherwise protect investors against opaque and illiquid assets that could be easily misrepresented, manipulated, or dissipated. To that end, OCIE noted that examinations will focus on internal controls relating to the pricing and safety of client portfolios.

1 OCIE 2019 Examination Priorities (Dec. 20, 2018), <https://www.sec.gov/files/OCIE%202019%20Priorities.pdf>.

2 OCIE Risk Alert, Observations from Investment Adviser Examinations Relating to Electronic Messaging (Dec. 14, 2018), <https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Electronic%20Messaging.pdf>.

3 OCIE Risk Alert, Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers (Apr. 12, 2018), <https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf>.

4 OCIE Risk Alert, Investment Adviser Compliance Issues Related to the Cash Solicitation Rule (Oct. 31, 2018), <https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Cash%20Solicitation.pdf>.

5 OCIE Risk Alert, Compliance Issues Related to Best Execution by Investment Advisers (July 11, 2018), <https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20IA%20Best%20Execution.pdf>.