Official Newsletter of Gordian Compliance Solutions, LLC.

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INVESTMENT ADVISER NEWS UPDATES

SEC Rule Proposal Would Require Advisers to Establish a Business Continuity Plan

On June 28, 2016, the United States Securities & Exchange Commission (SEC) proposed a rule that would "require SEC-registered investment advisers to adopt and implement written business continuity and transition plans reasonably designed to address operational and other risks related to a significant disruption in the investment adviser's operations."[1]

The principles-based amendment would compel advisers to contemplate potential service disruptions to their advisory businesses and develop a strategy to avoid or mitigate any adverse effects from those interruptions.[2] While use of a business continuity plan is already an industry best practice, the SEC's decision to create an affirmative requirement coincides with their focus on information protection—particularly given the multi-year emphasis on cybersecurity and red flag detection.

[1] *Release No. IA-4439*, United States Securities & Exchange Commission (June 28, 2016)
[2] *SEC Proposes Rule to Require Business Continuity Plans for Advisers*, InvestmentNews.com (June 29, 2016)

Proposed Legislation Could Alter 13D Reporting

Senators Tammy Baldwin (D-WI) and Jeff Merkley (D-OR) introduced formal legislation this past May that could have large ramifications for activist hedge fund reporting.[1] The Brokaw Act (S. 2720) would affect hedge fund reporting on Schedule 13D in the following fashion: 1) 2-Day Filing Deadline 2) Expanded

"Beneficial Ownership" Definition 3) New Definition of "Person" 4) Disclosure of Short Positions.

1. **2-Day Filing Deadline**: "Currently, an initial report on Schedule 13D must be filed with the United States Securities & Exchange Commission (SEC) within 10 days of the acquisition of more than five percent of a class of registered voting securities."[2] If enacted, The Brokaw Act would shorten this window to two business days in an effort to increase transparency surrounding activist acquisitions.[3]
2. **Expanded "Beneficial Ownership" Definition**: The proposed legislation would also expand the current definition of "beneficial ownership" under Section 13(d) of the Securities Exchange Act of 1934. The existing beneficial ownership definition covers "the power, directly or indirectly, to vote or dispose of an equity security (and the right to acquire such power in 60 days, if passive, or at any time, if activist)."[4] The new definition expands this to include any "pecuniary or indirect pecuniary interested in such security."[5] This would require persons to include derivative instruments and cash-settled swaps in their beneficial ownership calculations.[6]
3. **New Definition of "Person"**: The Brokaw Act presents an enhanced definition of "person" to include: "two or more persons acting as a partnership, limited partnership, syndicate, or other group, or otherwise coordinating the actions of the persons, for the purpose of (i) acquiring, holding, or disposing of securities of an issuer; (ii) seeking to control or influence the board, management, or policies of an issuer; or (iii) evading, or assisting others in evading, designation as a 'person.' "[7]
4. **Disclosure of Short Positions**: "Under the proposed legislation, a beneficial owner would not be permitted to net out its short interest from its long interest but would be required to use the greater percentage of its short or long interest to calculate beneficial ownership in accordance with Rule 13d-3(d)(1) of the Exchange Act."[8]

If enacted, The Brokaw Act represents sweeping changes to the Schedule 13D filing regime. If you have any questions about The Brokaw Act's potential effect on your 13D reporting, please contact your Gordian consultant.

[1] *Proposed Legislation would Increase 13D and Other Securities Disclosure Requirements for Hedge Funds and Others*, Sidley Austin LLP (May 31, 2016)

[2] *Id.*

[3] *Id.*

[4] *Id.*

[5] .*Proposed Legislation would Increase 13D and Other Securities Disclosure Requirements for Hedge Funds and Others*, Sidley Austin LLP (May 31, 2016)

[6] *Id.*

[7] *Id.*

[8] *Id.*

SEC Issues Sub-Adviser Guidance on Custody

On April 25, 2016, the United States Securities & Exchange Commission (SEC) issued No-Action Letter No. 20164261627,[1] clarifying that sub-advisers would not be required to conduct a surprise annual examination by an independent public accountant as outlined in Rule 206(4)-2 of the Investment Advisers Act of 1940.

The SEC's reasoning was based on the following:[2]

1. The sole basis for the sub-adviser having custody is its affiliation with the qualified custodian and the primary adviser;
2. The primary adviser will comply with Rule 206(4)-2, including by having client funds and securities in the investment advisory program verified by a surprise examination conducted by an independent public accountant registered with the Public Company Accounting Oversight Board ("PCAOB") pursuant to an agreement entered into by the primary adviser;
3. The sub-adviser does not (i) hold client funds or securities itself; (ii) have authority to obtain possession of clients' funds or securities; or (iii) have authority to deduct fees from clients' accounts; and
4. The sub-adviser will continue to be required to obtain from the primary adviser or qualified custodian annually a written internal control report prepared by an independent public accountant registered with and subject to regular inspection by the PCAOB as required by Rule 206(4)-2(a)(6).

The No-Action Letter reaffirms the SEC's position that compliance with Rule 206(4)-2 will fall on primary advisers that maintain custody, rather than sub-advisers.[3]

[1] *No Action Letter No. 20164261627*, United States Securities & Exchange Commission (April 25, 2016)

[2] *Id.*

[3] *Id.*

Large Whistleblower Awards Signal Increased Regulatory Focus

Two large whistleblower awards have made waves this past quarter.

First, the United States Securities & Exchange Commission (SEC) awarded between $5 million and $6 million to a former company insider this past May.[1] The award is the third highest for a whistleblower, which is partly a function of the program's growth and the SEC's aggressive encouragement for reporting.

Second, the Commodity Futures Trading Commission (CFTC) also announced their "third largest whistleblower award [of] more than $10 million"[2] this past April. Like the SEC, "[a]n award this size shows the importance that the Commission places on incentivizing future whistleblowers."[3]

"We're seeing a significant uptick in whistleblower tips over prior years, and we believe that's attributable to increased public awareness of our program and the

tens of millions of dollars we've paid to whistleblowers for information that helped us bring successful enforcement actions,"[4] says Sean X. McKessy, Chief of the SEC's Office of the Whistleblower. These recent whistleblower awards further highlight the importance of a strong compliance program and firm-wide "culture of compliance." With an increased awareness of the SEC's whistleblower program, advisers should expect to see a heightened evaluation of whistleblower policies during regulatory examinations.

Please contact your Gordian consultant for any questions relating to your firm's whistleblower policies.

[1] *SEC Awards More than $5 million to Whistleblower*, United States Securities & Exchange Commission (May 17, 2016)
[2] *CFTC Announces Whistleblower Award of More Than $10 Million*, United States Commodity Futures Trading Commission (April 4, 2016)
[3] *Id.*
[4] *SEC Awarding Nearly $2 Million to Three Whistleblowers*, United States Securities & Exchange Commission (March 8, 2016)

Recent Enforcement Actions

Several high profile enforcement actions focusing on improper or inadequate disclosure made headlines this past quarter:

- **J.P. Morgan**: Financial Industry Regulatory Authority Inc. (FINRA) fined J.P. Morgan Securities $775,000 and J.P. Morgan Clearing Corp. $250,000 for violating multiple FINRA and Securities and Exchange rules.[1] Violations included J.P. Morgan's failure to confirm client investment objectives, non-delivery of the annual privacy notice for thousands of customers, and failure to review outside brokerage accounts of nearly 2,000 representatives.[2]

- **Momentum Investment Partners**: Doing business as Avatar Investment Management, Momentum Investment Partners and its principal were charged with fraud for failing to disclose additional fees charged to clients.[3] According to the complaint, "Avatar's clients paid almost $111,000 in additional fees from May 2013 to March 2014 for no additional advisory services..."[4] The firm's principal directed Avatar to charge these fees after moving clients over to newly created mutual funds, without notifying them of the higher cost.[5]
- **Hope Advisers Inc.**: The United States Securities and Exchange Commission (SEC) charged Hope Advisers and its owner, Karen Bruton, with fraudulently collecting fees from unknowing investors.[6] "The SEC alleges that in order to circumvent the funds' fee structure under which the firm is entitled to fees only if the funds' profits that month exceed past losses, Hope Advisers and Bruton have been orchestrating certain trades that enable the funds to realize a large gain near the end of the current month while basically guaranteeing a large loss to be realized early the following month."[7] Based on these facts, it appears Hope Advisers would not have been able to collect incentive fees from October 2014 to the present.[8]

The enforcement actions highlighted above contain several repeating themes: inadequate disclosure, suspect fee practices, and poor record keeping. Such signs

are the hallmark of an inadequate compliance program. By contrast, firms with an efficient and buttoned-up back office tend to avoid enforcement—they have identified firm risks and prioritized the resources necessary to fulfill their compliance obligations.

[1]*J.P. Morgan Broker-Dealer and Custodian Fined $1 Million*, InvestmentNews.com (April 25, 2016)
[2]*Id.*
[3]*Partners Fraudulently Failed to Disclose Higher Fees, SEC says*, InvesmentNews.com (May 31, 2016)
[4]*Partners Fraudulently Failed to Disclose Higher Fees, SEC says*, InvesmentNews.com (May 31, 2016); see also *Securities And Exchange Commission v. Momentum Investment Partners LLC (D/B/A Avatar Investment Management) and Ronald Fernandes*, United States Securities & Exchange Commission (May 31, 2016)
[5]*Partners Fraudulently Failed to Disclose Higher Fees, SEC says*, InvesmentNews.com (May 31, 2016)
[6]*SEC: Nashville Firm Schemed to Collect Extra Fees from Hedge Funds,* United States Securities & Exchange Commission (May 31, 2016)
[7]*Id.*
[8]*Id.*

SEC Investor Bulletin: Performance Claims

On April 15, 2016, the United States Securities and Exchange Commission's (SEC) Office of Investor Education and Advocacy issued an Investor Bulletin to educate investors about performance claims.[1]

While the Investors Bulletin serves to educate potential investors, its substance serves investment advisers as well—particularly in the creation of marketing materials. Advisers should understand the components of their own performance calculations to ensure marketing materials are not misleading and do not run afoul of the Investment Adviser's Act of 1940. Understanding the variables that affect performance figures will also assist in crafting appropriate disclaimers and disclosures to provide investors with the information they need to make an appropriate investment decision.

The Investor Bulletin highlighted several factors that affect performance calculations:

- Fees: Fees reduce investment returns[2] and can inflate gross figures. Performance should be presented net of fees in nearly all circumstances. If gross performance figures are included, be sure to display net performance metrics with equal prominence.
- Market and Economic Conditions: "Performance calculations should be considered in light of material market and economic conditions."[3]
- Methodology: Include information on how the performance "calculation accounts for dividends and its assumptions about taxes, market, and economic conditions."[4]
- No Performance Guarantees: It is virtually impossible to guarantee future returns on investments. Do not include any promises or guarantees.
- Backward Looking Performance: Historical performance presentations are often called "backward looking." Adequately disclaim backward looking performance as back-tested (applying an investment strategy, algorithm, or model to past market conditions to show how that strategy may have performed in the past),[5] as many investors may not understand the past application of an existing strategy cannot predict how the model will perform in future market conditions.

- Do Not "Cherry-Pick" Past Performance: Advisers should avoid displaying past returns that were positive while excluding periods of poor performance. [6]

Benchmark Disclosures: When performance is compared to a benchmark (e.g., market index like S&P 500), advisers should adequately disclose the inherent limitations in a one-to-one comparison. "[P]erformance on a benchmark may not reflect the deduction of the fees you pay, which would reduce returns."[7] Benchmarks should also represent the same market segment as an adviser's strategy to provide investors the closest comparison.

[1] *Investor Bulletin: Performance Claims*, United States Securities & Exchange Commission (April 15, 2016)

[2] *Id.*

[3] *Id.*

[4] *Id.*

[5] *Investor Bulletin: Performance Claims*, United States Securities & Exchange Commission (April 15, 2016)

[6] *Id.*

[7] *Id.*

SEC Resource Allocation Hints at Additional Cyber Enforcement Actions

Cybersecurity has been at the top of the United States Securities and Exchange Commission's (SEC) exam priorities throughout 2015-2016.[1]

As such, the SEC has taken swift action to keep up with an ever growing number of registrants. The Commission has reallocated broker-dealer exam personnel to investment adviser exams in order to boost its current examination rate, which averages around 10% annually.[2] But the SEC hasn't stopped there. Chairwoman Mary Jo White "has directed staffers to develop recommendations for how the SEC might deputize an outside organization to help with advisor exams."[3] Third party support will not replace Office of Compliance Inspections and Examinations (OCIE), but rather, provide additional support to the OCIE in their selection of risk-based examinations.[4]

Investment advisers should be wary of the SEC's recent efforts to mobilize examine resources directed towards cybersecurity. Firms should have strong policies designed to safeguard personal client data, supported by regular systems testing. Given the SEC's mobilization, it's clear that cybersecurity will continue to be an area of exam focus for quite some time.

[1] *SEC Warns More Cyber Enforcement Actions Coming*, FinancialPlanning.com (April 20,2016)

[2] *Id.*

[3] *Id.*

[4] *Id.*

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