Investment Services Regulatory Update

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Litigation and Enforcement Actions

Section 36(b) Excessive Fee Litigation Update

Federal Court Issues Opinion Following Trial in AXA Section 36(b) Excessive Fee Case

On August 25, 2016, the US District Court for the District of New Jersey issued its opinion in *Sivolella v. AXA Equitable Life Insurance Company* following a 25-day, non-jury trial. The lawsuit was brought by holders of variable annuity contracts with AXA Equitable Life Insurance Company (AXA) who had allocated assets to twelve mutual funds in EQ Advisors Trust (the Trust) managed by AXA Equitable Funds Management Group, LLC (FMG). Plaintiffs had alleged that FMG charged exorbitant fees for investment management and administrative duties while delegating substantially all of those same duties to sub-advisers and sub-administrators for nominal fees. In a lengthy analysis of testimony and evidence, Judge Peter G. Sheridan concluded that plaintiffs failed to meet their burden (1) to demonstrate that defendants breached their fiduciary duty in violation of section 36(b) of the 1940 Act, and (2) to have shown any actual damages. In an order accompanying the opinion, the case was dismissed with prejudice.

Section 36(b) imposes a fiduciary duty on mutual fund investment advisers with respect to the receipt of compensation for services and provides shareholders with an express private right of action against advisers and affiliates receiving compensation from funds to enforce this fiduciary duty. The burden of proof rests with plaintiffs to show that the adviser's fee is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining," the standard that was embraced by the US Supreme Court in its 2010 decision in *Jones v. Harris Associates L.P.*

Notably, the *AXA* case is the first 36(b) lawsuit to proceed to trial since the *Jones* decision and the first to trial on a so-called "manager of managers" theory of liability, relating to circumstances in which an adviser relies on sub-advisers to provide investment management services. In cases brought on this theory, plaintiffs generally assert that sub-advisers perform most or all of the services, but receive only a "fraction" of the fee paid to the delegating adviser/manager.

A few observations about the *AXA* decision are as follows:

- **Analysis of Services Provided Beyond Contractual Terms:** The crux of plaintiffs' claim was that the fees paid to FMG were unjustified by the services FMG provided to the funds since FMG delegated virtually all of its duties to sub-advisers and sub-administrators and retained a disproportionate amount of the total fees paid by the funds. In evaluating this claim, the court noted that plaintiffs' were "essentially correct" that the services described in the advisory agreements were largely the same as those described in the sub-advisory agreements and thus, "may suggest that the sub-advisers perform a majority of the investment management services on behalf of FMG." However, Judge Sheridan rejected plaintiffs' contention that the "plain language of the agreements controls" in determining the extent and scope of services provided. Instead, he adopted defendants' view that to rely solely on the contractual terms "elevates form over substance" and "overlooks crucial evidence demonstrating that FMG retained a substantial amount of work for the Funds." On this issue, the opinion concluded that an analysis must consider the totality of

services provided, "whether enumerated in a contract or undertaken in a manner to carry out the contractual duties." Based on "voluminous testimony of credible witnesses," the court found that FMG performed "significant administrative and investment management duties," including "a number of services beyond those expressly outlined in the agreements."

- **Assessments of Witness Credibility and Interests of the Parties:** Witness credibility had a "significant impact" on the case's outcome. Indeed, Judge Sheridan devoted a significant portion of the opinion to "credibility assessments" of the witnesses appearing at trial, including expert witnesses, and the court's determinations relating to the "appropriate weight to accord their testimony." For instance, the court found that Steven M. Joenk, the President and CEO of FMG and Chairman of the Board of Trustees of the Trust (the Board), "is motivated to ensure that FMG receives higher fees because he serves as the CEO, rather than to protect the interest of investors." The court suggests that "[t]his calls into question whether [Joenk] made accurate statements and presentations to the Board regarding the *Gartenberg* factors" and assigns a "potential bias" to Joenk's testimony. In addition, the court gave certain plaintiffs' expert witness testimony "little weight" due to inconsistent statements, lack of sufficient preparation and, in one case, an expert's "sarcastic demeanor" and "unprofessional" comments. In contrast, the court found that the lead independent trustee and defense witness, Gary S. Schpero, gave "generally consistent, thorough, and accurate" testimony. Judge Sheridan also reached conclusions about plaintiffs and defendants based solely on attendance at the trial. Noting, in this regard, that only one of the seven plaintiffs testified at or attended the trial, the court concludes that "this lack of attendance demonstrates that Plaintiffs had little interest in the trial or its impact upon them." In contrast, the court notes that Joenk attended nearly all 25 days of the trial, stating that "this juxtaposition between the parties' respective attendance demonstrates that Plaintiffs may not have had a significant issue at stake."
- **Statutory Inconsistencies and the Parties at Issue:** In the introductory portion of the opinion, the court reviewed the statutory cause of action under section 36(b) of the 1940 Act, including its legislative history. In this connection, the opinion notes that an action for breach of fiduciary duty under section 36(b) may not be brought against any person other than the recipient of compensation for services, "i.e. the defendant must be either an investment adviser or an affiliated person to the investment adviser." However, in summarizing the elements necessary for proving a breach of fiduciary duty under section 36(b), the opinion states that the defendants must be "investment advisers or a *board of trustees*" (emphasis added). Moreover, although the Board was not named as a defendant in the case, at several points the opinion refers to the plaintiffs' allegation that the "Board breached its fiduciary duty in approving the fees" for investment management and administrative services and stated that "at issue in this case is whether the Board breached its fiduciary duty in approving [the agreements]."
- **Risk Assumption as a Justification for Fees:** The court found that the adviser's fee was justified, in part, by FMG's enterprise risk, which is described as relating to "litigation and reputational risks, operational and business risks, and the risk that FMG and the Funds may have to pay the sub-advisers in the event of legal action." In reaching this conclusion, the court was persuaded by defendants' testimony that FMG's risk is not eliminated by contractual provisions limiting its liability and providing for indemnification in certain circumstances. In this regard, the opinion cites the lead independent trustee's testimony that, "notwithstanding the contract language [which provided for a gross negligence standard of care], both the

Board and regulators would ultimately hold FMG liable for any issues that impact the Funds or investors." FMG was not required to quantify its enterprise risk in citing such risk to justify a portion of the fees paid.

- **Profitability Findings:** Plaintiffs contended that FMG's methodology used to determine profitability was improper. In particular, plaintiffs challenged FMG's (1) accounting treatment of sub-advisory and sub-administration expenses, which plaintiffs' argued should have been excluded from profitability calculations and (2) use of revenue to allocate expenses in calculating profitability. In finding that classifying sub-adviser and sub-administrator fees as expenses is "within ordinary accounting principles," the court cited each party's expert witness and, noting that plaintiffs' witness gave "muddled" and "inconsistent" testimony, was persuaded by the "more credible" testimony of defendants' expert witness. Similarly, the court cited the weight of witness testimony in finding that FMG's use of the cost allocation method based on revenue is consistent with accounting principles. In this connection, the court noted that two audit firms, Ernst & Young and PricewaterhouseCoopers, were "involved in creating FMG's methodology for allocating expenses based on revenue" and that plaintiffs' expert witness neither opined on an alternative methodology that FMG should have employed nor provided any documentation suggesting that the auditors thought cost allocation based on revenue was unreasonable.
- **Importance of Board's Composition and Process, Including Sources of Information:** Judge Sheridan rejected plaintiffs' claims that the Board lacked impartiality, diversity, care and conscientiousness. Despite the "Wall Street leanings" of the Board and the supposed lack of a trustee with significant regulatory experience, the court was convinced, largely from Schpero's testimony, that the Board was sufficiently diverse and was assisted by independent counsel with regulatory experience. In finding that the Board was conscientious and "robustly reviewed" the adviser's compensation, Judge Sheridan credited the trustees' attendance at and frequency of meetings, their involvement in preparing and requesting materials for the contract review process and reliance on multiple outside consultants and experts, including Lipper, Morningstar, Strategic Insight and independent legal counsel to the independent trustees.
- **Consequential Benefits of Litigation:** Interestingly, the opinion includes a section titled "Benefits of the Lawsuit," wherein Judge Sheridan, citing *Jones*, states that since "all pertinent facts must be weighed," it is relevant to note the "positive change[s]" to the Board's process supposedly attributable to the filing of the plaintiffs' lawsuit. Thus, although plaintiffs failed to meet their burden to demonstrate a breach of fiduciary duty, the opinion reviews several "Board improvements, including changes to the Board composition and Board presentations" which "did not occur until after [the] suit was filed." For instance, Judge Sheridan maintains that "it is clear to the Court that Plaintiffs' lawsuit resulted in a more scrupulous and rigorous examination of Board expenses," a "significant benefit to investors that only occurred because of this lawsuit."

Next Steps

The lawyers for the plaintiffs have indicated that they intend to appeal the decision to the US Court of Appeals for the Third Circuit. Towards that end, on September 20, 2016, plaintiffs filed a motion to amend the trial opinion and to amend or make new findings of fact and/or conclusions of law.

U.S. District Court Grants Defendant's Motion to Dismiss in State Farm Excessive Fee Case

On June 22, 2016, the U.S. District Court for the Central District of Illinois issued an order granting the defendant's motion to dismiss an excessive fee case brought under Section 36(b) of the 1940 Act against State Farm Investment Management Corporation (SFIMC) relating to five of the LifePath Funds, a group of target-date mutual funds advised by SFIMC. Each of the LifePath Funds invests all of its assets in a master portfolio that, in turn, invests its assets in a number of underlying funds. BlackRock Fund Advisors (BFA), an investment adviser that is not affiliated with SFIMC, serves as investment adviser to each master portfolio, and BFA or its affiliates serve as the investment adviser to most of the underlying funds in which the master portfolios invest.

In the complaint filed in July 2015, the plaintiffs alleged that the portion of the management fee SFIMC retains from the LifePath Funds is "so disproportionately large that it bears no reasonable relationship to the services rendered (if any) for that fee, and could not have been negotiated through arms-length bargaining." The plaintiffs alleged that SFIMC does not provide day-to-day investment services, or investment guidance or policy direction in connection with daily portfolio management, to the LifeTime Funds, and that the non-advisory monitoring, oversight and other services SFIMC provides to the LifePath Funds are minimal and do not justify the fees retained by SFIMC.

In granting the defendant's motion to dismiss, the District Court generally concluded that the plaintiffs' allegations were merely "speculative assertions" not supported by actual facts. Among other things, the court found that the plaintiffs failed to present facts to support their assertions that the non-advisory services provided by SFIMC under the LifePath Funds' management agreement did not merit the fees retained by SFIMC and that the board received inadequate information to fulfill its obligations to review and approve the management agreements.

The litigation was filed in the U.S. District Court for the Central District of Illinois under the name *Ingenhutt et al. v. State Farm Inv. Mgmt. Corp.*, Case No. 15-cv-1303.

U.S. District Court Denies Defendant's Motion to Dismiss in Metropolitan West Excessive Fee Case

On June 16, 2016, the U.S. District Court for the Central District of California issued an order denying the defendant's motion to dismiss an excessive fee case brought under Section 36(b) of the 1940 Act against Metropolitan West Asset Management, LLC (MetWest). In the complaint submitted in October 2015, the plaintiff alleged that MetWest, in managing the Metropolitan West Total Return Bond Fund, breached its fiduciary duties by charging fees "so disproportionately large that they bear no reasonable relationship to the value of the services provided by [MetWest] and could not have been the product of arm's-length bargaining." The complaint alleges that the fees charged to the Fund were as much as 497% higher than the rates MetWest negotiated at arm's length with other clients for the same or substantially the same services, allowing MetWest to retain the benefits of economies of scale resulting from the Fund's significant asset growth in recent years.

In moving to dismiss the plaintiff's complaint, MetWest argued that the plaintiff improperly compared the management

fee rate MetWest charges as investment adviser to the Fund to the sub-advisory fees MetWest charges to funds outside the MetWest complex to which it provides sub-advisory services. MetWest noted that in each case the management fee MetWest charges to the Fund is less than the total management fee paid by each sub-advised fund. To counter these arguments, the plaintiff contended that there was no indication the non-advisory services MetWest provides to the Fund are comparable to the non-advisory services the sub-advised funds' investment advisers provide, and that in any event the comparison of the Fund's management fee to the management fees of the sub-advised funds may not be appropriate as there is no indication the sub-advised funds' fee rates were negotiated at arm's length. The District Court denied MetWest's motion to dismiss, concluding that the plaintiff alleged sufficient questions of fact relating to three of the Gartenberg factors—comparative fees, economies of scale and the independence and conscientiousness of the board.

The litigation was filed in the U.S. District Court for the Central District of California under the name *Kennis v. Metropolitan West Asset Mgmt., LLC*, Case No. 15-cv-8162.

SEC Settles with Thirteen Investment Advisers for Negligent Reliance on False Performance Claims

On August 25, 2016, the SEC announced settled administrative proceedings against thirteen investment advisory firms (the Advisers) for negligently relying on an unaffiliated adviser's materially inflated, hypothetical and back-tested performance track record. According to the SEC orders, the matter stemmed from the misrepresentations made by F-Squared Investments, Inc. (F-Squared) regarding the performance history of its "AlphaSector" strategy, which was marketed to each of the Advisers as a sector rotation strategy for investing in ETFs.

The SEC alleges that each Adviser entered into a model manager agreement with F-Squared whereby the Adviser would establish an investment product based on the AlphaSector strategy. According to the SEC, each Adviser used advertisements repeating F-Squared's false statements that: (1) the AlphaSector strategy had been used to manage client assets from April 2001 to September 2008; and (2) the track record had significantly outperformed the S&P 500 Index from April 2001 to September 2008. In fact, the SEC alleges, no assets tracked the strategy until 2008 and the back-tested track record was substantially overstated. (By a separate settled administrative proceeding announced by the SEC on December 22, 2014, F-Squared agreed to pay disgorgement of $30 million and a penalty of $5 million and admit wrongdoing to settle charges that it defrauded investors through false performance advertising.)

The SEC orders state that each Adviser took insufficient steps to confirm the accuracy of the AlphaSector performance data before using it in its own advertisements and did not obtain sufficient documentation to substantiate F-Squared's advertising claims. Consequently, the SEC alleges that each of the Advisers failed to have a reasonable basis to believe that AlphaSector's performance was accurate for use in its own advertisements for clients considering the strategy. In a statement, Andrew J. Ceresney, Director of the SEC's Division of Enforcement, said that "[w]hen an investment adviser echoes another firm's performance claims in its own advertisements, it must verify the information first rather than merely accept it as fact."

Each of the Advisers consented to the entry of an order finding that it violated: (1) Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder by publishing, circulating and distributing advertisements that contained untrue statements of material

fact; and (2) Section 204(a) of the Advisers Act and Rule 204-2(a)(16) thereunder by failing to make and keep true, accurate and current records or documents necessary to form the basis for or demonstrate the calculation of the performance or rate of returns that it circulated and distributed. Without admitting or denying the findings, the Advisers agreed to pay between $100,000 to $500,000 in penalties (based upon the fees each firm earned from AlphaSector-related strategies).

A press release issued by the SEC about this enforcement matter, including a link to each of the SEC orders, is available at: https://www.sec.gov/news/pressrelease/2016-167.html

SEC Settles Charges against Adviser for Failing to Disclose Termination Waiver Arrangement with Sub-Adviser in Connection with a Manager-of-Managers Exemptive Application

On August 25, 2016, the SEC announced settled administrative proceedings against Orinda Asset Management, LLC (the Adviser), a registered investment adviser, for failing to disclose a termination waiver arrangement with a sub-adviser in connection with a “manager-of-managers” exemptive order application. The Adviser and Advisors Series Trust, a registered open-end management investment company (the Trust, and together with the Adviser, the Parties), sought an exemptive order to permit the Parties to enter into and materially amend sub-advisory agreements without shareholder approval and to exempt them from certain disclosure requirements.

According to the SEC, the Parties’ initial application for multimanager exemptive relief disclosed that the Adviser entered into an agreement with its lead sub-adviser, SkyView Investment Advisors, LLC (the Sub-Adviser), providing for termination payments should the Adviser recommend the Sub-Adviser’s termination for something other than cause. The SEC order explains that the Division of Investment Management (IM) informed the Parties that, in view of the prohibition against termination restrictions in Section 15(a)(3) of the 1940 Act[1] and the potential inconsistency with fiduciary obligations, it would not support the application with the termination payment provisions. Consequently, the Parties agreed to remove the provisions at issue and filed an amended application. The SEC alleges that, in the interim, the Adviser and Sub-Adviser entered into a revised side agreement in which the Adviser waived its ability to terminate, or recommend the termination of, the Sub-Adviser altogether. The order states that neither the Adviser nor the Trust informed IM of the revised side agreement and, subsequently, IM granted the exemptive order. The SEC also alleges that the Trust’s registration statements for the funds advised by the Adviser inaccurately stated that all of its sub-advisory agreements could be terminated at any time by the Adviser and failed to disclose the side agreement with the Sub-Adviser.

Section 34(b) of the 1940 Act makes it unlawful for any person to make any untrue or misleading statement of material fact in any registration statement, application, report, account, record or other document filed with the SEC under the 1940 Act, or to omit from any such document any fact necessary in order to prevent the statements made therein from being materially misleading. According to the SEC, multimanager orders rely upon a fund’s primary investment adviser being able to oversee sub-advisers and to recommend their hiring, termination and replacement to the fund’s board. The SEC alleges that because the Adviser was to oversee the Sub-Adviser, and the Sub-Adviser was to assist the Adviser in the selection, monitoring and evaluation of other sub-advisers, the termination waiver was material to IM’s evaluation of the request for exemptive relief. As a result, the SEC found that the Adviser violated, and caused the Trust’s violations of, Section 34(b) of the 1940 Act.

[1] Section 15(a) of the 1940 Act states, in relevant part, that it is unlawful for any person to act as investment adviser for a registered investment company, except pursuant to a written contract which, among other things, provides in substance that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered investment company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days’ written notice to the investment adviser. Based on the 1940 Act’s definition of “investment adviser,” a sub-adviser is deemed to be an “investment adviser” to any registered investment company or series thereof that it sub-advises.

The SEC ordered that the Adviser cease and desist from committing or causing any violations and any future violations of Section 34(b) of the 1940 Act, censured the firm and ordered the Adviser to pay a $75,000 civil money penalty.

A copy of the order is available at: www.sec.gov/litigation/admin/2016/ia-4513.pdf

FINRA Fines UBS Financial Services for Failing to Provide Fund Sales Charge Waivers for Eligible Customers

On August 15, 2016, the Financial Industry Regulatory Authority (FINRA) accepted a Letter of Acceptance, Waiver and Consent (the Letter) from UBS Financial Services, Inc. (UBS) to settle alleged rule violations in connection with the firm's failure to apply mutual fund sales charge waivers for certain eligible customers.

As the Letter explains, many mutual funds waive front-end sales charges if the fund is purchased pursuant to a right of reinstatement, which allows customers who have previously sold Class A shares to repurchase those shares at net asset value (NAV) without paying a front-end sales charge, provided certain conditions are met. In most cases, the customer must reinvest the proceeds from an earlier redemption of a Class A mutual fund in the same fund or fund family within a period of time specified in the prospectus, typically within 90 to 180 days. If these conditions are satisfied, the mutual fund waives the front-end sales charge. FINRA alleged that, from about September 2009 through about June 2013 (the Relevant Period), UBS failed to provide approximately 2,700 customers with mutual fund sales charge waivers to which they were entitled through rights of reinstatement, resulting in the payment of $277,636 in excess sales charges.

FINRA also alleged that during the Relevant Period, UBS failed to establish, maintain and enforce a supervisory system and written supervisory procedures reasonably designed to ensure that all eligible mutual fund investors received sales charge waivers available through rights of reinstatement. The Letter states that UBS employed a "NAV Reinstatement Report" (the Report) to monitor whether its registered representatives were appropriately identifying and applying available sales charge waivers under rights of reinstatement. However, FINRA alleged that this Report was deficient because it only monitored mutual fund trades exceeding $5,000 in amount and failed to monitor any transactions for approximately 20 of the funds sold by UBS. Consequently, FINRA also alleged that UBS had no supervisory system or procedures to review or test the Report to ensure that it was accurate, complete and functioning as intended.

For these alleged violations of NASD Conduct Rule 3010 and FINRA Rule 2010, UBS consented to the imposition of a censure and a fine in the amount of $250,000.

SEC Settles Charges Against Morgan Stanley For Failing To Adopt Written Policies and Procedures Designed to Protect Customer Data

On June 8, 2016, the SEC announced settled administrative proceedings against Morgan Stanley Smith Barney LLC (MSSB), a registered investment adviser and broker-dealer, for failing to adopt written policies and procedures reasonably designed to protect customer records and information in violation of Rule 30(a) of Regulation S-P under the Securities Act (the Safeguards Rule). The Safeguards Rule, which the SEC adopted in 2000 and amended in 2005, requires SEC-registered broker-dealers, investment companies and investment advisers to adopt written policies and procedures reasonably designed to: (1) ensure the security and confidentiality of customer records and information; (2) protect against

any anticipated threats or hazards to the security or integrity of customer records and information; and (3) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.

According to the SEC, from at least August 2001 through December 2014, MSSB stored sensitive personally identifiable information (PII) of individuals to whom MSSB provided brokerage and investment advisory services on two of the firm's applications: the Business Information System Portal and the Fixed Income Divisions Select Portal (collectively, the Portals). The SEC order states that between 2011 and 2014, Galen J. Marsh (Marsh), then an MSSB employee, misappropriated data of approximately 730,000 customer accounts by gaining unauthorized access to the Portals and downloading and transferring the confidential customer data, including PII, to his personal server. Although MSSB had installed and maintained certain technology controls on its computer systems that, among other things, restricted employees from copying data onto removable storage devices and from accessing certain categories of websites, the SEC order indicates that Marsh was able to transfer customer data to his personal server by using his personal website. The order states that, at the time, MSSB's Internet filtering software did not prevent employees from accessing "uncategorized" websites, such as Marsh's website, from MSSB computers. The SEC found that from December 15, 2014 to February 3, 2015, portions of the data stolen by Marsh were posted to at least three different Internet sites with an offer to sell a larger quantity of stolen data in exchange for payment in digital currency.

The SEC order indicates that on December 27, 2014, MSSB discovered the data breach through one of its routine Internet sweeps, promptly took steps to remove the data from the Internet and notified law enforcement and other authorities.

According to the SEC, although MSSB had adopted written policies and procedures relating to the protection of customer PII, those policies and procedures were not reasonably designed to safeguard its customers' PII as required by the Safeguards Rule. In this regard, the SEC order cites the failure of MSSB's written policies and procedures to adequately address certain key administrative, technical and physical safeguards, such as: (1) reasonably designed and operating authorization modules for the Portals to restrict employee access to only the confidential customer data as to which such employees had a legitimate business need; (2) auditing and/or testing of the effectiveness of such authorization modules; and (3) monitoring and analyzing employee access to and use of the Portals to identify any unusual or suspicious patterns.

Although the SEC considered the remedial efforts promptly undertaken by MSSB and its cooperation afforded to the SEC staff, the SEC ordered that MSSB cease and desist from committing or causing future violations of the Safeguards Rule, censured the firm and required MSSB to pay a $1 million civil money penalty. By a separate settled administrative proceeding, the SEC barred Marsh from association with any broker, dealer or investment adviser, with the right to apply for reentry after five years. In a related criminal action, Marsh pled guilty to one count of exceeding his authorized access to a computer and thereby obtaining information contained in a financial record of a financial institution, in violation of 18 U.S.C. § 1030(a)(2)(A). Marsh was sentenced to 36 months' probation and ordered to pay restitution in the amount of $600,000.[2]

A copy of the order concerning MSSB is available at: http://www.sec.gov/litigation/admin/2016/34-78021.pdf

2 United States v. Galen Marsh, No. 15 Cr. 641 (KTD) (S.D.N.Y.).

New Rules, Proposed Rules and Guidance

SEC Adopts New Disclosure and Recordkeeping Requirements for Advisers

On August 25, 2016, the SEC approved the adoption of amendments to Form ADV to enhance and modernize certain disclosure requirements and to codify the requirements for "umbrella registration," streamlining the registration and reporting requirements for multiple private fund advisers that operate as a single advisory business. The SEC also adopted certain revisions to the books and records rule, Rule 204-2 under the Advisers Act, requiring the retention of additional records relating to the calculation and distribution of performance information.

Form ADV Reporting Changes

Separately Managed Accounts

The amendments to Form ADV include several new disclosure requirements relating to separately managed accounts (SMAs)[3] that are intended to enhance the SEC staff's ability to effectively carry out its risk-based examination program and other risk assessment and monitoring activities. The amendments will require advisers to SMAs to report, among other things:

- the approximate percentage of "regulatory assets under management" (RAUM) attributable to SMAs (SMA RAUM) invested in 12 broad asset categories (e.g., exchange-traded equity securities, U.S. government/agency bonds and sovereign bonds);
- for advisers with at least $500 million but less than $10 billion in SMA RAUM, the amount of SMA RAUM and the dollar amount of borrowings attributable to those assets that correspond to three levels of gross notional exposures (i.e., less than 10%, 10%-149%, and 150% or more);
- for advisers with at least $10 billion in SMA RAUM, the same information described above with respect to gross notional exposure and the dollar amount of borrowings, as well as the derivative exposures attributable to those SMAs within six specific categories of derivatives; and
- the identity of custodians (and location of their offices) that hold at least 10% of SMA RAUM and the amount of the adviser's SMA RAUM held at the custodian.

Other Reporting Changes

In addition to the enhanced reporting for SMAs described above, the SEC adopted several changes to Form ADV disclosure requirements, in addition to various technical revisions and clarifications. Of note, the amendments to Form ADV will require disclosure of the following information:

- all adviser websites as well as all social media platforms (e.g., Twitter, Facebook, LinkedIn) on which the adviser has an account;
- the total number of offices at which the adviser conducts business and certain information about the size of and business activities conducted at each of the adviser's 25 largest offices by headcount;
- whether the adviser's chief compliance officer is compensated or employed by a person other than

[3] While "separately managed accounts" is not a formally defined term, the SEC considers separately managed accounts to refer to advisory accounts other than registered investment companies, business development companies and other pooled investment vehicles (e.g., private funds).

the adviser (or a related person) and, unless the other person is a registered investment company, the name and IRS Employer Identification Number (if any) of the other person;

- the number of advisory clients, the types of advisory clients and the amount of total regulatory assets under management (as opposed to the range of regulatory assets under management, as is currently required) attributable to each category of advisory clients;
- the RAUM of all parallel managed accounts related to registered investment companies (or series thereof) or business development companies that the adviser advises; and
- whether the adviser participates in a wrap fee program and, if so, the RAUM attributable to acting as a sponsor to or portfolio manager for a wrap fee program.

Umbrella Registration

The amendments to Form ADV also include amendments codifying prior SEC guidance regarding umbrella registration for certain advisers to private funds. Consistent with prior guidance, one adviser (the filing adviser) may file a single Form ADV on behalf of itself and other advisers controlled by or under common control with the filing adviser (each, a relying adviser), subject to five conditions set forth in the adopting release, including that the filing adviser and each relying adviser advise only private funds and clients in SMAs that are "qualified clients," as defined in Rule 205-3 under the Advisers Act, and otherwise eligible to invest in such private funds and whose accounts pursue investment objectives and strategies that are substantially similar or otherwise related to those private funds. In addition, umbrella registration requires that the filing adviser and each relying adviser operate under a single code of ethics administered by a single chief compliance officer. The conditions are intended to limit eligibility for umbrella registration to groups of private fund advisers that operate a single advisory business.

Books and Records Concerning Performance Information

The SEC adopted two amendments to the books and records rule, Rule 204-2 under the Advisers Act (the Recordkeeping Rule), that will require advisers to maintain additional records relating to the calculation and distribution of performance information.

The amendments revise the Recordkeeping Rule to require an adviser to maintain materials demonstrating the calculation of performance or rate of return in any communication that the adviser circulates or distributes, directly or indirectly, to any person. Currently, the Recordkeeping Rule requires an adviser to maintain such materials only for performance claims in communications distributed or circulated to 10 or more persons.

The amendments also revise the Recordkeeping Rule to require an adviser to maintain originals of all written communications received and copies of written communications sent by the adviser relating to the performance or rate of return of any or all of the adviser's managed accounts or securities recommendations.

The amendments will become effective on October 31, 2016, but advisers will not be required to comply with the amendments until October 1, 2017. Consequently, any adviser filing an initial Form ADV or an amendment to an existing Form ADV on or after October 1, 2017 will be required to provide responses to the Form revisions adopted by the SEC. Similarly, the adopting release states that amendments to the Recordkeeping Rule will apply to communications circulated or distributed after October 1, 2017.

The adopting release is available at: https://www.sec.gov/rules/final/2016/ia-4509.pdf

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SEC Approves Adoption of Generic Listing Standards for Actively Managed ETFs

On July 22, 2016, the SEC issued orders to BATS Exchange, Inc. (BATS) and NYSE Arca, Inc. (NYSE Arca) approving proposed rule changes to adopt generic listing standards for actively managed exchange-traded funds (ETFs). The orders will enable the exchanges to list actively managed ETFs that satisfy the applicable criteria without first having to seek separate approval from the SEC's Division of Trading and Markets.

Section 19(b) of the Exchange Act requires a self-regulatory organization – including BATS, NYSE Arca and other exchanges – to obtain SEC approval for "any proposed rule or proposed change in, addition to, or deletion from" existing rules of the exchange. Since the listing or trading of a new securities derivative product qualifies as a proposed rule change, and ETFs are deemed to be "derivative products" for this purpose, exchanges, on behalf of an ETF sponsor, must seek SEC approval in order to launch a new ETF by submitting a rule change proposal with the SEC pursuant to Rule 19b-4 under the Exchange Act. This process, which can take several months or longer, can create uncertainty for the ETF sponsor.

Rule 19b-4(e) under the Exchange Act provides an exception from this requirement for ETF shares that satisfy "generic listing standards" that have already been approved by the SEC. In this connection, the SEC has already approved rule changes for several exchanges enabling passively managed, index-tracking ETFs that meet the generic listing requirements to be listed without SEC approval. However, prior to issuing the orders to BATS and NYSE Arca, the SEC had not approved generic listing standards for an actively managed ETF.

The generic listing standards in the orders to BATS and NYSE Arca generally codify various restrictions on portfolio composition that commonly appeared in the SEC's prior Rule 19b-4 orders for actively managed ETFs and are based on the generic listing standards applicable to index-based ETFs. The standards establish portfolio requirements and limitations which vary based on asset class and relate to, among other things, in the case of equity securities, minimum market capitalization, minimum trading volume, portfolio weightings, number of issuers and issuer listing requirements, with certain differences in criteria for U.S. versus non-U.S. stocks. Similarly, an actively managed ETF's fixed income portfolio securities must satisfy minimum original principal amount and other issuer criteria. The generic listing standards also set forth criteria for the portion of an actively managed ETF's portfolio represented by derivatives, with key distinctions in the treatment of listed vs. over-the-counter derivative instruments. Listed actively managed ETFs will be required to meet the applicable portfolio composition requirements both at the time of listing and on an ongoing basis.

The exchanges will still be required to apply for relief before listing actively managed ETFs that do not meet the new listing standards. In addition, actively managed ETFs themselves will continue to be required to obtain exemptive relief under various provisions of the 1940 Act, which would not otherwise allow the ETF structure.

The generic listing standards for actively managed ETFs also include expanded website portfolio disclosure requirements, require that intra-day indicative values for actively managed ETFs be widely disseminated by one or more major market data vendors at least every 15 seconds during the trading day, and require each actively managed ETF to adopt a stated investment objective to be adhered to during "normal market conditions." In general, "normal market conditions" means the absence of trading halts in the applicable financial markets, operational issues such as systems failures causing the dissemination of inaccurate market information or *force majeure* events.

The SEC order issued to BATS is available at: https://www.sec.gov/rules/sro/bats/2016/34-78396.pdf.

The SEC order issued to NYSE Arca is available at: https://www.sec.gov/rules/sro/nysearca/2016/34-78397.pdf.

Division of Investment Management Issues Guidance Update Concerning Business Continuity Planning for Funds

On June 28, 2016, the staff of the SEC's Division of Investment Management issued a Guidance Update (the Guidance) discussing business continuity plans (BCPs) for registered investment companies (funds).[4] The Guidance reviews various measures that the SEC staff believes a fund should consider when evaluating the robustness of its BCP as well as the BCPs of "critical fund service providers," which the staff identifies as the adviser, principal underwriter, administrator, transfer agent, custodian and pricing agent.

BNYM/SunGard Incident and Lessons Learned

In emphasizing the importance of robust business continuity planning in order to mitigate risks for funds and investors, the Guidance cites the August 2015 incident when Bank of New York Mellon (BNYM) experienced a malfunction in one of its third-party systems (SunGard's InvestOne) that prevented it from calculating accurate net asset values for hundreds of mutual funds and exchange-traded funds (ETFs). The Guidance notes that the SEC staff conducted outreach to the fund industry during the course of and following the BNYM incident which revealed that "some funds could have been better prepared for the possibility that one of their critical service providers would suffer an extended outage." The SEC staff advises that fund complexes consider how to mitigate the consequences of disruptive events, such as the BNYM incident, through compliance policies and procedures tailored to the nature and scope of the complex and that address, among other things, "potential disruptions in services (whether provided internally at the fund complex or externally by a critical third-party service provider) that could affect a fund's ability to continue operations, such as processing shareholder transactions." Noting that fund complexes outsource critical functions to third parties, the staff also advises that fund complexes conduct initial and ongoing due diligence of those third parties, including assessments of their service providers' business continuity and disaster recovery plans.

"Notable Practices"

The Guidance lists several "notable practices" observed by the SEC staff in recent discussions with fund complexes (which may be understood as recommended features of BCPs), including:

- BCP coverage of facilities, technology/systems, employees, and activities of the adviser and affiliated entities, as well as dependencies on critical third-party services;
- Involvement of a broad cross-section of employees from key functional areas, including senior management, in BCPs;
- Service provider oversight by key personnel, including the Chief Compliance Officer (CCO) of the fund complex and/or the CCO of other entities in the fund complex;
- Service provider oversight methods including, but not limited to, service provider presentations, on-site visits, questionnaires, certifications, independent control reports (such as Service Organization Control

[4] On the same date that the Guidance was issued, the SEC published a release regarding proposed Rule 206(4)-4 under the Advisers Act, which would require every SEC-registered investment adviser to adopt and implement written business continuity and transition plans reasonably designed to address operational risks related to a significant disruption in the adviser's business (see summary below).

(SOC) reports prepared by independent auditors) and summaries of programs and testing;

- Annual BCP presentations to the fund board (either separately, or as part of the CCO's annual compliance report to the board or the board's annual 15(c) contract review process);
- Annual BCP testing, with results shared with the fund board; and
- CCO monitoring of business continuity outages, with reporting to the fund board as warranted.

Additional Considerations Regarding Critical Service Providers

The Guidance identifies certain additional recommendations regarding critical service providers that fund complexes should take into account, including:

- **Back-Up Processes and Contingency Plans**

  A fund complex should examine its critical service providers' backup processes and redundancies, the robustness of the providers' contingency plans, including reliance on other critical service providers, and how these providers intend to maintain operations during a significant business disruption.

  A fund complex should understand how its own BCP addresses risk that a critical service provider could suffer a significant business disruption and how the provider and the fund complex might respond under certain scenarios.

- **Monitoring Incidents and Communications Protocols**

  A fund complex should consider how to best monitor whether a critical service provider has experienced a significant disruption (such as a cybersecurity breach) that could impair the service provider's ability to provide uninterrupted services, the potential impacts such events may have on fund operations and investors, and the appropriate communication protocols. Such protocols might include:

  - Policies and procedures for internal communications across the fund complex, as well as with fund boards;
  - External communications plans that address ongoing discussions with the affected service provider, as well as other providers as warranted, and intermediaries, investors, regulators, and the press, as appropriate;
  - Maintaining updated and accessible contact information for essential communications with various constituents during an event; and
  - Providing timely communications that report progress and next steps, which may include posting updates to websites or using other portals to broadly disseminate information.

- **Understanding the Interrelationship of Critical Service Providers' BCPs**

  A fund complex should consider how the BCPs of its critical service providers relate to each other to better ensure that funds can continue operations and/or promptly resume operations during a significant business disruption.

- **Contemplating Various Scenarios**

  A fund complex should generally have a plan for managing the response to potential disruptions under various scenarios, whether such disruptions occur internally or at a critical third-party service provider.

Although the SEC staff acknowledges that it is not possible for a fund complex to anticipate or prevent every business continuity event, the Guidance states that a fund complex should consider its compliance obligations under the federal securities laws when assessing its ability to continue operations during such an event.

The Guidance is available at https://www.sec.gov/investment/im-guidance-2016-04.pdf

SEC Proposes New Rule and Rule Amendment Requiring Business Continuity and Transition Plans for Advisers

On June 28, 2016, the SEC proposed Rule 206(4)-4 under the Advisers Act that would require all SEC registered investment advisers to adopt and implement written business continuity and transition plans, including certain specific components, that are reasonably designed to address risks related to a significant disruption in the adviser's operations. The proposed rule is intended to help ensure that an adviser's policies and procedures minimize material service disruptions and any potential client harm from such disruptions. The SEC also proposed an amendment to Rule 204-2 under the Advisers Act, imposing certain record-keeping requirements regarding an adviser's business continuity and transition plans.

Proposed Rule 206(4)-4

Under the proposed rule, it would be unlawful for an adviser to provide investment advice unless the adviser adopts and implements written business continuity and transition plans and reviews those plans at least annually. These plans must include policies and procedures concerning: (1) business continuity after a significant business disruption, and (2) business transition in the event the adviser is unable to continue providing investment advisory services to clients. The proposing release states that business continuity situations generally include "natural disasters, acts of terrorism, cyber-attacks, equipment or system failures, or unexpected loss of a service provider or key personnel." Business transitions are described generally as including "situations where the adviser exists the market and thus is no longer able to serve its clients, including when it merges with another adviser, sells its business or a portion thereof, or in unusual situations, enters bankruptcy proceedings."

As proposed, an adviser's plan would be based upon the risks associated with the adviser's operations and specifically must address: (1) maintenance of critical operations and systems, and the protection, backup, and recovery of data; (2) pre-arranged alternate physical location(s) of the adviser's office(s) and/or employees; (3) communications with clients, employees, service providers and regulators; (4) identification and assessment of third-party services critical to the operation of the adviser; and (5) plan of transition that accounts for the possible winding down of the adviser's business or the transition of the adviser's business to others in the event the adviser is unable to continue providing advisory services. The proposing release states that while an adviser's plan must address the foregoing components, "the degree to which an adviser's plan addresses a required component will depend upon the nature of each particular adviser's business."

As noted, the proposed rule would also require each adviser to review the adequacy of its business continuity and transition plan on at least an annual basis, including a review of the adviser's effectiveness in implementing the plan. The annual review should: (1) consider other regulatory changes and changes to the adviser's business that might suggest a need to revise the plan; and (2) address any weaknesses identified through prior testing, assessments or instances where the plan had to be carried out.

Proposed Amendment to Rule 204-2

Under the proposed amendment to Rule 204-2, advisers would be required to maintain copies of all written business continuity and transition plans that are in effect or were in effect at any time during the last five years after the compliance date of the amendment. Each adviser would also be required to maintain records documenting the annual review of its business continuity and transition plans that would be required by proposed Rule 206(4)-4.

A copy of the proposing release is available at: https://www.sec.gov/rules/proposed/2016/ia-4439.pdf.

SEC Staff Provides Temporary No-Action Relief on Auditor Independence and the "Loan Provision"

On June 20, 2016, the staff of the SEC's Division of Investment Management, in consultation with the Office of the Chief Accountant and the Division of Corporation Finance, issued a no-action letter to Fidelity Management & Research Company (FMR) assuring that, for at least the next 18 months from issuance, and subject to certain conditions set forth in the letter, the staff would not recommend enforcement action to the SEC if a registered fund or other entity (a Fidelity Entity) in its "investment company complex" (as defined by Regulation S-X) employs a registered public accounting firm (an Audit Firm), that has relationships causing non-compliance with certain independence requirements under the so-called "Loan Provision."

Background

Rule 2-01(c) under Regulation S-X sets forth a non-exclusive list of circumstances that are considered inconsistent with an Audit Firm's independence, including the Loan Provision. The Loan Provision provides that an Audit Firm is not independent when the Audit Firm has a loan from "record or beneficial owners of more than ten percent of the audit client's equity securities." An "audit client," in turn, is defined to include any affiliate of the audit client and, when the audit client is an entity within an "investment company complex," it also includes every entity within the investment company complex, regardless of whether the Audit Firm actually provides audit services to those other entities.

FMR's request for no-action relief refers to discussions with Audit Firms about the "scope of their lending relationships," and identifies "one or more of the following circumstances, each of which could have potential implications under the Loan Provision" (collectively, Lending Relationships):

- An institution that has a lending relationship with an Audit Firm holds of record, for the benefit of its clients or customers (for example, as an omnibus account holder or custodian), more than 10% of the shares of a Fidelity Entity;
- An insurance company that has a lending relationship with an Audit Firm holds more than 10% of the shares of a Fidelity Entity (in this case, a Fidelity registered fund) in separate accounts that it maintains

on behalf of its insurance contract holders;

- An institution that has a lending relationship with an Audit Firm acts as an authorized participant or market maker to a Fidelity exchange-traded fund and holds of record or beneficially more than 10% of the shares of a Fidelity Entity.

The No-Action Relief

As noted, the SEC staff provided temporary no-action relief to a Fidelity Entity that employs an Audit Firm that has a Lending Relationship causing non-compliance with the Loan Provision.

The SEC staff conditioned its temporary no-action assurance on the following requirements:

(1) the Audit Firm has complied with Public Company Accounting Oversight Board (PCAOB) Rule 3526(b)(1) and

(2) (the provision governing independence communications), or, with respect to any Fidelity Entity to which Rule 3526 does not apply, has provided substantially equivalent communications;

(2) the non-compliance of the Audit Firm is with respect to the Lending Relationships; and

(3) notwithstanding such non-compliance, the Audit Firm has concluded that it is objective and impartial with respect to the issues encompassed within its engagement.

In granting this no-action relief, the SEC staff cited the Audit Firm's representation to FMR that, notwithstanding the Firm's non-compliance with the Loan Provision due to a Lending Relationship, following an evaluation of the impact of this lending relationship on its independence, the Audit Firm has been able to maintain its impartiality and objectivity with respect to the planning for and execution of the Fidelity funds' audits, emphasizing, among other things, that the institution with which it has a lending relationship is not able to impact the impartiality of the Audit Firm or assert any influence over the Fidelity fund whose shares the institution owned or its investment adviser. Also important to the SEC staff in this regard was FMR's representation that "[t]hose responsible for the oversight of the Fidelity funds have not reached a different conclusion with respect to the Audit Firm's objectivity and impartiality."

Notably, the no-action letter indicates that more stringent requirements are needed in connection with certain shareholder votes. If shareholders are voting on: (1) the election of trustees or directors; (2) the appointment of an independent auditor; or (3) "other matters that similarly could influence the objectivity and impartiality of the independent auditor," the Fidelity Entity must make "reasonable inquiry" as of the record date of the shareholder meeting regarding the impact of the Loan Provision. Reasonable inquiry could include the review of available ownership records and contacting applicable owners to inquire whether a lending institution in a Lending Relationship owns of record or beneficially more than 10% of the shares of a Fidelity Entity. FMR represented that if the reasonable inquiry reveals that an institution in a Lending Relationship can exercise discretionary voting authority with respect to at least 10% of the Fidelity Entity's shares, the Fidelity Entity would not rely on the relief granted by the staff in the no-action letter and would instead take "other appropriate action, consistent with its obligations under the federal securities laws."

The SEC staff concluded that it would not object to a Fidelity Entity relying on an audit opinion from an Audit Firm "that has identified a failure" to comply with the Loan Provision, "where the failure to comply with the Loan Provision is limited to the Lending Relationships, including making a reasonable inquiry, as described within this letter and where the Audit Firm's

judgment remains objective and impartial."

A copy of the no-action letter is available at: http://edgar.sec.gov/divisions/investment/noaction/2016/fidelity-management-research-company-062016.htm

Public Statements, Press Releases and Testimony

OCIE Announces Share Class Initiative Focused on Conflicts of Interest

On July 13, 2016, the SEC's Office of Compliance Inspection and Examinations (OCIE) issued a Risk Alert announcing the launch of a share class initiative (the Initiative) to examine whether registered advisers and their associated persons are receiving undisclosed compensation or other financial incentives when recommending certain share classes to clients. As part of its focus on retail investor protection (one of OCIE's 2016 examination priorities), OCIE seeks to identify conflicts of interest concerning advisers' compensation or financial incentives for recommending mutual fund and 529 Plan share classes that have "substantial loads or distribution fees."

In the Risk Alert, OCIE identifies the following situations as examples of a conflict of interest related to share class recommendations: (1) where the adviser is dually registered as a broker-dealer (or is affiliated with a broker-dealer) that receives fees from the sale of certain share classes; and (2) where the adviser recommends that clients purchase more expensive share classes of funds for which an affiliate of the adviser receives greater fees.

In seeking to identify such conflicts of interest, the Risk Alert indicates that the SEC staff will focus on adviser practices relating to share class recommendations and compliance oversight of the process, including the following "high risk areas":

- **Fiduciary Duty and Best Execution.** In view of an adviser's fiduciary duty to act in the client's best interest, including to seek best execution for client transactions (which, according to the staff, may be defined as an obligation "to seek the most favorable terms reasonably available under the circumstances"), OCIE examiners are expected to review advisers' investment practices associated with share class recommendations, as well as advisers' books and records, in order to identify share classes held and purchased in client accounts and any related compensation received by the adviser or any of its associated persons.
- **Disclosures.** Noting an adviser's duty to make full and fair disclosure of all material facts, OCIE staff will likely review an adviser's practices surrounding its selection of mutual fund and 529 Plan investments in its clients' accounts with "a focus on assessing the accuracy, adequacy, and effectiveness of the adviser's disclosures regarding compensation for the sale of shares and the conflicts of interest created."
- **Compliance Program.** Examiners will likely review the adviser's practices surrounding its selection of mutual fund and 529 Plan share class investments in clients' accounts and assess the adequacy and effectiveness of the adviser's corresponding written policies and procedures (which must be reasonably designed to prevent violations of the Advisers Act and the rules thereunder).

The Risk Alert cautions that examiners may select additional topics based on other risks identified during the course of the examination.

The Risk Alert concludes by encouraging investment advisers to reflect upon their own practices, policies and procedures in these areas and to make improvements in their compliance programs as necessary.

The Risk Alert is available at: https://www.sec.gov/ocie/announcement/ocie-risk-alert-2016-share-class-initiative.pdf.

Other News and Developements

Financial Stability Board Issues Policy Recommendations to Address "Structural Vulnerabilities" in Asset Management Industry

On June 22, 2016, the Financial Stability Board (FSB)[5] issued proposed policy recommendations to "address risks to global financial stability associated with the relevant structural vulnerabilities from asset management activities," with a request for public comment by September 21, 2016. The recommendations are the product of an initiative launched by the FSB in March 2015.

The proposed policy recommendations seek to address financial stability risks associated with: (1) the mismatch between liquidity of fund investments and redemption terms and conditions for fund units; (2) leverage within investment funds; (3) operational risk and challenges in transferring investment mandates in stressed conditions; and (4) securities lending activities of asset managers and funds. Following receipt and review of public comments, the FSB intends to finalize the recommendations by the end of 2016, "some of which will then be operationalised by [the International Organizational of Securities Commissions (IOSCO)][6] and the relevant FSB working groups."

Notably, several of the policy recommendations appear to have been addressed, at least in part, by recent SEC rule proposals, including liquidity risk management.

The FSB's proposed policy recommendations are categorized by the four areas noted above and include the following:

(1) Recommendations to address liquidity mismatch between fund investment assets and redemption terms and conditions for fund units

Lack of information and transparency:

- Authorities should: (a) collect information on the liquidity profile of open-ended funds in their jurisdiction proportionate to the risks they may pose from a financial stability perspective; (b) review existing reporting requirements; and (c) enhance reporting requirements as appropriate to ensure that they are adequate, sufficiently granular and frequent.
- Authorities should: (a) review existing investor disclosure requirements; and (b) determine the degree to which additional disclosures should be provided regarding fund liquidity profiles.

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5 The FSB was established in April 2009 as the successor to the Financial Stability Forum (FSF) by the G20 and is an international body that monitors and makes recommendations about the global financial system.

6 IOSCO is an international body of securities regulators founded in April 1983 and includes the SEC among its 211 members. SEC Chair Mary Jo White is a member of IOSCO's Board.member of IOSCO's Board.

Gaps in liquidity risk management tools both at the design phase and on an ongoing basis:

- In order to reduce the likelihood of "material liquidity mismatches arising from an open-ended fund's structure," authorities should have requirements or guidance stating that funds' assets and investment strategies should be consistent with the terms and conditions governing fund unit (share) redemptions both at fund inception and on an ongoing basis (for new and existing funds), taking into account the expected portfolio liquidity and investor behavior during normal and stressed market conditions.
- When appropriate, authorities should widen the availability of liquidity risk management tools (such as swing pricing, redemptions fees and other anti-dilution methods) to open-ended funds, and reduce barriers to the use of those tools to: (a) increase the likelihood that redemptions are met even under stressed market conditions; and (b) reduce first-mover advantage, where it may exist.

Adequacy of liquidity risk management tools to deal with exceptional circumstances:

- Authorities should promote (through regulatory requirements or guidance) clear decision-making processes for open-ended funds' use of "extraordinary liquidity risk management tools" (e.g., suspensions of redemptions, gates), and the processes should be made transparent to investors and the relevant authorities.

(2) Recommendations to address leverage within funds

- IOSCO should develop simple and consistent measure(s) of leverage in funds with due consideration of appropriate netting and hedging assumptions, which would "enhance authorities' understanding of risks that leverage in funds may create, facilitate more meaningful monitoring of leverage, and help enable direct comparisons across funds and at a global level."

(3) Recommendations to address operational risk and challenges in transferring investment mandates or client accounts

- Authorities should have requirements or guidance for asset managers that are "large, complex, and/or provide critical services" to have comprehensive and robust risk management frameworks and practices, particularly with respect to business continuity and transition plans, "to enable orderly transfer of their clients' accounts and investment mandates in stressed conditions."

(4) Recommendation to address securities lending activities of asset managers and funds

- Authorities should monitor indemnifications provided by securities lending agents and asset managers to clients in relation to their securities lending activities, i.e., authorities should verify and confirm asset managers adequately cover potential credit losses from the indemnification provided to their clients.

The FSB's policy recommendations are available at: http://www.fsb.org/2016/06/proposed-policy-recommendations-to-address-structural-vulnerabilities-from-asset-management-activities/.

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