VedderPrice

April 2017

Investment Services Regulatory Update

New Rules, Proposed Rules and Guidance

SEC Adopts T+2 Settlement Cycle for Securities Transactions, Shortening Timing Mismatch for Mutual Funds

On March 22, 2017, the SEC adopted an amendment to the settlement cycle rule under the Securities Exchange Act to shorten the standard settlement cycle for most broker-dealer securities transactions from three business days after the trade date (i.e., T+3) to two business days after the trade date (i.e., T+2). The SEC's adopting release for the rule amendment cites comments on the T+2 proposing release (published on September 28, 2016), including from the Investment Company Institute (ICI), that noted, in the context of mutual funds, a shortened settlement cycle would reduce the timing mismatch and funding gap between settlement of a mutual fund's portfolio securities (which settle on T+3) and the settlement of shares issued to investors through the mutual fund itself (which generally settle on T+1), improving cash management for funds to meet redemptions. The adopting release notes that such comments support the SEC's belief that "by better aligning the settlement cycle between the underlying portfolio securities and the securities issued to investors through the mutual fund, the risk to the fund, and ultimately investors is reduced." The amendment to the settlement cycle rule will go into effect on September 5, 2017.

The adopting release directs the SEC staff to submit a report to the SEC no later than September 5, 2020, examining the impact of the establishment of the T+2 standard settlement cycle on market participants and the potential impacts associated with moving to an even shorter settlement cycle.

The SEC's adopting release is available at: https://www.sec.gov/rules/final/2017/34-80295.pdf.

SEC Staff Issues No-Action Letter Permitting U.S. Master Fund—Foreign Feeder Fund Arrangements

On March 8, 2017, the staff of the SEC's Division of Investment Management (the Staff) issued a no-action letter (the No-Action Letter) stating that it would not recommend enforcement action to the SEC under Section 12(d)(1)(A) or (B) of the 1940 Act against: (i) a foreign investment company that is not registered under the 1940 Act (a Foreign Feeder Fund), if the Foreign Feeder Fund acquires (1) securities of a single 1940 Act-registered open-end fund (a U.S. Master Fund) in excess of the limits of Section 12(d)(1)(A) of the 1940 Act and, for certain Foreign Feeder Funds, (2) Foreign Currency Instruments (as defined in the No-Action Letter); and (ii) the U.S. Master Fund and its principal underwriter (the Master Fund Principal Underwriter) and any broker or dealer for selling the U.S. Master Fund's securities in excess of the limits of Section 12(d)(1)(B) of the 1940 Act to a Foreign Feeder Fund (the Proposed Structure). As explained in the letter to the Staff seeking no-action assurance (the Incoming Letter), the Proposed Structure would enable global investment managers to efficiently offer investment products across several foreign jurisdictions. The law firm that submitted the request (the Applicant) asserts in the Incoming Letter that the "Proposed Structure would be beneficial to the U.S. mutual fund industry and could potentially attract significant assets to the U.S. and create significant scale to the benefit of investors in U.S. Master Funds."

Section 12(d)(1)(A) of the 1940 Act, in relevant part, prohibits a registered or unregistered investment company (an acquiring fund) from investing in the securities of a registered fund (the acquired fund) if immediately after the acquisition the acquiring fund: (i) owns more than 3% of the outstanding voting securities of the acquired fund; (ii) has more than 5% of its total assets invested in the acquired fund; or (iii) has more than 10% of its total assets invested in the acquired fund and all other acquired funds. Section 12(d)(1)(B) of the 1940 Act prohibits an acquired fund, its principal underwriter and any broker or dealer registered under the Exchange Act, from knowingly selling the acquired fund's securities to any acquiring fund and any companies controlled by such acquiring funds if, immediately after the sale: (i) more than 3% of the acquired fund's outstanding voting securities would be owned by the acquiring fund or companies controlled by it; or (ii) more than 10% of the acquired fund's outstanding voting securities would be owned by the acquiring fund and other funds and companies controlled by them.

Section 12(d)(1)(E) of the 1940 Act provides a conditional exemption from the restrictions in Sections 12(d)(1)(A) and (B) of the 1940 Act that is relied upon by, among others, private funds and foreign investment companies to invest in U.S.-registered funds. Absent no-action relief from the Staff, as applied to the Proposed Structure, Section 12(d)(1)(E) would require that: (1) the principal underwriter for the Foreign Feeder Fund must be a broker or dealer registered under the Exchange Act or a person controlled by such broker or dealer; (2) the U.S. Master Fund's securities are the only investment security held by the Foreign Feeder Fund; and (3) the Foreign Feeder Fund purchases or otherwise acquires securities issued by the U.S. Master Fund pursuant to an arrangement with the U.S. Master Fund or its principal underwriter whereby the Foreign Feeder Fund is obligated: (i) either to seek instructions from its shareholders with regard to the voting of all proxies with respect to the U.S. Master Fund's securities and to vote such proxies only in accordance with such instructions, or to vote the shares held by it in the same proportion as the vote of all other shareholders of the U.S. Master Fund's securities; and (ii) to refrain from substituting the U.S. Master Fund's securities unless the SEC shall have approved such substitution in the manner provided in Section 26 of the 1940 Act. However, as the Applicant explains in the Incoming Letter, a Foreign Feeder Fund may not be able to comply with certain provisions of Section 12(d)(1)(E) because of its structure and the laws and/or market practices of the foreign jurisdiction in which it operates. As examples, the Applicant notes that the laws and/or market practices of the foreign jurisdiction in which a Foreign Feeder Fund operates: (i) may prohibit the Foreign Feeder Fund from directly voting the shares of the applicable U.S. Master Fund, which could be viewed as precluding compliance with the “pass through” or “echo” voting requirements under Section 12(d)(1)(E); or (ii) not require the Foreign Feeder Fund to distribute its securities through a principal underwriter or a principal underwriter that is, or that is controlled by, a broker-dealer registered under the Exchange Act.

In granting the no-action relief, the Staff allowed the following deviations from the conditions of Section 12(d)(1)(E):

- a Foreign Feeder Fund: (a) may have a principal underwriter that either controls or is under common control with an Exchange Act-registered broker-dealer (Foreign Principal Underwriter); and (b) will have as its investment adviser an adviser (Feeder Fund Adviser) that (i) controls, is controlled by, or is under common control with (Control Affiliate), the investment adviser to the U.S. Master Fund (Master Fund Adviser) and the Master Fund Principal Underwriter and (ii) may be registered under the Advisers Act;

- a Foreign Feeder Fund may hold certain investment securities other than the securities of the U.S. Master Fund, but will do so solely for purposes of hedging either: (a) the performance of the U.S. Master Fund, measured in the U.S. dollar, against the currency of the foreign jurisdiction in which the Foreign Feeder Fund’s securities are primarily offered and sold (Designated Currency); or (b) if the U.S. Master Fund seeks to approximate the return of an index, the U.S. dollar and/or foreign currency exposure of the U.S. Master Fund to the Foreign Feeder Fund’s Designated Currency; and

- a Foreign Feeder Fund may either abstain from voting or withhold voting the U.S. Master Fund’s shares, rather than pass through such vote to the Foreign Feeder Fund’s shareholders or vote proportionately to the vote of the U.S. Master Fund’s other shareholders.

In allowing the foregoing deviations from Section 12(d)(1)(E), and in view of, in particular, the potential absence of a principal underwriter or depositor for a Foreign Feeder Fund or participation in the Proposed Structure by a Foreign Principal Underwriter, the Staff required that:

- the Foreign Feeder Fund will have an investment adviser that is a Control Affiliate of the Master Fund Adviser and Master Fund Principal Underwriter;

- to the extent the Feeder Fund Adviser is not registered under the Advisers Act, such Feeder Fund Adviser must make its books and records with respect to the activities of the Foreign Feeder Fund available to the SEC and its Staff, designate the Master Fund Adviser as its agent for service of process in the U.S. with respect to the Foreign Feeder Fund, and consent to the jurisdiction of the U.S. courts and the SEC with respect to its activities in connection with the Foreign Feeder Fund;

- the Foreign Feeder Fund will be organized in, and regulated under the laws of, jurisdictions whose securities regulators have entered into a cooperation agreement with the SEC; and

- no Foreign Feeder Fund will offer or sell its securities in the U.S., either publicly or privately, or sell its securities to any "U.S. person," as defined in Rule 902(k) of Regulation S; each Foreign Feeder Fund's transactions with its shareholders will be consistent with the definition of "offshore transactions" in Rule 902(h) of Regulation S; and no Foreign Feeder Fund, Feeder Fund Adviser, Foreign Principal Underwriter, any of their respective affiliates, or any person acting on behalf of any of the foregoing, will engage in any "directed selling efforts," as defined in Rule 902(c) of Regulation S, with respect to securities of the Foreign Feeder Fund in the U.S.

The No-Action Letter is available at: https://www.sec.gov/divisions/investment/noaction/2017/dechert-030817-12d1.htm.

SEC Issues Proposal Requiring Use of Inline XBRL Format for Mutual Fund Risk/Return Summaries

On March 1, 2017, the SEC issued a proposed rule that would require the use of the "Inline XBRL" format for the submission of mutual fund risk/return summaries. Inline XBRL allows filers to embed XBRL data directly into an HTML document, eliminating the need to tag a copy of the information in a separate XBRL exhibit. In 2009, the SEC required mutual funds to provide risk/return summary information from their prospectuses in eXtensible Business Reporting Language (i.e., XBRL) format by submitting it to the SEC in an "Interactive Data File" exhibit. The Interactive Data File is required to be posted on a mutual fund's website for as long as the registration statement or post-effective amendment to which the Interactive Data File relates remains current. If a mutual fund does not submit or post interactive data as required, its ability to file post-effective amendments to its registration statement under Rule 485(b) under the Securities Act is automatically suspended until it submits and posts the interactive data required. The 2009 requirements were intended to make mutual fund risk/return summaries easier for investors to analyze and to assist in automating regulatory filings.

To "help facilitate efficiencies in the mutual fund post-effective amendment filing process," the SEC is proposing changes to the General Instructions to Form N-1A that would change the timing requirements for the submission of Interactive Data Files. As noted in the proposing release, the SEC proposes permitting mutual funds to submit Interactive Data Files concurrently with certain post-effective amendments filed pursuant to Rule 485(b) under the Securities Act. The SEC also is proposing to eliminate the current 15 business day filing period accorded to all mutual fund filings containing risk/return summaries, including initial registration statements, post-effective amendments, and forms of prospectuses filed pursuant to Rule 497. In the case of initial registration statements and post-effective amendments, the Interactive Data File would be required to be submitted no later than the effective date of those filings. In the case of forms of prospectuses filed pursuant to Rule 497, the Interactive Data File would be required to be submitted concurrently with the filing.

The SEC proposes a phase-in for mutual funds based on net asset size. For "larger entities," identified in the proposing release as mutual funds that together with other investment companies in the same "group of related investment companies” have net assets of $1 billion or more as of the end of the most recent fiscal year, the proposed compliance date is one year after the effective date to comply with the new reporting requirements. For “smaller entities,” i.e., mutual funds that together with other investment companies in the same “group of related investment companies” have net assets of less than $1 billion as of the end of the most recent fiscal year, the SEC proposes to provide for an additional year to comply with the new reporting requirements.

Comments on the proposed rule are due by May 16, 2017. The SEC’s proposing release is available at: https://www.sec.gov/rules/proposed/2017/33-10323.pdf.

SEC Staff Issues Guidance Update Addressing Advisers Act Obligations of Robo-Advisers

On February 23, 2017, the staff of the SEC’s Division of Investment Management (the Staff) issued a Guidance Update addressing the unique issues raised by automated investment advisers, i.e., “robo-advisers,” and offering suggestions on meeting disclosure, suitability and compliance obligations under the Advisers Act. As the Staff notes, robo-advisers operate under a wide variety of business models and provide a range of advisory services with varying levels of human interaction. Although the Guidance Update focuses on robo-advisers that provide services directly to clients over the internet, the Staff notes that the guidance may be helpful for other types of robo-advisers as well as other registered investment advisers generally.

Substance and Presentation of Disclosures

The Guidance Update notes that since client relationships with robo-advisers may occur with limited, if any, human interaction, robo-advisers should be mindful that the ability of a client to make an informed decision about whether to enter into, or continue, an investment advisory relationship may be dependent solely on a robo-adviser’s electronic disclosures made via email, websites, mobile applications and/or other electronic media. Accordingly, the Staff offers several suggestions for a robo-adviser to consider in explaining its business model, the scope of advisory services offered and the manner in which it presents material information to clients.

Explanation of Business Model

In explaining its business model, the Staff recommends, among other things, that robo-advisers provide:

- a statement that an algorithm is used to manage individual client accounts and a description of the algorithmic functions used for this purpose (e.g., that the algorithm generates recommended portfolios);
- a description of the assumptions and limitations of the algorithm;
- a description of the particular risks inherent in the use of an algorithm to manage client accounts (e.g., that the algorithm might rebalance client accounts without regard to market conditions or on a

more frequent basis than the client might expect);

- a description of any circumstances that might cause the robo-adviser to override the algorithm;
- a description of any involvement by a third party in the development, management or ownership of the algorithm, including an explanation of any conflicts of interest such an arrangement may create; and
- an explanation of the degree of human involvement in the oversight and management of individual client accounts.

Scope of Advisory Services

The Staff cautions robo-advisers to "consider the clarity of the descriptions of the investment advisory services they offer and use reasonable care to avoid creating a false implication or sense about the scope of those services which may materially mislead clients." For instance, the Staff states that robo-advisers should be careful not to mislead clients by implying that:

- the robo-adviser is providing a comprehensive financial plan if it is not in fact doing so;
- a tax-loss harvesting service also provides comprehensive tax advice; or
- information other than that collected by the questionnaire (e.g., information concerning other client accounts held with the robo-adviser, its affiliates or third parties) is considered when generating investment recommendations if such information is not in fact considered.

Presentation of Disclosures

In presenting their disclosures, the Staff recommends that robo-advisers consider:

- whether key disclosures are presented prior to the sign-up process so that information necessary to make an informed investment decision is available to clients before they engage, and make any investment with, the robo-adviser;
- whether key disclosures are specially emphasized;
- whether some disclosures should be accompanied by interactive text or other means to provide additional details to clients who are seeking more information; and
- whether the presentation and formatting of disclosure made available on a mobile platform have been appropriately adapted for that platform.

Provision of Suitable Advice

The Staff, which, in coordination with the Staff of the Office of Compliance Inspections and Examinations, has been monitoring and engaging with robo-advisers to evaluate how these advisers meet their obligations under the Advisers Act, observed that robo-advisers may provide investment advice based primarily, if not solely, on client responses to online questionnaires. In making this observation, the Staff notes that an investment adviser's fiduciary duty includes an obligation to act in the best interests of its clients and to provide only suitable investment advice reasonably determined based on the client's financial situation and investment objectives. Consequently, the Staff suggest that a robo-adviser consider whether its questionnaire is designed to elicit sufficient information to support its suitability obligation. In particular, the Staff recommends that a robo-adviser consider factors such as:

- whether the questions elicit sufficient information to allow the robo-adviser to conclude that its initial recommendations and ongoing investment advice are suitable and appropriate for that client based on his or her financial situation and investment objectives;
- whether the questions in the questionnaire are sufficiently clear and/or whether the questionnaire is designed to provide additional clarification or examples to clients when necessary; and
- whether steps have been taken to address inconsistent client responses.

The Staff also observed that some robo-advisers allow investors to select alternatives to the recommended portfolio, but do not give investors an opportunity to discuss with investment personnel the suitability of the selected portfolio in light of their stated investment objectives and risk profile. To address this issue, the Staff recommends that robo-advisers provide clients with commentary supporting their recommended portfolio, as well as incorporate features that alert clients when their selected portfolio conflicts with their stated investment objectives.

Effective Compliance Programs

The Staff recommends that robo-advisers tailor their compliance programs to address the unique features of their business models; namely, their reliance on algorithms, the limited human interaction with clients and the provision of advice over the internet. In particular, the Staff suggests that robo-advisers consider adopting policies and procedures that address the following:

- the development, testing, and back-testing of the algorithmic code and the post-implementation monitoring of its performance;
- the questionnaire eliciting sufficient information to allow the robo-adviser to conclude that its initial recommendations and ongoing investment advice are suitable and appropriate for that client based on his or her financial situation and investment objectives;
- the disclosure to clients of changes to the algorithmic code that may materially affect their portfolios;

- the appropriate oversight of any third party that develops, owns, or manages the algorithmic code or software modules utilized by the robo-adviser;
- the prevention and detection of, and response to, cybersecurity threats;
- the use of social and other forms of electronic media in connection with the marketing of advisory services; and
- the protection of client accounts and key advisory systems.

The Staff indicates that it will continue to monitor robo-advisers and other innovations in the provision of advisory services and implement safeguards, as necessary, to help facilitate such developments and protect investors.

The Guidance Update is available at: https://www.sec.gov/investment/im-guidance-2017-02.pdf.

SEC Staff Issues Guidance on "Inadvertent Custody" of Client Assets

On February 21, 2017, the staff of the SEC's Division of Investment Management (the Staff) addressed circumstances in which an investment adviser may inadvertently have custody of client assets for purposes of Rule 206(4)-2 under the Advisers Act (the Custody Rule) because of provisions in a separate custodial agreement entered into between its advisory client and a qualified custodian. Noting "widespread confusion and uncertainty" among investment advisers, custodians, broker-dealers, compliance professionals and legal counsel, the Investment Adviser Association (IAA) requested clarification from the Staff that an investment adviser that exercises limited authority to disburse client funds to one or more third parties, as specifically designated by the client pursuant to a standing letter of instruction or other similar asset transfer authorization arrangement established by the client with a qualified custodian (a SLOA) does not have custody under the Custody Rule. The IAA alternatively requested no-action relief if the investment adviser exercises such limited authority pursuant to a SLOA without undergoing an annual surprise exam by an independent public accountant to verify client assets as required by the Custody Rule.

Under the Custody Rule, an investment adviser has "custody" of client funds or securities where it or its related person "holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services [it] provide[s] to clients." In addition, "custody" includes "[a]ny arrangement… under which [an investment adviser is] authorized or permitted to withdraw client funds or securities maintained with a custodian upon [its] instruction to the custodian." In its letter to the Staff, the IAA asserted that an investment adviser that simply follows a client's instructions to transfer assets pursuant to a SLOA and the adviser's corresponding direction to the qualified custodian do not result in an adviser "holding" client funds or give an adviser "authority to obtain possession" of client funds or permit an adviser to "withdraw clients funds," each as contemplated by the Custody Rule.

The Staff disagreed, stating that "an investment adviser with power to dispose of client funds or securities for any purpose other than authorized trading has access to the client's assets." The Staff asserted that a SLOA provides an adviser with such power and thus, an adviser that enters into such an arrangement with its client would have custody of client assets and would be required to comply with the Custody Rule. Nevertheless, the Staff provided no-action relief with respect to an investment adviser that does not obtain a surprise audit where it acts pursuant to such an arrangement under the following circumstances:

1. The client provides an instruction to the qualified custodian, in writing, that includes the client's signature, the third party's name, and either the third party's address or the third party's account number at a custodian to which the transfer should be directed.
2. The client authorizes the investment adviser, in writing, either on the qualified custodian's form or separately, to direct transfers to the third party either on a specified schedule or from time to time.
3. The client's qualified custodian performs appropriate verification of the instruction, such as a signature review or other method to verify the client's authorization, and provides a transfer of funds notice to the client promptly after each transfer.
4. The client has the ability to terminate or change the instruction to the client's qualified custodian.
5. The investment adviser has no authority or ability to designate or change the identity of the third party, the address, or any other information about the third party contained in the client's instruction.
6. The investment adviser maintains records showing that the third party is not a related party of the investment adviser or located at the same address as the investment adviser.
7. The client's qualified custodian sends the client, in writing, an initial notice confirming the instruction and an annual notice reconfirming the instruction.

The Staff also advised that, beginning with the next annual updating amendment after October 1, 2017, an investment adviser should include client assets that are subject to a SLOA that result in custody in its response to Item 9 of Form ADV.

The Staff's letter to the IAA is available at:

https://www.sec.gov/divisions/investment/noaction/2017/investment-adviser-association-022117-206-4.htm.

In addition to its letter to the IAA, the Staff also issued a Guidance Update titled "Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority" (the Guidance Update). Echoing the view expressed in the letter to the IAA, the Guidance Update cautions advisers to be aware that they may have custody depending on the wording of or rights conferred by custodial agreements, even though advisers did not otherwise intend to have access to client funds or securities triggering application of the Custody Rule. As examples of agreements between clients and qualified custodians that might permit the client's adviser to instruct the custodian to disburse, or transfer, funds or securities, the Guidance Update identifies the following:

- a custodial agreement that grants the client's adviser the right to "receive money, securities, and property of every kind and dispose of same."
- a custodial agreement under which a custodian "may rely on [adviser's] instructions without any direction from you. You hereby ratify and confirm any and all transactions with [the custodian] made by [adviser] for your account."
- a custodial agreement that provides authorization for the client's adviser to "instruct us to disburse cash from your cash account for any purpose…"

The Guidance Update advises that the definition of custody turns on whether the adviser is permitted to "withdraw" client funds or securities "upon [the adviser's] instruction to the qualified custodian," which may occur even in circumstances in which provisions in a custodial agreement and advisory agreement conflict as to an adviser's authority in this regard. As an example, the Staff believes an adviser would have custody if the custodial agreement authorizes the adviser to withdraw client funds or securities, notwithstanding a provision in the advisory agreement to the contrary. Indeed, according to the Staff, a separate bilateral restriction between the adviser and the client would be insufficient to prevent the adviser from having custody where the custodial agreement enables the adviser to withdraw or transfer client funds or securities upon instruction to the custodian.

The Guidance Update is available at: https://www.sec.gov/investment/im-guidance-2017-01.pdf

Other Developments

Mutual Fund Directors Forum Issues Report on the Role of Directors in Oversight of the Risk Management Function

On February 17, 2017, the Mutual Fund Directors Forum released a report titled "Role of the Mutual Fund Director in the Oversight of the Risk Management Function" (the Report). The purpose of the Report is to assist fund directors by outlining key concepts and principles relevant to fund directors' risk oversight. The Report is divided into three sections: (1) a fund director's duties and role in the risk oversight process; (2) context to help directors better understand how investment advisers develop and monitor risk management programs; and (3) discussion of several specific areas of risk, including, among others, regulatory risk, valuation risk, cybersecurity risk, reputational risk, and risks related to new strategies.

The Report encourages fund directors, when thinking about risk and their role in risk oversight, to consider the characteristics of the funds they oversee, including fund type, fund size, the assets and number of funds in the fund complex, the structure of management and other service arrangements, fees, vendor management framework, the nature of the investment objectives and the investments used in the funds.

Risk Oversight Function

The Report notes that, generally, effective risk oversight contemplates that a fund's directors understand a fund's regulatory, investment, and operational risks. The Report also advises that fund directors should avoid the temptation to become drawn into the day-to-day operations of a fund and its adviser. Instead, fund directors should (1) delegate day-to-day management responsibilities relating to the fund to the fund's investment adviser and other third-party service providers and (2) focus on overseeing these parties' performance and operate as an independent check on those charged with day-to-day management responsibilities. The Report encourages fund directors to work with outside parties and the fund's investment adviser to oversee how risks are identified and managed. The Report also notes the fund's chief compliance officer (the CCO) can be a valuable asset in overseeing risk management given the CCO's involvement in a variety of risk areas, such as those for valuation, securities lending, and disclosure.

The Report suggests that, to gain an understanding of these risks, directors should:

- request enough information regarding the fund's activities and the critical services provided to the fund to develop an appropriate understanding of the risks inherent in the operation of a fund and to then assess the effectiveness of risk practices and controls implemented by the adviser and other service providers;
- receive regular updates from the investment adviser regarding the risks associated with outsourced services and how they are being managed; and
- evaluate on an ongoing basis whether fund policies and procedures in place are reasonably designed and effective at preventing the fund's operations from violating applicable federal securities laws.

Risk Management Programs

As part of their risk oversight, a fund's directors should discuss with the adviser its risk assessment process and how potential risks are identified and addressed, and how ongoing risks are regularly evaluated, managed and/or mitigated. The board should appreciate how the adviser identifies the variety of risk concerns appropriate to a particular fund. While there is no standard model or organizational structure for risk management, and investing styles, operations and service providers can vary widely, most risk management programs follow similar principles. Risk management programs are designed to identify, measure, and manage the most significant risks, not to eliminate every risk.

The Report identifies several elements directors should consider when evaluating the effectiveness of a risk management program and, for each, includes a list of questions fund directors may want to ask. The elements that the Report encourages fund directors to consider include:

- the firm's attitude toward risk management and the risk culture at a firm;
- how a firm communicates about its risk management program across the organization, including (1) how it notifies appropriate parties about risk events, (2) how issues are escalated through various levels of management within the organization, and (3) what information the board receives on a regular basis and when the board should be notified of risk events;
- how the adviser assesses risk in relation to the adviser's risk appetite, risk tolerance in relation to the overall objectives of a fund, and whether a fund's strategy is aligned with its risk appetite and risk tolerances;
- what mechanisms exist to identify risk events (e.g., a cyber breach, a significant trading error, or exceeding the expected volatility range for a fund's return) and what is the process for responding to risk events;
- the firm's current controls; the ongoing development, execution and evolution of the control structure; and adjustments and responses to the control structure to address risk events;
- whether the adviser is continuously evaluating its risk management program in connection with shareholder expectations, current market conditions, and regulatory concerns;
- how the risks of relying on third parties to perform critical functions (e.g., sub-advisers, fund administrators, custodians, transfer agents, other intermediaries, and sub-accounting firms) are being identified and managed; and
- critical service providers' business continuity planning and disaster recovery protocols and how the fund complex's own business continuity planning addresses the risk that a critical third-party provider could suffer a significant business disruption.

Key Risks Facing the Investment Management Industry

The Report provides details on several key risks facing the investment management industry, but notes that not all of the risks discussed will require equal levels of board attention or time during board meetings and that boards may address risks differently. The Report encourages directors to pay particular attention to areas where there are potential conflicts between the shareholders and the fund's adviser when considering the key risks facing the funds they oversee. For each of the risks identified, the Report includes a list of key considerations for fund directors.

The risks identified by the Report include:

- Investment Risk: both the intended or expected risk from the investment process and the unintended risk that may result from investment decisions, assumptions, market movements, and other factors.
- Regulatory Risk: the risk that a fund is operating in a manner that is not in compliance with existing regulation.
- Liquidity Risk: the risk that (1) a fund does not have sufficient liquid assets to meet redemption requests in a manner consistent with SEC requirements without harming remaining shareholders; (2) established methods to determine liquidity have not been applied consistently and/or accurately; (3) established liquidity determination methods are no longer appropriate; and (4) the fund's valuation procedures and policies do not appropriately consider liquidity in the valuation process to achieve accurate security valuations.
- Valuation Risk: the risk that a fund inappropriately determines the value of one or more of its investments, resulting in an inaccurate net asset value for the fund.
- Cyber Risk: the risk that a negative cyber event will impact an organization.
- Reputational Risk: a loss of trust in the brand of the fund or an increase in negative perception of the brand that can lead to negative publicity, loss of revenues, asset withdrawals, loss of clients, and loss of key talent.
- Risk Related to New Strategies: the risk that new strategies or investments can result in heightened leverage, operational risk, liquidity and valuation risk, as well as disclosure risk for the fund complex.
- Model Risk Management: the potential for adverse consequences from decisions based on incorrect or misused model outputs and reports.
- Disclosure Risk: that disclosures and statements could be made in fund documents that are not true.
- Anti-Money Laundering Risk: the risk that funds fail to identify potential money laundering scenarios or to comply with regulatory standards.

The Report is available at: http://www.mfdf.org/images/Newsroom/RiskPaperFinal2017.pdf.

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