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**2016 INVESTMENT MANAGEMENT CONFERENCE**

## Financial Industry Developments

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# Hedge Funds and Private Funds – Recent Developments

# INDUSTRY GROWTH

- The number of investment advisers registered under the Investment Advisers Act of 1940 has risen by 17% in the last two years.

- Collectively they manage $70 trillion in assets, an increase of more than $40 trillion over the last decade.

- In response, the SEC has recently increased by 20% the number of examiners that monitor investment advisers and investment companies.

# FORM ADV / REPORTING

- The amount of information that the SEC requires registered advisers to provide continues to increase.

- The SEC amendments to Form ADV to require disclosure of additional information regarding separately managed accounts.

- The SEC did not clarify whether a fund of one would be considered a separately managed account for this purpose.

- The compliance date for these amendments is October 1, 2017.

# FORM ADV / REPORTING

- At the same time, the SEC amended Part 1A of Form ADV to provide for more efficient umbrella registration of multiple private fund adviser entities that operate a single advisory business.

- A similar procedure had originally been endorsed by the SEC in a letter to the American Bar Association of January 19, 2012.

# BUSINESS CONTINUITY / TRANSITION

- In June of this year the SEC proposed a new rule to require registered advisers to adopt and implement written business continuity and transition plans.

- Most advisers have already implemented business continuity plans as a matter of best practice, but if this rule is adopted each adviser will be required to adopt a plan that is based upon the particular risks associated with the adviser's operations.

- Moreover, advisers would be required to have a transition plan in place should the adviser be unable to provide advisory services to its clients.

# BUSINESS CONTINUITY / TRANSITION

- The SEC proposed the business continuity and transition plan rule under Section 206 of the Advisers Act, which is the antifraud provision.

- If the rule is adopted, a violation of the rule would presumably constitute fraud.

- Many industry participants have expressed concern about the proposal to adopt the rule under Section 206.

# SIDE LETTERS

- A decision of the Delaware Chancery Court has focused attention on the need to conform Subscription Agreements and Partnership or LLC Agreements to the possibility that the adviser will enter into side letters.

# Robo-Advisers

# ROBO-ADVISERS AND REGULATORY RESPONSES

- "Robo-advisers" implement multiple, overlapping business models:
  - Direct client interaction
    - Favored by younger investors comfortable with social media and virtual relationships
    - Favorable fee structure
  - Traditional advisers relying on robo-advisers for certain functions
    - Refer clients to robo-advisers for certain aspects of portfolio management
    - Incorporate robo-advisers into traditional financial planning
  - Use of robo-advisers in providing investment advice
    - portfolio construction
    - automated tax-loss harvesting
    - portfolio rebalancing
    - "white label" / customized robo-advice platforms

# PROLIFERATION OF ROBO-ADVISERS

- Cerulli Associates (2015): assets managed by robo advisers to rise 2,500% between 2015 and 2020, to $489 billion

- Tiburon Strategic Advisors (2016): 51 robo advisers in the market, collectively managing close to $250 billion

- InvestmentNews*:
  - 7.3% of independent advisory firms use a robo-advice platform
  - 63.2% of independent BDs plan to offer robo-advisory services over the next two years
  - Of those, 50% plan to do so by the end of 2016

- Independent robo-advisers (e.g., Betterment, Wealthfront) receive a lot of press, but represent only 3% of digital wealth management AUM**

*Liz Skinner, Robo-Advisers Demand Attention, InvestmentNews, December 20, 2015.

**"The hard truth about the rise of robo advisers," Financial Planning, October 3, 2016.

## SEC INVESTOR ALERT: AUTOMATED INVESTMENT TOOLS (MAY 8, 2015)

*"While automated investment tools may offer clear benefits—including low cost, ease of use, and broad access—it is important to understand their risks and limitations before using them."*

*"Investors should be wary of tools that promise better portfolio performance."*

# SEC INVESTOR ALERT: AUTOMATED INVESTMENT TOOLS (MAY 8, 2015)

1. Understand any terms and conditions.

   ▪ Ask an automated investment tool sponsor whether it receives any form of compensation for offering, recommending, or selling certain services or investments.

2. Consider the tool's limitations, including any key assumptions.

   ▪ Be aware that an automated tool may rely on assumptions that could be incorrect or do not apply to your individual situation.

   ▪ Automated investment tool may be programmed to consider limited options.

3. Recognize that the automated tool's output directly depends on what information it seeks from you and what information you provide.

# SEC INVESTOR ALERT: AUTOMATED INVESTMENT TOOLS (MAY 8, 2015)

4. Be aware that an automated tool's output may not be right for your financial needs or goals.

5. Safeguard your personal information.

   - Collection of personal information for purposes unrelated to the tool.

   - Beware of phishing and other scams.

# FIDUCIARY STATUS OF ROBO-ADVISERS

*"We're all being disrupted, but regulators are also"*

*"What would a fiduciary duty mean to a robo-adviser? Or suddenly, is there no fiduciary duty if it's automated advice? How should the SEC be thinking about that and regulating that?"*

*-Commissioner Kara Stein, Investment Adviser Association Compliance Conference (March 10, 2016)*

# FIDUCIARY STATUS OF ROBO-ADVISERS

- Duty of Loyalty
  - Conflicts of interest and disclosure
  - Standard criteria for determining the appropriate investments drawn from a defined universe of potential investments
  - Disclosure of inherent and latent conflicts of interest
- Duty of Care
  - Competence and suitability of recommendations
  - Suitability is the real issue--Knowledge of client's financial status and investment needs may not be sufficiently established by an automated, inflexible set of questions

## FIDUCIARY STATUS OF ROBO-ADVISERS

- But how does this really differ from wrap accounts, SMAs?
- Can a robo-adviser disclaim responsibility for considering a *retail* investor's entire financial situation?

# Cybersecurity Updates

# CYBERSECURITY REGULATORY STANDARDS FOR INVESTMENT MANAGERS – THE BIG PICTURE

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| 2011 | 2013 | 2014 | 2015 | Future Initiatives |
|------|------|------|------|--------------------|

**2011**
- SEC Corporation Finance Disclosure Guidance

**2013**
- SEC adopts Identify Theft Red Flag Rules (Regulation S-ID)

**2014**
- SEC Roundtable
- OCIE Risk Alert and Sweep Exams
- CFTC Best Practices

**2015**
- OCIE Risk Alert and Sweep Exam Summary
- FINRA Report on Cybersecurity Practices
- IM Guidance Update
- NFA Cybersecurity Rule
- Second OCIE Risk Alert
- Second Round of OCIE Sweep Exams
- SEC Enforcement

**Future Initiatives**
- More Interpretive Guidance?
- More Rulemaking?
- More Enforcement?
- NFA Examinations?

## Primary Legal Requirements:
- Regulation S-P (Safeguards Rule)
- Regulation S-ID (Identity Theft Red Flags)
- IAA Rule 206(4)-7 and ICA Rule 38a-1 (Compliance Rules)
- IAA Rule 204-2(g) and ICA Rule 31a-2(f) (Electronic Recordkeeping Rules)
- ICA Rule 30a-3 (Internal Controls)
- Disclosure Considerations
- Business continuity plans
- Suspicious activity reporting
- CFTC Regulations, Part 160.30
- FTC enforcement of Section 5 of FTCA
- State data breach and information security program requirements

## Primary Regulatory Authorities:
- Securities and Exchange Commission
- Financial Industry Regulatory Authority
- Commodity Futures Trading Commission
- National Futures Association
- Federal Trade Commission
- Federal and State Enforcement Authorities

# NFA CYBERSECURITY SELF-EXAMINATION QUESTIONNAIRE (FEBRUARY 2016)

- On February 29, NFA issued Interpretive Notice I-16-10
- Notifies NFA member firms about the addition of a cybersecurity section to NFA's Self-Examination Questionnaire
- Designed to help assist member firms in complying with NFA's Interpretive Notice to NFA Compliance Rules 2-9, 2-36 and 2-49 (2015)
- The NFA Cybersecurity rule became effective March 1, 2016
- NFA expects each member firms to complete the cybersecurity section based on the size and complexity of its operations
- To further assist firms, NFA has also published answers to frequently asked questions (FAQs) about the Notice and the ISSP implementation requirements

# CONTINUED SEC FOCUS ON CYBERSECURITY

- SEC Chair Mary Jo White, comments to the Reuters Financial Regulation Summit in Washington D.C. (May 17, 2016)
  - Cyber security is the biggest risk facing the financial system
  - On cybersecurity practices of exchanges and clearinghouses: "What we found, as a general matter so far, is a lot of preparedness, a lot of awareness but also their policies and procedures are not tailored to their particular risks."
  - SEC examiners continue to be pro-active about doing sweeps of broker-dealers and investment advisers to assess their defenses against a cyberattack
  - "We can't do enough in this sector."
- June 8, 2016, SEC charges Morgan Stanley Smith Barney with violation of Rule 30(a) of the Regulation S-P (Safeguards Rule)
  - insure the security and confidentiality of customer records and information
  - protect against any anticipated threats or hazards
  - protect against unauthorized access to or use of customer records or information

# CYBERSECURITY IN 2016 AND BEYOND

- Any "grace period" for implementing SEC and NFA standards for effective cybersecurity protocols has likely expired
- "Reasonably designed" policies and "best practices":
  - Data security / encryption
  - Procedures for responding to a cybersecurity incident
  - Periodic risk assessments
  - Testing authorization to access critical information and PII
  - Monitoring for unusual or suspicious patterns
- Outstanding questions
  - Enforcement actions in the absence of an actual data breach
  - Impact of remedial measures on enforcement decisions
  - 20/20 hindsight: enforcement actions may be brought against firms with "reasonably designed" policies and "best practices" if there is an actual breach