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Non-Enforcement

Cybersecurity Is At the Top of SEC Examination Concerns

In a recent SEC “risk alert” for registered broker-dealers and investment advisers, the SEC’s Office of Compliance Inspections and Examinations (OCIE) listed the factors that OCIE will be applying when the staff conducts a second round of examinations of registrants’ readiness for cybersecurity attacks.

During the first round of examinations conducted earlier this year, OCIE found that a significant number of registrants had experienced a cyberattack. Most of those registrants had written policies and procedures to handle and prevent such occurrences but, in many cases, those policies and procedures were not always effective. Based on the findings from the first round of examinations, OCIE determined it necessary to conduct a second round but to first alert the industry about what the staff expects in terms of adequate policies and procedures.

OCIE’s alert includes the factors that the staff will be closely reviewing which include; the registrant’s cybersecurity risk assessment, the involvement of senior management and board of directors, and the safeguards employed to control access to their systems.

An emphasis during the examination is how the registrant selects and monitors vendors so that private information is kept secure. According to OCIE, the vendor selection process should include a thorough review of the safeguards and systems employed by the vendor and ongoing monitoring by the registrant to ensure that the vendor is carrying out its safeguards and systems.

Clearly, OCIE expects each registrant to have clear written policies and procedures addressing cybersecurity, an assignment of roles among key personnel, and an ongoing assessment program to determine areas susceptible to cybersecurity attacks.

To assist registrants, OCIE's alert included a sample request listing the information and questions likely to be requested and asked by the OCIE examiners while conducting the cybersecurity exam.

Time to Check Your Fund's Liquidity Risk

The SEC recently released a rule proposal on liquidity risk management for mutual funds and exchange-traded funds (ETFs). If adopted, this rule proposal will require significant changes to fund operations, disclosure, and reporting requirements. The rule proposal also contains guidance that the SEC has provided to help mutual funds and ETFs manage their liquidity risk today.

Others, including the SEC, have ably summarized the rule proposal, and this summary is found below. The following are items that chief compliance officers and boards of directors may want to consider in addressing risk liquidity risk today:

1. The SEC seems to believe that many funds may have been a bit lax in managing their "liquidity risk." Specifically, the SEC stated that "while some funds and their managers have developed comprehensive liquidity risk management programs, others have dedicated significantly fewer resources to managing liquidity risk in a formalized way," and then later stressed that "a mutual fund must adequately manage the liquidity of its portfolio so that redemption requests can be satisfied in a timely manner." In other words, liquidity risk management is not only a regulatory compliance matter, but also a risk management matter, and should be taken seriously.

2. The SEC views "liquidity risk" as "the risk that a fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting the fund's net asset value." And the SEC states that it believes a fund must also consider "both expected requests to redeem, as well as requests to redeem that may not be expected, but are reasonably foreseeable," when evaluating its liquidity risk.

3. The SEC provided guidance on key factors to consider when assessing the "liquidity risk" of a fund. They are not an exhaustive list of factors, but an illustrative list: "(A) short-term and long-term cash flow projections, taking into account the following considerations: (i) the size, frequency, and volatility of historical purchases and redemptions of fund shares during normal and stressed periods; (ii) the fund's redemption policies; (iii) the fund's shareholder ownership concentration; (iv) the fund's distribution channels; and (v) the degree of certainty associated with the fund's short-term and long-term cash flow projections; (B) the fund's investment strategy and liquidity of portfolio assets; (C) use of borrowings and derivatives for investment purposes; and (D) holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources."

4. The SEC noted that "as a practical matter, many investors expect to receive redemption proceeds in less than seven days as some mutual funds disclose in their prospectuses that they will generally pay redemption proceeds on a next-business day basis." And then the SEC followed this up by noting that it believes a fund may have liability for failure to redeem on a next-business day basis when the prospectus states the fund generally or usually redeems on a next-business day basis.

5. The SEC provided guidance on key factors to consider when assessing the liquidity of individual portfolio holdings. They are not an exhaustive list of factors, but an illustrative list:

“(A) the existence of an active market for the asset, including whether the asset is listed on an exchange, as well as the number, diversity, and quality of market participants; (B) the frequency of trades or quotes for the asset and average daily trading volume of the asset (regardless of whether the asset is a security traded on an exchange); (C) the volatility of trading prices for the asset; (D) the bid-ask spreads for the asset; (E) whether the asset has a relatively standardized and simple structure; (F) for fixed income securities, the maturity and date of issue; (G) restrictions on trading of the asset and limitations on transfer of the asset; (H) the size of the fund’s position in the asset relative to the asset’s average daily trading volume and, as applicable, the number of units of the asset outstanding; and (I) relationship of the asset to another portfolio asset.”

With regard to derivative securities the SEC noted that “assets used by a fund to cover derivatives and other transactions would be liquid when considered in isolation,” but that when evaluating the overall liquidity of a fund, the fund would have to consider that such assets “are only available for sale to meet redemptions once the related derivatives position is disposed of or unwound.” So, a fund should “classify the liquidity of these segregated assets using the liquidity of the derivative instruments they are covering.”

6. The SEC stated that it believes “that, as part of a fund's management of its liquidity risk, a fund that engages in or reserves the right to engage in in-kind redemptions should adopt and implement written policies and procedures regarding in-kind redemptions.” It expects that “these policies and procedures would address the process for redeeming in kind, as well as the circumstances under which the fund would consider redeeming in kind.”

7. The SEC provided guidance on the use of borrowing arrangements and other funding sources as a liquidity risk management tool and the use of exchange-traded fund (ETF) portfolio holdings as a liquidity risk management tool. While the SEC generally seemed to endorse the thoughtful use of borrowing arrangements as a liquidity risk management tool, the SEC expressed some concerns about the use of ETF portfolio holdings as a liquidity risk management tool. The SEC noted that while ETFs may be useful in managing purchases and redemptions, “funds should consider the extent to which relying substantially on ETFs to manage liquidity risk is appropriate,” stating, for example, that “an ETF whose underlying securities are relatively less liquid ... may not be able to be counted on as an effective liquidity risk management tool during times of liquidity stress.”

The following is a summary of the rule proposal:

Liquidity Risk Management Programs

Proposed Rule 22e-4 would require mutual funds and other open-end management investment companies, including ETFs, to have a liquidity risk management program. The proposed rule would exclude money market funds from the requirements. The liquidity risk management program would be required to include multiple elements, including:

- Classification of the liquidity of fund portfolio assets
- Assessment, periodic review and management of a fund’s liquidity risk

- Establishment of a three-day liquid asset minimum
- Board approval and review

Classification of the Liquidity of Fund Portfolio Assets: Each fund would be required to classify and engage in an ongoing review of each of the assets in its portfolio. The classification would be based on the number of days in which the fund's position would be convertible to cash at a price that does not materially affect the value of that asset immediately prior to sale. Proposed Rule 22e-4 would include factors that a fund would be required to take into account when classifying the liquidity of each portfolio position.

Funds would be required to classify each asset position or portion of a position into one of six liquidity categories that would be convertible to cash within a certain number of days: one business day; 2-3 business days; 4 – 7 calendar days; 8 – 15 calendar days; 16 – 30 calendar days; and more than 30 calendar days.

Assessment, Periodic Review and Management of a Fund's Liquidity Risk: Funds would be required to assess and periodically review their liquidity risk, based on specified factors. Liquidity risk would be defined as the risk that a fund could not meet redemption requests that are expected under normal conditions or under stressed conditions, without materially affecting the fund's net asset value (NAV) per share. Proposed Rule 22e-4 would codify the 15 percent limit on illiquid assets included in current SEC guidelines.

Determination of a Three-Day Liquid Asset Minimum: A fund would be required to determine a minimum percentage of its net assets that must be invested in cash and assets that are convertible to cash within three business days at a price that does not materially affect the value of the assets immediately prior to sale.

Board Approval and Review: A fund's board, including a majority of the fund's independent directors, would be required to approve the fund's liquidity risk management program, including the fund's three-day liquid asset minimum. The board also would be responsible for reviewing a written report that reviews the program's adequacy, provided at least annually from the fund's investment adviser or officer administering the program.

Swing Pricing

Proposed, amended Rule 22c-1 would permit, but not require, open-end funds (except money market funds or ETFs) to use "swing pricing." Swing pricing is the process of reflecting in a fund's NAV the costs associated with shareholders' trading activity in order to pass those costs on to the purchasing and redeeming shareholders.

A fund that chooses to use swing pricing would reflect in its NAV a specified amount, the swing factor, once the level of net purchases into or net redemptions from the fund exceeds a specified percentage of the fund's NAV known as the swing threshold. The proposed amendments include factors that funds would be required to consider to determine the swing threshold and swing factor, and to annually review the swing threshold. The fund's board, including the independent directors, would be required to approve the fund's swing pricing policies and procedures.

Disclosure and Reporting Requirement Proposals

The following disclosure forms would be amended:

Form N-1A

Proposed amendments to Form N-1A would require funds to disclose swing pricing, if applicable, and the methods used by funds to meet redemptions. Funds also would be required to file agreements related to lines of credit and reflect, as applicable, the use of swing pricing in the fund's NAV per share in the financial highlights section of fund financial statements.

Proposed Form N-PORT

Form N-PORT, which was proposed by the SEC in May, would require a fund to report the liquidity classification of each of the fund's assets based on the categories in proposed Rule 22e-4. Funds also would be required to disclose the three-day liquid asset minimum, in addition to the requirement proposed in May that funds report whether an asset is a 15 percent standard asset.

Proposed Form N-CEN

Form N-CEN, which was proposed by the SEC in May, would require funds to disclose information regarding committed lines of credit, interfund borrowing and lending, and swing pricing. The proposed amendments also would require ETFs to report whether they required an authorized participant to post collateral to the ETF or any of its designated service providers in connection with the purchase or redemption of ETF shares.

Are You Paying for Distribution or Non-Distribution Services? Better Be Sure

The SEC issued its first enforcement action regarding distribution in guise. The SEC order is helpful because it begins to frame the items that the SEC views as distribution versus shareholder servicing. The end result for mutual fund boards will likely be a more careful policing and understanding of a fund's marketing and shareholder servicing agreements.

The SEC order notes the following as clearly not marketing or distribution: (1) maintaining separate records for each customer in the omnibus account for each fund; (2) transmitting purchase and redemption orders to the Funds; (3) preparing and transmitting account statements for each customer; (4) transmitting proxy statements, periodic reports, and other communications to customers; (5) providing periodic reports to the Funds to enable each fund to comply with state Blue Sky requirements; and (6) providing standard monthly contingent deferred sales charge reports.

The SEC order then notes two intermediary agreements where the intermediary provided services that the SEC believes are "generally marketing and distribution, not Sub-TA services," with the SEC concluding that a fund is prohibited from using the fund's assets to make payments under such agreements unless the payments are made pursuant to a Rule 12b-1 plan. This conclusion suggests that the fund could not use any of its assets to make any portion of the payments under said intermediary agreements. So, with regard to an agreement that covers both distribution and Sub-TA, it begs the question of whether a fund can ever use its assets to make payments under such an agreement for the Sub-TA services that are part of the agreement.

It would seem a strange result to say that a fund can never use its assets to make payments under a mixed services agreement to pay for the Sub-TA services. However, that is a possible read of the SEC order. Another conclusion is that where there is an agreement covering both distribution and

Sub-TA, you have to look to see if the agreement is primarily aimed at distribution, as the SEC order suggests that the problematic intermediary agreements it reviewed were primarily for distribution. If you conclude an agreement is primarily for distribution, then a fund may only make payments out of a Rule 12b-1 plan, as suggested in the SEC order. Otherwise, a fund could presumably bifurcate the payments.

With respect to the first intermediary agreement that the SEC found problematic, the SEC identified the services below (in describing the services later in the order, it says they “were generally marketing and distribution, not Sub-TA services”):

1. Due diligence
2. Legal review
3. Training
4. Marketing

With respect to the second intermediary agreement that the SEC found problematic, the SEC identified the services below (in describing the services later in the order, it says they “were generally marketing and distribution, not Sub-TA services”):

1. Provide email distribution lists of correspondent broker-dealers that have requested “sales and marketing concepts” from intermediary
2. Market the funds on its internal website
3. Invite the funds to participate in special marketing promotions and offerings to correspondent broker-dealers
4. Invite the investment advisor to participate in the Intermediary’s annual conference
5. Provide quarterly statements detailing which correspondent broker-dealers are selling the funds
6. Waive all trading fees charged to correspondent broker-dealers relating to the funds

Enforcement

Adviser Subject to Cybersecurity Attack Sanctioned by SEC

An SEC registered investment adviser was recently sanctioned by the SEC (see Investment Advisers Act Release No. 4204, September 22, 2015) for failure to have in place adequate cybersecurity policies and procedures that may have warded off a cybersecurity attack that resulted in the compromise of private consumer information of approximately 100,000 individuals.

Regulation S-P under the Securities Act of 1933 requires investment advisers, among others, to adopt written policies and procedures reasonably designed to protect customer records and information.

According to the SEC’s complaint, the adviser, during the period from September 2009 up to the date of the cyberattack (i.e., July 2013), stored personally identifiable information of approximately

100,000 individuals, including thousands of its clients on a third party-hosted web server. In July 2013, an unknown hacker (believed to be located in China) gained access to the data hosted in the server. Up until then, the adviser had no written policies and procedures in place designed to safeguard customer information. The adviser failed to perform even the most basic requirements to protect customer information such as the conducting of periodic assessments, implementing a firewall, utilizing encryption, or having a response plan for cybersecurity incidents.

One thing in the adviser's favor was the apparent quick remedial action taken after the cybersecurity attack became known. Among other things, the adviser promptly engaged consulting firms to determine the extent of the attack and measures to prevent such an attack from reoccurring, and to alert all persons whose private information was compromised and the offer of free identity theft monitoring.

The adviser agreed to a settlement of the enforcement matter with the SEC which imposed a $75,000 penalty and order of censure. The sanctions imposed by the SEC in this matter may have been more severe if it was not for the adviser's prompt remedial actions once the cyberattack was detected.

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