ADVISOR SOLUTIONS GROUP, INC

Compliance Update
September 2014

Cybersecurity

- Cybersecurity is a regulatory priority
  - SEC National Examination Priorities for 2014 (January 9, 2014). The letter cited "Technology" as one of the NEP-Wide Initiatives, specifically, "The NEP will continue to examine governance and supervision of information technology systems, operational capability, market access, information security, and preparedness to respond to sudden malfunctions and system outages." Cybersecurity is being addressed in exams and has been informally assessed at comprising up to 10% of the exam.
  - SEC Cybersecurity Roundtable (March 26, 2014). The SEC Staff hosted a cybersecurity roundtable to open a dialogue with registrants on the current state of cybersecurity and to move forward with ideas for improvement. In her opening remarks, Chair Mary Jo White stated, "This [cybersecurity] is a global threat. Cyber threats are of extraordinary and long-term seriousness. They are first on the Division of Intelligence's list of global threats, even surpassing terrorism. And Jim Comey, Director of the FBI, has testified that resources devoted to cyber-based threats are expected to eclipse resources devoted to terrorism. What emerges from this view of the cybersecurity landscape is that the public and private sectors must be riveted, in lockstep, in addressing these threats."
  - SEC National Exam Program Risk Alert – OCIE Cybersecurity Initiative (April 15, 2014). The SEC formally announced their cybersecurity initiative and published the sweep letter that was sent to fifty firms. The fifty firms were diverse in size and business type.
- There have been enforcement proceedings against firms for weak passwords, inadequate anti-virus protection, and lack of response to stolen computers.

➢ **Practical considerations:**

- IT Challenges. Cybersecurity can be challenging because it touches upon highly technical issues that are unfamiliar to many compliance professionals, while at the same time encompassing familiar measures that may provide preliminary protection. Compliance professionals must determine which processes can be handled within the firm and which may require third party service providers.
- What is One Supposed to Do? In addition to the SEC guidance, there has been a plethora of guidance from law firms, consultants, compliance professionals and others. The guidance adequately discusses the need and what should be done, but most of the guidance falls short in telling you HOW to address cybersecurity. For example, most of the guidance states, "you should start by taking an inventory and assessing the risk." Easier said than done.
- Implement Basic Measures Internally. As a preliminary step, compliance professionals can put basic security measures in place. Methods can include:
  - Requiring employees to select strong passwords which change periodically
  - Keeping non-public information secured (clean desk policy)
  - Setting computers to lock out after a certain period of inactivity
  - Activating firewalls and anti-virus software
  - Maintaining updated computer software
- Stay Tuned.
  - ASG is developing Cybersecurity materials to assist with the implementation of a firm's cybersecurity efforts.
  - The centerpiece of the Cybersecurity materials is an annotated version of the SEC cybersecurity sweep letter. The SEC's sweep letter incorporates elements of the National Institute of Standards and Technology (NIST) Cybersecurity Framework, and serves as an excellent template for a cybersecurity risk analysis. The annotations provide guidance on each step and many refer the user to templates and tools included in the materials.
  - The materials will include the following forms:

- Risks/Cybersecurity Governance Identification Matrix
- Vendor/Product Risk Inventory
- Device Inventory
- Software Inventory
- External Connections Log
- Training Log
- Training Signature Log
- Change Management Log

▪ The materials will also include links to free, publicly available policies, including a strong password policy, an encryption policy, and a mobile computing policy.

Lessons from Enforcement Actions

Insider Trading

June 11, 2014 – Thomas E. Meade:

- The President/CCO of a firm was barred from the industry and fined for poor compliance controls, culminating in the failure to detect and investigate insider trading.

➢ **Practical considerations:**

- Keep your Policies Current. The SEC noted that the firm stopped requiring employees to submit quarterly transaction reports and instead relied on the CCO's review of Portfolio Center, but did not update its Policies and Procedures to reflect this practice.
- Collect Holdings Reports. While Rule 204A-1 allows firms to maintain account statements in lieu of quarterly transaction reports, no such exception exists for annual holdings reports.
- Update Watch Lists and Restricted Lists. If your policies call for the firm to maintain Watch Lists or Restricted Lists of securities, make sure you are monitoring to identify securities that would meet the criteria of those lists and update the lists when needed.
- Investigate Suspicious Trading. If you identify red flags in employee trading, follow up. Insider trading is a serious offense, and any indication of it calls for a careful investigation. In addition, your policies may require you to conduct and document such investigations.
- Do Not Assume the Problem Leaves with the Employee. If you identify potential insider trading violations by an employee who subsequently leaves the firm, continue to investigate the possibility that the employee tipped other employees or clients.
- Policies Must be Customized. Ensure your policies address any unique conflicts and risks given your business practices and relationships.
- Train Employees. Do not solely rely on employees to review the firm's Policies and Procedures on their own and self-report violations.

Focus on Private Fund Advisers

April 30, 2014 – Barry R. Bekkedam:

- The complaint alleges, among other things, that the CEO of an adviser recommending and acting as Limited Partner Representative of a private fund failed to conduct due diligence, causing the fund to invest in a Ponzi scheme, and misrepresented to investors the due diligence the fund adviser had performed.

➢ **Practical considerations:**

- Do your Due Diligence. Ensure that you are conducting and documenting any due diligence outlined in the private fund offering documents or marketing materials.
- Process is Important. Once you establish a reasonable due diligence process, follow and document it consistently.
- Disclose Conflicts. Any relationship or financial arrangement with the issuer or other parties must be fully disclosed to clients/investors.

Out of the Mouths of Regulators

Charging Individuals

May 19, 2014 – Speech by SEC Chair Mary Jo White:

- In a speech to the NYC Bar Association, Chair White emphasized the SEC's efforts to charge individuals in most cases. The SEC is looking for ways to innovate in order to further strengthen the agency's ability to charge individuals, such as charging them under alternative securities laws.
- The Chair has also encouraged the Enforcement Division to increase the use of industry bars, require the use of monitors or independent compliance consultants, and require admissions of wrongdoing.

➢ **Practical considerations:**

- Personal Liability. One of the best ways for CCOs and senior executives to protect themselves from personal liability is to establish a strong culture of compliance and supervisory system within the firm. Having policies is not enough; they must be customized to the firm and reasonably designed to address the firm's risks, reviewed and updated on an ongoing basis, and enforced within the firm.
- Protective Measures. If desired, firms can indemnify individuals and can usually obtain insurance coverage. Check with your insurance provider to identify available options.
- Separate Roles. If possible, firms should maintain appropriate separation between supervisory and compliance administrative functions. CCOs and compliance personnel should not act as supervisors for employees not within their supervisory line. While this will be based on the facts and circumstances of any given situation, in general, policies and procedures should not name compliance officers as supervisors, and compliance personnel should not have authority to discipline or terminate employees (but compliance may make recommendations to the appropriate supervisor).

Private Equity Compliance Problems

May 6, 2014 – Speech by Andrew Bowden, Director of Office of Compliance Inspections and Examinations (OCIE):

- Speaking at the Private Equity International (PEI) Private Fund Compliance Forum, Mr. Bowden gave insights into the industry trends and exam findings identified for private equity advisers under the Presence Exam initiative. Mr. Bowden noted the following weaknesses seen in private equity practices:
  - Inherent Risks: The manager's ability to influence or control the portfolio company leads to conflicts of interest, and lack of disclosure restricts investor's ability to identify and monitor those conflicts
  - LP Agreements:
    - Overly broad characterization of the types of fees and expenses that can be charged to portfolio companies
    - Lack of clearly defined valuation procedures, investment strategies, and protocols for mitigating certain conflicts of interest, including investment and co-investment allocation
    - Insufficient information rights to enable limited partners to adequately monitor their investments and the operations of their manager
  - Zombie Advisers: Managers that are unable to raise additional funds continue to manage legacy funds past their expected life
  - Consolidation: Larger managers created as a result of consolidation may lack the expertise to address the complexities and inherent conflicts of interest that arise with changes from the private equity-focused business model, including side-by-side co-investments by

separately managed accounts and allocation of expenses

- Expenses:
  - Use of consultants or "Operating Partners" to provide operational advice to the portfolio company, which is paid for by the portfolio company or fund without sufficient disclosure to investors – these consultants are often presented as part of the manager's team for marketing purposes, but are not employees or affiliates for purposes of fee offsets due to the fund
  - Shift of expenses from the adviser to the fund during the life of the fund without disclosure to investors
  - Automation software and tools used to make the adviser more efficient is charged to the fund
- Hidden Fees:
  - Accelerated monitoring fee – the monitoring fee contract with the portfolio company extends past the life of the holding period and the contract must be bought out upon a triggering event, incurring significant cost
  - Undisclosed administrative fees not contemplated by the LP agreement
  - Transaction fees that exceed agreed upon limits or that are not contemplated by the LP agreement
  - Hiring service providers related to the adviser
- Marketing and Valuation:
  - Use of a valuation methodology that is different than the one disclosed to investors
  - Failure to deduct fees and expenses when calculating internal rate of return
  - Cherry picking comparables or adding back inappropriate items to EBITDA if there are not rational reasons for the changes and sufficient disclosure to investors
  - Changes in the valuation methodology from period to period unless there is a logical purpose for the change
  - Inconsistencies and misrepresentations, including performance marketing using projections in place of actual valuations without proper disclosure and misstatements about the investment team

➢ **Practical considerations:**

- Understand the Business Model. CCOs and executives should be knowledgeable about the unique characteristics of private equity investments in order to implement appropriate policies for the firm.
- Evaluate Risks. Take an inventory of the risks within your firm and business model, then identify ways to mitigate those risks through controls and disclosure.
- Review Agreements. Work with a knowledgeable securities attorney to ensure your agreements are sufficiently clear in defining permissible fees and expenses, valuation procedures, investment strategies, and information rights of limited partners.
- Monitor Fees and Expenses. Identify what fees and expenses are being charged to the fund and who is being paid.
- Consistency is Key. Implement policies, such as valuation, consistently and ensure that disclosures in agreements and marketing materials match each other and your practice.

New SEC Guidance

Proxy Voting Responsibilities of Investment Advisers

- On June 30, 2014, the SEC's Division of Investment Management, jointly with the Division of Corporation Finance, issued Staff Legal Bulletin No. 20, which addresses considerations to be made when using third-party proxy voting service providers.

- While an adviser may delegate its duty of voting client proxies to an outside provider, its fiduciary duty to clients and accountability for failures in adhering to that duty rest solely with the adviser. Further, an adviser's oversight obligations should include initial and periodic due diligence on the outside providers it utilizes to safeguard itself against:
  - Violations of the adviser's stated policies
  - Violations of Rule 206(4)-6
- In the 2003 Final Rule Release of the Proxy Voting Rule, the SEC made clear that it would be unacceptable for an adviser to adopt a pre-determined policy of simply voting proxies with management. Moreover, a stated policy of refraining from voting proxies would be equally unacceptable when voting authority has been delegated to the adviser.
  - Interestingly, the June 30 bulletin provides new flexibility in these areas. It specifies that each of the aforementioned could be acceptable in the presence of a specific arrangement negotiated between the adviser and a client.

➢ **Practical considerations:**

- Capability of the Vendor. When utilizing third-party proxy voting service providers, the adviser must determine that the "firm has the capacity and competency to adequately analyze proxy issues." The following are listed as potential areas of consideration:
  - The adequacy and quality of the proxy advisory firm's staffing and personnel;
  - The robustness of its policies and procedures regarding its ability to:
    - Ensure that its proxy voting recommendations are based on current and accurate information; and
    - Identify and address any conflicts of interest and any other considerations that the investment adviser believes would be appropriate in considering the nature and quality of the services provided by the proxy advisory firm.
- Other Factors. Advisers might want to inquire about additional areas when choosing a provider:
  - Philosophy (especially if adviser plans to adopt/utilize provider's voting policies)
  - Back office support/adequate staffing
  - Suitable technology to efficiently handle the entire scope of adviser's policies and any established exceptions
  - Override ability
  - Ability for adviser to interface with provider to quickly deliver information to accommodate:
    - Periodic sampling/testing
    - Recordkeeping reviews
    - Regulatory requests
  - Data integrity/security
  - Industry reputation

The Bulletin may be found here: http://www.sec.gov/interps/legal/cfslb20.htm.

This is only a brief summary of some of the regulatory changes and should not be relied upon for making decisions for your firm. For further clarification on how these changes affect you or for assistance in complying, please contact us.

1300 Bristol Street North | Suite 100 | Newport Beach, CA 92660 | 949.250.1855
www.advisorsolutionsgroup.com

