INVESTMENT ADVISER ASSOCIATION

IAA NEWSLETTER

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SEC Proposes New Framework for Registered Investment Company Use of Derivatives

The SEC has proposed significant new rules for registered open-end and closed-end investment companies (funds and ETFs) and business development companies that would limit the use of derivatives in their portfolios and would require changes in the way funds "segregate" assets to comply with Section 18 of the Investment Company Act. This is the third of Chair **Mary Jo White**'s five major rulemakings intended to strengthen the SEC's oversight and regulation of the asset management industry.

The proposal marks a major departure from decades of long-standing established SEC guidance that neither explicitly nor quantifiably limited the aggregate exposure of derivatives or use of financial commitment transactions in a fund. Instead, that guidance imposed broader asset segregation requirements for covering certain exposures, often based on the type and operation of the particular derivative instrument.

"This is a complex proposal on a complex topic, with the potential to significantly impact the portfolio management and operations of certain types of registered funds. We look forward to hearing our members' views as we evaluate the proposed rules and consider whether to weigh in."

— Bob Grohowski, IAA General Counsel

The new rule includes the following primary elements: limits on the percentage of portfolio exposure to derivatives; new limits on the specific types of assets that can be used for asset segregation (coverage of exposures); for many funds, a formalized and Board-approved derivatives risk management program, including the appointment of a new derivatives risk manager; and additional disclosure under the Act.

The Division of Economic and Risk Analysis (DERA) also issued a white paper on the use of derivatives by registered investment companies to accompany the release, which is available at http://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf.

Rule Limits Portfolio's Exposure to Derivatives and Financial Commitment Transactions

A fund relying on new rule 18f-4 to enter into derivatives transactions would need to comply with *either* the *exposure-based portfolio limit* or the *risk-based portfolio limit* in order to limit the amount of leverage the fund may obtain through derivatives and certain other transactions.

Under the first option, the *exposure-based portfolio limit*, a fund would be required to limit its aggregate exposure to 150 percent of the fund's net assets.

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FROM THE PRESIDENT & CEO

Looking Ahead: 2016 Could Bring Profound Regulatory Changes

The IAA and the investment adviser community faced a tidal wave of regulatory activity in 2015 (see our *2015 Year in Review* included with this *IAA Newsletter*, and online at www.investmentadviser.org/eweb/Dynamicpage.aspx?webcode=activityreport), and that trend promises to continue unabated in the New Year—from a new anti-money laundering regime, to heightened data reporting on Form ADV, to a requirement that advisers help the SEC supplement its adviser examinations by paying independent third parties to conduct compliance reviews, to a second round of SEC cybersecurity examinations. These developments will not only present business, risk, and compliance impacts but also significant technological challenges affecting firms' operations and budgets.

The IAA is deeply involved with key policy-makers to ensure that our regulatory framework meets the goals of investor protection and capital formation—while minimizing burdens on advisers, their clients and their businesses. The IAA is already engaging with regulators and legislators on regulatory changes looming in 2016.

First and foremost, the IAA will continue to lead the charge for maintaining the SEC as the primary regulator for investment advisers, and we will vigorously oppose any efforts to authorize an SRO for advisers. The SEC is expected to issue a proposal to require all federally registered investment advisers to hire independent third parties to perform compliance review of their firms—and report their findings back to the SEC. The IAA has already expressed industry concerns about this proposal to the SEC and will continue its advocacy in the year ahead. The IAA will also continue its engagement with respect to congressional and regulatory activities related to fiduciary duty and "harmonization" of rules governing brokers and advisers.

Karen Barr, President & Chief Executive Officer, IAA

SEC Chair **Mary Jo White** is pursuing a five-part rulemaking agenda aimed at asset managers, which she hopes to complete in 2016. Three of the five initiatives have been formally proposed and await final action: revising Form ADV to require all advisers to report additional data about their businesses and their clients' investments; enhancing management of liquidity risks by mutual funds; and a new framework for regulating the use of derivatives by registered investment companies. The rest of that agenda is coming this year: a proposal to require all advisers to create transition plans for a major disruption in business, and a proposal mandating annual stress tests by large funds and large advisers.

Chair White's agenda is intended to improve the SEC's ability to monitor and regulate our industry. The IAA supports the SEC's lead role in that regard, and will continue to engage with the Financial Stability Oversight Council (FSOC), the Treasury Department, the Office of Financial Research, the Commodity Futures Trading Commission, and the Federal Reserve Board—as well as with foreign regulators—on assessing whether asset managers pose potential systemic risks and how to address any risks that might exist.

Last year, the IAA submitted extensive comments on the Treasury Department's proposal to bring investment advisers under the AML regime. We objected to Treasury's characterization of advisers as a way for money launderers to enter the financial system and argued that advisory activities that do not present any meaningful risk of money laundering should be carved out of the proposal. But 2016 will likely bring implementation of those rules in some form—and the IAA will provide valuable resources to help members comply with whatever new AML requirements may be mandated.

In 2016 we are also likely to see the re-emergence of Dodd-Frank-mandated rules on executive compensation, a proposal to revise the definition of accredited investor, and CFTC requirements related to cross-border swap transactions. And there will be more challenges on the international front, with dramatic changes to the European regulatory environment (through MiFID II, among other things), and in Asia.

The IAA's representation of our members on Capitol Hill, at the SEC, and before other U.S. and international regulators and policymakers will be more crucial than ever in 2016. We encourage all of our members to become involved—by sending your feedback on regulatory proposals, by joining our issue-specific committees and online communities, and by joining us in person to lobby lawmakers on Capitol Hill. Working together, our collective voice will be even louder and ever stronger.

Happy New Year and thank you for your continuing support of the IAA.

Advisers Closer to Compliance Date for Third-Party Solicitor Rule as FINRA Proposes Pay-to-Play Regulations, Backs Off Imposing Written Disclosure Requirement

Investment advisers are now a major step closer to having to comply with the third-party solicitor provision of the SEC's "pay-to-play" rule, now that the Financial Industry Regulatory Authority (**FINRA**) and the Municipal Securities Rulemaking Board (**MSRB**) have proposed pay-to-play and related recordkeeping rules similar to rules adopted by the **SEC** in 2010 for investment advisers.

Investment advisers have been required to comply with most provisions of the SEC pay-to-play rule since 2011. However, the SEC delayed the compliance date of this **third-party solicitor** aspect of the rule at least in part so that FINRA and the MSRB would have time to adopt pay-to-play rules for broker-dealers and municipal advisors, respectively. Earlier this year, the SEC staff stated publicly that it would not enforce these provisions until the later effective date of either FINRA- or MSRB-adopted pay to play rules.

The currently unenforced provision of the SEC pay-to-play rule specifically prohibits an adviser and its covered associates from engaging third parties for solicitation of advisory business from government entities, unless the third party is a "regulated person." A regulated person, in relevant part, includes a registered broker or dealer subject to restrictions adopted by FINRA that are "substantially equivalent or more stringent" than the SEC's pay-to-play rule and consistent with the objectives of that rule. Regulated persons also include other investment advisers and municipal advisors subject to pay-to-play rules.

The FINRA proposal, announced December 16 and subject to SEC approval, would regulate broker-dealers that, for compensation, solicit government entities on behalf of investment advisers.

FINRA's original proposal, published in November 2014, included a highly controversial requirement that specified written disclosures be provided to the government entity by third-party solicitors. In a nod to industry concerns, including those expressed by the **IAA**, that part of the proposal has been withdrawn. The IAA had expressed concern with how the provisions affected affiliated solicitors. FINRA has cautioned, however, that it will continue to consider whether a disclosure requirement would be appropriate in the future.

If the SEC approves the proposal, as expected, FINRA has indicated that it intends to provide an ample transition period for firms to identify their covered associates and government entity clients and to modify their compliance programs pursuant to the new rules.

FINRA's proposal is available at http://www.finra.org/sites/default/files/rule_filing_file/SR-FINRA-2015-056.pdf.

The IAA's 2014 comment letter is available at https://www.investmentadviser.org/eweb/docs/Publications_News/Comments_and_Statements/Current_Comments_Statements/141222cmnt.pdf.

"FAST Act" Includes New Exemption for Advisers from Annual Privacy Notice Requirement

On December 4, President **Barack Obama** signed into law the "FAST Act" (Fixing America's Surface Transportation Act). Although the Act relates primarily to improving America's surface transportation systems, it also includes a provision that relates directly to investment advisers.

The provision establishes two criteria that, when met, exempt advisers from the requirement to send an annual privacy notice pursuant to SEC Regulation S-P and CFTC Regulation P. SEC-registered advisers will no longer have to send privacy notices if (1) the adviser does not share personal financial information in a way that requires notice and opt-out and (2) the firm has not changed its privacy policies and practices regarding use of client non-public personal information since the firm's most recent privacy disclosure sent to consumers.

The law, signed on December 4, appears to be self executing and immediately effective. The SEC and the CFTC are expected to ultimately amend Regulation S-P and Regulation P, respectively, to conform to the law's new exemptions. The Act does not eliminate the need to provide clients with all other privacy disclosures, including the initial report to consumers as to the firm's use of personal financial information, but the new provision could substantially reduce some required ongoing paperwork for advisers with respect to privacy notice requirements.

Fixing America's Surface Transportation Act, Title LXXV (Sec. 75001)—Eliminate Privacy Notice Confusion is available at http://transportation.house.gov/uploadedfiles/fastact_xml.pdf. See section 75001 on page 1268.

SEC Publishes Report on "Accredited Investor" Definition

The SEC on December 18 published a report on its first comprehensive review of the definition of "accredited investor," as required by the Dodd-Frank Act. How the term is defined can have significant implications for investment advisers, since the definition determines who is eligible to invest in privately placed securities, including interests in private funds. It is also a topic on which the IAA has made specific recommendations to the SEC for modifications.

The SEC is now considering whether the current definition, with its qualifying financial thresholds based on income and net worth, should be modified or adjusted, and is inviting members of the public to provide comments. As detailed in the report, the SEC staff has recommended that the SEC consider any one or more of the following methods of revising the definition:

▶ **Revise the financial thresholds requirements for natural persons and the list-based approach for entities. The SEC is considering:**

- Leaving the current income and net worth thresholds in place but imposing limitations on investments per issuer based on a percentage of income or net worth (*e.g.*, 10 percent of prior year income or 10 percent of net worth).

- Adjusting the current thresholds for inflation with no investment limitations.
- Indexing the financial thresholds for inflation on a going-forward basis every four years to coincide with the SEC's ongoing review of the definition.
- Allowing spousal equivalents to pool finances to provide consistent treatment among marriages, civil unions, and domestic partnerships.
- Permitting all entities with investments in excess of $5 million to qualify.
- Grandfathering issuers' existing investors that meet the current definition with respect to future offerings of the issuer.

▶ **Allow individuals to qualify as accredited investors based on other measures of sophistication.** Options suggested by the SEC staff include permitting individuals with a minimum amount of investments, certain professional credentials, experience investing in exempt offerings, or who pass a specified examination to qualify as accredited investors. The SEC staff also suggests that knowledgeable employees of private funds be permitted to qualify for investments in their employer's funds.

The report cites the **IAA comment letter** on the **JOBS Act** proposals in which the IAA had urged the SEC to

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The IAA's 2016 Annual Leadership Conference brings together executives from a variety of investment advisory firms and provides a special opportunity to understand industry trends, exchange ideas, and develop valued relationships with IAA members.

A fund's "exposure" generally would be calculated as the aggregate notional amount of its derivatives transactions, together with its obligations under financial commitment transactions and certain other transactions. "Notional" amount is defined as the market value of an equivalent position in the underlying reference asset for the derivatives transaction, or the principal amount on which payment obligations under the derivatives transactions are calculated. However, the rule requires some adjusted notional amounts to be used if the return is based on the leveraged performance of a reference asset (the notional amount will be multiplied by the leverage factor).

Under the second option, the *risk-based portfolio limit*, a fund would be permitted to obtain exposure up to 300 percent of the fund's net assets, provided that the fund satisfies a risk-based test (based on value-at-risk). This test is designed to determine whether the fund's derivatives transactions, in aggregate, result in a fund portfolio that is subject to less market risk than if the fund did not use derivatives.

Rule Requires Segregating Mark-to-Market Coverage Amount Plus a Risk-Based Coverage Amount and Specific Qualifying Coverage Assets

In addition to the quantitative limit on funds' aggregate notional derivatives exposure, the proposal would require a fund to segregate "qualifying coverage assets" (generally cash and cash equivalents) in the amount of a *"mark-to-market coverage amount"* (MTM) **plus** an additional *"risk-based coverage amount."* In particular, the required "mark-to-market coverage amount" would be defined as the amount that the fund would pay if the fund exited the derivatives transaction at the time of the determination. In calculating the MTM coverage amount where a fund has a netting agreement, the amount would be the net amount payable by the fund with respect to all derivatives transactions covered by the netting agreement. The MTM coverage amount may also be reduced by the value of the assets that represent variation margin or collateral for amounts payable by the fund upon exit.

In addition, a fund would be required to segregate an additional "risk-based coverage amount" designed as a "cushion" to address future potential losses and that represents a reasonable estimate of the potential amount the fund would pay if the fund exited the derivatives transaction under stressed conditions.

A meaningful deviation in the proposal from current permitted practices is the proposed requirement that would severely limit the type of assets that would be considered qualifying coverage assets. Pursuant to current guidance, funds may use any liquid asset to cover. Under the proposal, asset segregation would be limited to cash or cash equivalents or, for a derivatives transaction where delivery of a particular asset is required, that particular asset. The SEC reasoned that other types of assets, such as equity or other debt securities, may be more likely to experience volatility in price or to decline in value in times of stress, and therefore, may be insufficient to cover the fund's obligations under derivatives transactions.

Rule Requires Full Asset Segregation for Financial Commitment Transactions

Funds are permitted to enter into "financial commitment transactions," such as reverse repos, short sale borrowings, or firm or standby commitment agreements (including similar agreements, such as making a capital commitment to a private fund that can be drawn at the fund general partner's discretion). A fund that enters into a financial commitment transaction would be required to segregate assets with a value equal to the full amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under those transactions.

Board-Approved Derivatives Risk Management Program and Manager

Under the proposal, many funds would be required to implement a formalized derivatives risk management program, reviewed and approved by the fund board, that includes the appointment of a designated derivatives risk manager. These requirements apply to any fund with aggregate exposure associated with its derivatives transactions exceeding 50 percent of the value of the fund's net assets, as well as any fund that uses "complex" derivatives. The designated derivatives risk manager would be prohibited from being a member of the fund's portfolio management team. These formalized risk management program requirements would be in addition to certain requirements related to derivatives risk management that would apply to every fund that enters into derivatives transactions in reliance on the rule.

Disclosure and Reporting

The SEC also proposed amendments to proposed Form N-PORT to require additional information about options and warrants and to proposed Form N-CEN to disclose whether the fund relied on the new rule and, if so, which portfolio exposure limitation the fund satisfied.

Parting Thoughts—For Now

As a result of these new exposure limits and restrictions on assets permitted

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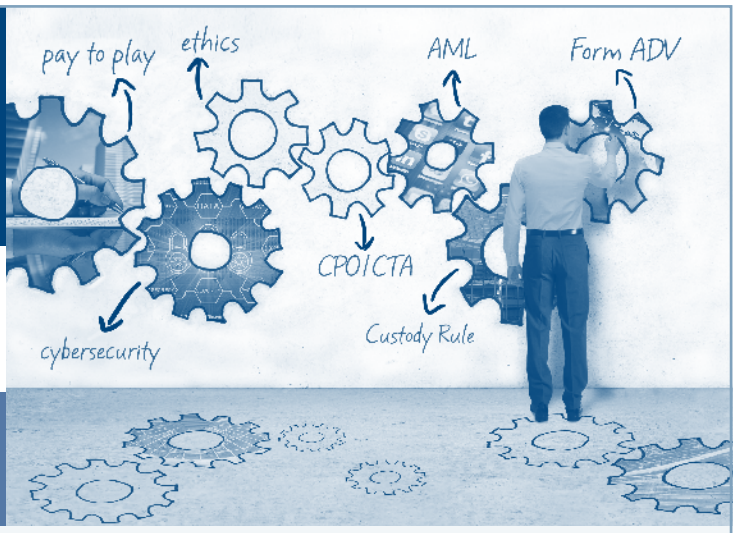

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- Compliance Issues for Advisers to Private Equity Funds
- ERISA 101
- Compliance Testing
- CPO/CTA and Derivatives Regulation
- International Issues for Advisers
- Compliance with Pay to Play Rule

Presenters

- In-house Legal Counsel
- Compliance Specialists
- IAA Attorneys
- Partners with Leading Law Firms
- SEC Representatives

Who Will Attend

- Compliance Officers
- Compliance Staff
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- Legal Professionals
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Contact Lisa Gillette at lisa.gillette@investmentadviser.org.

SEC IM Director Reiterates Rulemaking Priorities for Investment Advisers in 2016

In a December 16 speech, **David Grim**, the Director of the SEC's Division of Investment Management, looked back at the rulemaking initiatives from 2015 and looked ahead to what may be coming in 2016. He focused on SEC Chair **Mary Jo White**'s primary rulemaking agenda, noting that three of the five sets of rulemakings have been proposed: enhancing the regulation of funds' derivatives use, requiring mutual funds and ETFs to implement liquidity risk management programs, and modernizing and enhancing data reporting for both registered funds and investment advisers. The other two—transition plans and stress testing—are expected in 2016.

David Grim, Director, SEC's Division of Investment Management

In addition to those initiatives, Grim stated that IM staff is working in conjunction with staff from OCIE on a recommendation for the Commission to propose a new requirement for registered investment advisers to establish a program of third-party compliance reviews. He also noted that SEC staff in multiple divisions continues to work on developing a recommendation to the Commission to establish a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers.

See Remarks to the ICI 2015 Securities Law Development Conference, David Grim, Director, Division of Investment Management (Dec. 16, 2015), *available at* http://www.sec.gov/news/speech/grim-remarks-ici-2015-securities-law-development-conference.html.

SEC Publishes Report on "Accredited Investor" Definition—*continued from page 5*

consider additional criteria for the accredited investor definition, such as the use of investment advisers by investors. The report states that the idea was considered, but that the staff decided against recommending that change.

The report, which was prepared by SEC staff from the **Divisions of Corporation Finance** and **Economic and Risk Analysis**, provides extensive background on the accredited investor definition and discusses recommendations that were made by the SEC's **Investor Advisory Committee** and the **Advisory Committee on Small and Emerging Companies**.

"This report analyzes various approaches for modifying the definition of an accredited investor," said SEC Chair **Mary Jo White**. "I encourage investors, companies and other market participants to provide comments as public input will be very valuable as the Commission considers the definition."

The SEC staff report is available at http://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf.

The IAA comment letter on the JOBS Act proposals is available at https://www.investmentadviser.org/eweb/docs/Publications_News/Comments_and_Statements/Current_Comments_Statements/130923cmnt.pdf.

The IAA expects to submit comments to the SEC and is seeking member input on the SEC staff's recommendations contained in the report. Please contact IAA Assistant General Counsel Sanjay Lamba at (202) 293-4222 or sanjay.lamba@investmentadviser.org with any comments.

SEC Proposes New Framework for Use of Derivatives—*continued from page 6*

to be used for cover, the SEC forthrightly states in its release that "funds that use derivatives extensively . . . may be unable to scale down their aggregate exposures or otherwise de-lever their funds in a way that allows the fund to maintain its investment objectives or provide a product that has sufficient investor demand." These funds, the SEC staff went on to say, "may choose to deregister under the Act and liquidate, and/or the fund's sponsor may choose to offer the fund's strategy as a private fund or (public or private) commodity pool."

The SEC's proposal is available at http://www.sec.gov/rules/proposed/2015/ic-31933.pdf. The IAA will provide members with additional information regarding the proposal. Comments are due to the SEC 90 days after publication of the release in the *Federal Register* (with the comment deadline expected to be March 2016). Members interested in the proposal are encouraged to contact the IAA legal team at (202) 293-4222.

CFTC Amends Recordkeeping Rule 1.35 for CPOs and CTAs of SEFs, Excludes CTAs from Oral Recordkeeping Requirements

On December 18, the CFTC voted to adopt amendments to CFTC recordkeeping rule 1.35(a) in substantially the form it had proposed last year. The amendments include a provision the IAA had supported that excludes commodity trading advisor (CTA) members of a swap execution facility (SEF) from the requirement to maintain oral records.

No Oral Recordkeeping Requirement for CTAs

The final rule expands upon existing no-action relief by excluding CTAs that are members of a SEF or a designated contract market (DCM) from the requirement to record and keep oral pre-trade communications. In a comment letter filed this past January, the IAA urged the CFTC to adopt that type of exclusion in its final rule.

The CFTC did not, however, grant the IAA's request to exclude CTAs from the written recordkeeping requirements of rule 1.35(a) in the final rule. The CFTC reasoned that despite other regulatory requirements to maintain the particular records in rule 1.35, the CFTC's interest in ensuring customer protection and market integrity justifies the incremental costs to maintain these and other records under rule 1.35(a).

Required Written Records

Transaction Records. The rule requires that each registered CPO and CTA that is a member of a DCM or SEF keep all "transaction records"—which include "commodity interest and related records" (*i.e.,* records of all transactions relating to its business of dealing in commodity interests and related cash or forward transactions) and "original source documents" (*i.e.,* all documents on which trade information is originally recorded, whether or not such documents must be prepared pursuant to the rules or regulations of the CFTC, the DCM, or the SEF).

Written Pre-Trade Communications. In addition to transaction records, the rule requires each registered CPO and CTA that is a member of a DCM or SEF to keep all "written pre-trade communications." This would include all written communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading, and prices that lead to the execution of a transaction in a commodity interest and any related cash or forward transactions, whether transmitted by facsimile, instant messaging, chat rooms, electronic mail, mobile device, or other digital or electronic media. It would not include any oral pre-trade communications.

Flexible Format and Manner of Record Retention

Noting the concerns raised by the IAA and others commenters (and discussing the IAA's petition for rulemaking to amend recordkeeping regulation 1.31 filed in mid-2014), the CFTC stated that the "rule was deliberately drafted in a way that permits market participants to maintain their paper and electronic records in a manner which they deem prudent and appropriate for their particular business."

The CFTC explained the importance of the records being searchable but noted there is no requirement to convert their records to a searchable database. In particular, the rule does not prescribe any methodology under rule 1.35(a) by which records must be searched or retrieved, so long as those searches yield *"prompt, accurate and reliable location, access, and retrieval of any particular record, data, or information."*

For records other than pre-trade communications, the records must be maintained in a way that allows for identification of a particular transaction.

Exclusion for Unregistered CPO/CTA Members of a DCM or SEF

Under the final rule, CPO or CTA members of a DCM or SEF that are not required to be CFTC registered do not have to keep records of written communications that lead to the execution of a commodity interest transaction and related cash or forward transactions, keep text messages, or keep records in a particular form and manner.

Compliance Date/Effective Date

The rule will be effective as of the date it is published in the *Federal Register*. Though the release does not specify a compliance date, IAA staff has informally confirmed that CFTC staff will treat the effective date as the compliance date for the rule as well.

On a related note, CFTC no-action letter 15-65 was issued on December 8, 2015, extending the compliance date for earlier no-action relief on rule 1.35 (issued in 2014's no-action letter 14-147 and which expired on December 31, 2015) to match the effective date of the CFTC's final rule.

The CFTC's Final Rule, Records of Commodity Interest and Related Cash or Forward Transactions, is available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/federalregister121815.pdf.

Please contact IAA Associate General Counsel Monique Botkin at monique.botkin@investmentadviser.org or (202) 293-4222 or any member of the legal team with any questions.

FinCEN Extends FBAR Filing Deadline to April 15, 2017

Proposed Amendments to Required Reporting Under Review at OMB

On December 8, the Financial Crimes Enforcement Network (**FinCEN**) extended the deadline to April 15, 2017 for certain individuals required to file Form 114-FBAR, also known as the Report of Foreign Bank and Financial Accounts (**FBAR**). FinCEN took this action in light of its ongoing consideration of regulatory changes to the application of the filing requirement to individuals with signature authority over (but no financial interest in) certain types of accounts. Proposed amendments to the FBAR regulations have been under review by the Office of Management and Budget (**OMB**) since October 28, according to the OMB website.

FinCEN is further extending the filing due date from June 30, 2016 to April 15, 2017 for individuals whose filing due date for reporting signature authority was previously extended by Notice 2014-1, which include (i) employees and officers of certain financial institutions who have signature authority over (but no financial interest in) one or more foreign financial accounts; and (ii) certain employees or officers of SEC-registered investment advisers who have signatory or other authority over (but no financial interest in) foreign financial accounts of persons that are not registered investment companies. The FBAR filing deadline will move to April 15 beginning with the 2016 tax year as the result of a July 2015 legislative change.

The extension applies to the reporting of signature authority held during calendar year 2015 as well as all reporting deadlines previously extended by earlier notices. For all other individuals with an FBAR filing obligation, the filing due date remains unchanged.

*See FinCEN Notice 2015-1 FBAR Filing Requirement—Extended Filing Date Related to Notice 2014-1 (*Dec. 8, 2015), *available at* https://www.fincen.gov/whatsnew/pdf/20151208.pdf.

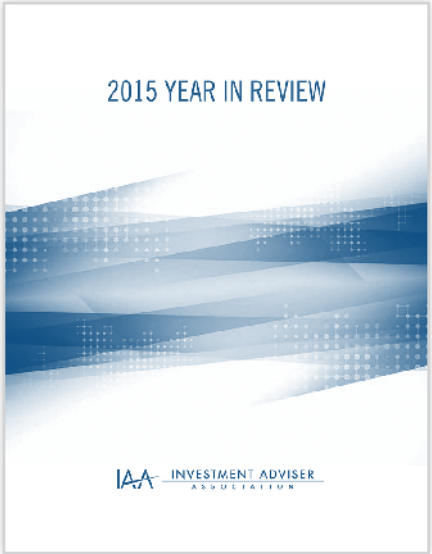
IN THE KNOW

IAA's 2015 YEAR IN REVIEW:

Publication Reviews the Industry and the IAA

The IAA's ***2015 Year in Review*** provides insight into the current state of the investment advisory industry and the regulatory and legislative challenges that faced our industry in the past year—and will continue to confront our industry into 2016. The just-published report highlights the many ways the IAA has been advancing member interests with legislators on Capitol Hill and with regulatory agencies at home and abroad. The IAA's ***2015 Year in Review*** is enclosed with the January newsletter mailing and available online at https://www.investmentadviser.org/eweb/Dynamicpage.aspx?webcode=activityreport.

In serving as the voice for investment advisers on key legislative and regulatory issues, the IAA strives to ensure that regulation is appropriately tailored so that members can run their businesses and serve their clients without undue burden. The report notes the IAA's efforts to fight proposals in 2015 that would subject all advisers to anti-money laundering rules, make advisers report significantly more data on Form ADV, and require advisers to hire and pay for independent third parties to perform compliance reviews for the SEC. The publication also takes a look at the IAA's role in the coming year, with a legislative and regulatory agenda under consideration that could have a profound impact on the investment advisory industry.



Additionally, the report highlights the variety of conferences, workshops, webinars, reports, and surveys the IAA offers to keep members informed about industry hot topics, trends, and new developments. New programs in 2015 included a series of webinars that addressed business development topics of particular interest to advisory firm executives.

IAA members represent the full range of SEC-registered investment advisers, including all types of firms as evaluated by size and specialty. By year's end, IAA members were managing more than $16 trillion in assets for a wide variety of individual and institutional clients. The Association will build on the successes of 2015 and focus on continued growth, in order to have an ever-increasing impact in representing adviser interests and to further enhance its services and benefits for IAA members.

CFTC Adopts Margin Requirements for Uncleared Swaps

A divided **CFTC** implemented major provisions of the Dodd-Frank Act requiring margin for uncleared swaps on December 16. The new rules essentially impose margin requirements for uncleared swaps entered into by swap dealers (SDs) or major swap participants (MSPs) that are not subject to regulation by prudential regulators. The rules, however, would not impose margin requirements on the swap activities of commercial end users. The CFTC is also seeking comment on an interim final rule that exempts certain uncleared swaps with certain counterparties from these margin requirements.

CFTC Chairman **Timothy Massad** stated that the adopted rules are "strong and sensible" and added that "[w]hile there are costs to this rule, they are justified in light of the potential risks that uncleared swaps can pose. We learned this firsthand in the global financial crisis, which resulted in dramatic suffering and loss for American families."

The new rules will require initial and variation margin to be exchanged with counterparties to swaps not cleared through a central counterparty, allow for the use of a range of types of collateral with appropriate haircuts, and require segregation of margin with third party custodians.

One aspect of the rules that received significant attention is how they should apply to so-called "interaffiliate" transactions. As adopted, the CFTC rule exempts most swaps between affiliates from initial margin requirements but will still require variation margin for such transactions. In her dissenting remarks, CFTC Commissioner **Sharon Bowen** expressed concerns that by "not requiring the collection of interaffiliate initial margin... we lose a vital financial shock absorber that is intended to help immunize institutions and the system against the risk of default."

The CFTC consulted with the banking **prudential regulators** as well as with the **Securities and Exchange Commission** in developing the rules. According to the CFTC, their rules are substantially similar to the joint rules issued by the banking prudential regulators and the international standards issued by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions.

The rules are to become effective April 1, 2016, followed by a phased in compliance schedule. The comment period for the interim final rule will end 30 days after publication in the *Federal Register.*

The CFTC's adopted rules are available at http://www.cftc.gov/PressRoom/PressReleases/pr7294-15#1.

Treasury Issues First-Ever Financial Stability Report

On December 15, the Treasury Department's Office of Financial Research (**OFR**) issued its first Financial Stability Report. The report highlights the progress of OFR's research and ongoing questions on a number of topics, including assessing potential financial stability risks in asset management activities. For example, the report discusses the design and application of **stress tests** for nonbanks such as asset managers; improving data about asset management activities; policies that address risks posed by nonbank financial institutions; and policies aimed at making nonbank financial entities more resilient.

In addition to developing monitoring tools to assess, measure, and monitor risks across the financial system, OFR's financial stability assessment includes analyses of asset management activities that may introduce excessive **liquidity mismatch** or **leverage** risks into the financial system. In its work on liquidity and leverage, "[t]he OFR's focus on asset management centers on the unintended and unpriced consequences of asset management activities—the risks that arise from asset management practices that are optimal for funds individually but that induce excess financial risk in aggregate."

OFR does not appear to be seeking industry comment.

OFR's Financial Stability Report is available at http://financialresearch.gov/financial-stability-reports/files/OFR_2015-Financial-Stability-Report_12-15-2015.pdf.

Interested IAA members may join the IAA FSOC/Prudential Regulation Working Group by contacting Laura Grossman at laura.grossman@investmentadviser.org.

Asset Management Stress Tests: *Research Questions Posed by the OFR*

- How do fund boards use the stress testing results? Should disclosure of the results be expanded?
- How should stress scenarios for increased shareholder redemptions be specified?
- Given the wide diversity of mutual funds and hedge funds, how can stress scenarios for different types of funds be defined to meet a consistent standard of extreme yet plausible?
- How can behavioral and strategic actions by investors, fund managers, and creditors be incorporated into the analysis of stress scenarios?

How to Minimize Errors in Investment Management Marketing Material

By Amy Jones, CIPM, Guardian Performance Solutions LLC, and Richard Kerr, K&L Gates LLP*

The investment management industry has automated almost every aspect of its operations over the last several decades. However, when it comes to pulling together data from different parts of the organization into cohesive presentations for existing and prospective clients, most firms still operate in a 20th century tech environment, relying on a hodgepodge of spreadsheets and manual calculations to create and publish the data they use in their marketing and reporting materials.

We call this the "last mile" problem, and it should be on the radar of chief compliance officers at investment advisory firms. By neglecting the last mile, investment advisory firms leave themselves susceptible to a variety of very real risks in a part of their reporting process that regulators are focused on: marketing presentations.

In today's aggressive regulatory climate, "that's how everyone does it" is not enough to exonerate an investment manager whose employee accidentally typed the wrong performance number into a marketing or client presentation as he or she headed out the door. At the very least, industry best practices that are still being developed are likely to become the "new normal," and if better processes were available, it will be incumbent on the firm to explain why they were not employed.

This article discusses the last mile problem: how it manifests in most investment advisory firms; common examples of operational, regulatory and legal risk events; and how investment advisers can use technology to reduce errors in investment results reporting caused by manual processes.

"Good Enough" isn't Good Enough Anymore

Most investment advisory firms automated their operations as relevant technology became available for various pieces of their business, such as trading, accounting and performance measurement. In order to present holistic investment results to prospective clients, investment advisers may need to combine data from a number of disparate systems to produce cohesive marketing presentations. In our experience, much of that process is performed manually by the firm's personnel. Printing reports from each silo and typing the data into marketing materials is still quite common. So is downloading data into spreadsheets and linking it into presentations. Both leave investment advisers vulnerable to human error.

To Err is Human

Any time human touch points are involved in calculating, combining or updating performance information, there is potential for error. While relying on spreadsheet links might have seemed a perfectly reasonable automated solution at the outset, these processes tend to fall apart over time. Spreadsheets and presentations are constantly changing, and every manual update to a spreadsheet can introduce an error into the results. And a broken link or wrong cell reference in a formula is more likely to go undetected than a manual error due to the false sense of security quasi-automation provides.

And then there's the "recycling" problem. Once performance information is generated, the data is often used to feed multiple types of marketing materials and reports—each of which may have its own combination of automated, semi-automated and manual processes. Without automated safeguards in place, it's easy to see how non-compliance-approved or outdated information can slip into a marketing document or client report—and the hands of regulators.

While checklists, peer reviews, vigilant compliance oversight and standardizing materials can reduce human errors, it is impossible to eliminate them, leaving investment advisory firms vulnerable to operational, regulatory and legal risks.

Operational, Regulatory and Legal Risks

Since the 2008 financial crisis, investment advisers have become more vigilant about operational risk management, especially trading, counterparty risks and other exposures related to

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potential loss of money. However, one of the neglected areas of operational risk is "production of information"—which includes information produced for regulatory reporting and communicating with current and prospective clients.

Investment firms have a duty to disseminate accurate information to external parties. The adopting release for the Securities and Exchange Commission (the "SEC") Final Rule regarding Compliance Programs of Investment Companies and Investment Advisers states: "We expect that an adviser's policies and procedures, at a minimum, should address the following issues to the extent that they are relevant to that adviser: ... The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements."

The SEC has widely publicized its data analytics capabilities, including forming specialized units that analyze mountains of data using sophisticated software. The SEC continues to increase the volume of data required from investment advisers through rulemaking related to regulatory reporting. It appears that the SEC seeks to build a mosaic of each firm, and firms want their mosaic to appear clean and intact. Should the SEC knock on your door, it's in your firm's best interest to show operational efficiency, internal controls and a solid culture of compliance.

Common "last mile" errors

While no investment advisory firm we know would ever willfully misrepresent information, unintentional mistakes can and do creep into marketing materials, exposing the firm to a variety of risks and inviting regulatory scrutiny. In our practices, we've encountered performance and reporting missteps as a result of the "last mile" problem. Some common examples include:

- **Copying return numbers into the wrong return-period column**
  It doesn't take much to copy a 3–year composite return number from a spreadsheet into the 5–year return column in a presentation or manager database. This common type of cut-and-paste error is easy to make and hard to catch.

- **Using an existing marketing pitch book as the template for a different strategy presentation**
  Let's say a firm uses its Small-Cap Core pitch book as the template for a Small-Cap Growth presentation. It's easy to copy-and-paste Small-Cap Growth returns into the existing document but forget to change the benchmark name—and/or data—from the original Russell 2000 Index to the correct Russell 2000 Growth Index.

- **Inadvertently including the wrong GIPS® information**
  For investment management firms that claim compliance with the Global Investment Performance Standards (GIPS), regulators understand that there are very specific requirements when presenting composite performance information. They look closely at composite data to verify that GIPS-compliant firms are including all required statistics, updated at least annually, for all marketed composites. When marketing materials, strategy fact sheets and website pages are updated manually, it is easy for unintentional mistakes to slip in unnoticed. A common example is to inadvertently copy the GIPS statistics or disclosures for one composite into materials designed for a different composite strategy.

- **Failing to include required regulatory disclosures in sales materials**
  While this can—and does—happen to of investment advisory firms, those claiming GIPS compliance are doubly vulnerable here. When it comes to GIPS errors, the offending firm can be required to redistribute the corrected Compliant Presentation ("CP") slide to current and prospective clients who received the original materials, which exposes the firm to reputational risk. Trust us when we say that no firm wants to go through that process!

- **Different sources for information**
  Unfortunately, when the firm's process is to manually update performance grids, charts and graphs, the door is left open for personnel in different departments to use their own sources and offline spreadsheets to calculate performance and use those results when updating materials. This is problematic since different sources and methodologies could produce different results––plus it makes it difficult to ensure that appropriate books and records are maintained that support all information that is presented. Without a process that locks down source data and then automatically uses that data to create presentation materials, the firm is forced to have additional compliance checks in place to validate and trace results to the firm's official source—thus creating inefficient processes.

- **Discrepancies between data in regulatory filings and marketing materials**
  Investment managers are constantly changing the content of their marketing materials to address the needs of specific audiences and/or to tell their story in a slightly different way. That process can be highly manual, resulting in any of the errors noted above and, in some cases, discrepancies between the facts and data that appear in regulatory filings and those that appear in the marketing presentation. These discrepancies or "different versions of the truth" send up regulatory red flags and could result in a violation.

Automating the Last Mile

So, what can managers do to avoid last mile problems? Best practices are

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to automate the entire process of producing marketing and presentation materials, from the first step of capturing accurate performance and making appropriate disclosure to the last step of obtaining compliance approval. Automation helps reduce human error, creates operational efficiencies and includes built-in safeguards that eliminate the possibility of distributing material that has not been approved by compliance.

Fortunately, firms today have many options. They can develop in-house software, purchase and install on-premises applications, or sign up for cloud-based services. Over the last decade, the cost of software has come down drastically and reliability has improved, so most firms should be able to find a solution that's right for them.

No matter which approach a firm takes, here are three key areas of functionality to look for:

1. **Quantitative data goes straight through from source systems to the final marketing materials and client reports**
   Returns and holdings from the firm's accounting system, attribution and characteristics from analytics systems, and GIPS statistics, if applicable, should all flow straight through to marketing presentations and other reports with zero manual updates. If a firm is massaging data because output from the source systems are incorrect, then the root cause for the data errors should be identified and fixed prior to automating marketing and client communications.

2. **Built-in checks for GIPS disclosures, mandatory slides and compliance approval**
   Any automated last mile solution should include safeguards against producing a presentation that does not include the most current GIPS CP slide and/or is not otherwise compliance-approved. Look for a system that has built-in checks for required regulatory elements and compliance approvals, an alert or do-not-publish default if the presentation is missing vital pieces, and a solid page-numbering protocol to ensure disclosures reference the correct page number for the GIPS CP slide.

3. **System provides a single pool of data and content for multiple communication purposes**
   A robust software platform should allow a firm to automatically gather data from multiple systems into a single pool, where it can be combined with regulatory disclosures and commentary from portfolio managers. This one pool becomes the sole source for production of all sales and client communication materials—not just marketing presentations.

Trust but Verify

Automation can increase accuracy while reducing operational, regulatory and legal risks. However, software is only as good as its inputs. Fully automating the last mile is not a substitute for prudent checks and balances or having appropriate procedures and controls in place during installation and on an ongoing basis. And whether a firm builds the software in-house, installs-on-premises or chooses a cloud-based system, be sure cybersecurity protocols are robust.

Technology can help bring the last mile up to par with the automation used in the rest of the organization. When the right controls and systems are in place, firms can leverage technology that allows for a predicable outcome and can reduce the burden on compliance personnel. The firm's internal risk score associated with performance advertising may also be lowered when automation is used to control where the data is derived from, how the content is updated, and who is involved to approve materials. However, investment advisers can never delegate their duties to software. Firms will always need qualified compliance personnel and other professionals with the expertise to oversee processes and stay ahead of changing regulatory requirements.

Conclusion

No matter how vigilant an investment management firm is, mistakes can still slip into marketing materials and client reports, leaving the firm vulnerable to unwanted regulatory scrutiny. Most firms rely on automated solutions in their performance and attribution calculation processes, but the final and most important part of the process—pulling all the required information and disclosures into holistic marketing and client presentations—is still largely a mishmash of disparate manual and quasi-automated events.

Automating this last mile removes human touch points to help produce accurate marketing and client materials and reduce operational, regulatory and reputational risks in the process. There are a variety of top-notch automation solutions available to managers today that pool data from various systems, combine it with input from portfolio managers, and have built-in safeguards to prevent many common errors, all while ensuring the final marketing presentation meets regulatory requirements. In order to communicate consistently accurate investment results—and avoid regulatory attention—investment managers would be well advised to automate the last mile when producing marketing presentations and client reports.

This article is based on material in a white paper prepared with our input and published by Assette. The complete white paper is available at www.assette.com/LastMile and includes some steps short of full automation that may also reduce operational, regulatory and legal risks.

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The Future of Wealth Management

It's not easy running an investment advisory practice these days. In the Internet era, clients no longer need to rely on advisers for information about markets or investments, and an increasing number are going online for asset allocation advice. Even the smallest investors can access all types of investment opportunities without professional help, while fees are shrinking as a result of the move to passive strategies. At the same time, generating alpha just seems to get harder and harder as markets become increasingly efficient.

But it's not all bad news. On the positive side, clients continue to want the personalized attention and customized recommendations that a relationship with an investment adviser can provide. However, it's clear that it can't be business as usual for advisers who want to thrive in the new environment.

In a recent IAA webinar, advisers at the forefront of change in the industry talked about the challenges and opportunities facing today's investment advisory practice. **Steve Lockshin**, Founder and Principal of **AdvicePeriod**, **Jamie McIntyre**, Founder of **Rewire Capital**, and **Scott Welch**, Chief Investment Officer of **Dynasty Financial Partners**, had these thoughts for advisers:

- **Emphasize clients, not operations.** Advisers can easily get distracted by the daily operational demands of the business, whether filing account paperwork, rebalancing portfolios or processing invoices. In fact, advisers report that they spend twice as much time on these activities as they think they should. Yet surveys have found a clear correlation between time spent on business development and growth in assets under management.

- **Focus on client advocates.** While building their business, advisers need to deepen their relationships with clients, because it's client "advocates" that ultimately drive the business. According to an IBM study, advocates are four times more likely than "antagonists" to view the advisory firm as a trusted source, are 60 percent less sensitive to fee levels, and are twice as likely to give the firm a large share of wallet.

- **Redefine alpha.** Perhaps the most important way that an advisory firm can build a core of client advocates is by carefully defining its value proposition—and how it's unique. Asset allocation advice has become a commodity and just won't make a firm stand out from others. Today, alpha is anything that can add value versus an index that an investor is willing to pay for. That could be advice about lowering fees, reducing taxes or managing leverage.

- **Use technology extensively.** To keep pace with change, advisers need to become faster about adopting new technologies, for a number of reasons. Automation can help them minimize time spent on operations. Clients of all ages—but especially millennials—expect an efficient user experience. And the investment opportunities of the future may be available only through a high-tech portal: think Kickstarter and Indiegogo.

- **It's all about the experience.** In sum, advisers need to think holistically about their practices. They need to be able to answer the question, "Why am I worth 90 basis points?"

For advisers operating under a more traditional model, the speakers had the following suggestion: experiment with some of the new technology today, if only in a personal account. The experience could help model a better approach for clients.

The IAA webinar that formed the basis of this article is available online at https://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=EventInfo&Reg_evt_key=271d3e88-2edf-4689-b50e-50cc3142c9c7&RegPath=EventRegFees. All IAA webinars are free to members and associate members.

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UPCOMING COMPLIANCE DATES

The following selected compliance dates are listed as a reminder for IAA members. For questions or more information, please contact the IAA legal staff.

January 10: If needed, ***file an amended Form 13H*** to reflect changes made during the fourth calendar quarter (promptly after the end of the quarter).

January 15: Large liquidity fund advisers (with at least $1 billion RAUM attributable to liquidity funds and registered money market funds) must ***file Form PF*** for the quarter ended December 31.*

February 14: Institutional investment managers that exercise investment discretion over $100 million or more in Section 13(f) securities must ***file Form 13F*** (45 days after the quarter ended December 31).

February 14: Large traders (whose transactions in NMS securities equal or exceed 2 million shares or $20 million during any calendar day, or 20 million shares or $200 million during any calendar month) must ***file Form 13H*** (45 days after the end of the calendar year). Form 13H filers can use the 13H-A submission form type to satisfy both their annual (13H-A) and fourth quarter amendment (13H-Q) filing requirements.

February 14: Registered investment advisers whose accounts are beneficial owners of more than 5% of a registered voting equity security must ***file an amendment to Schedule 13G*** (45 days after the end of the calendar year).

February 14: Registered commodity trading advisors (CTAs) with a December 31 fiscal year end must ***file Form CTA-PR*** (within 45 days after the end of the CTA's fiscal year end).

February 14: NFA-member CTAs must ***file NFA Form PR*** for the quarter ended December 31.

February 29: Large hedge fund advisers (with at least $1.5 billion RAUM attributable to hedge funds) must ***file Form PF*** for the quarter ended December 31.*

February 29: Large CPOs with between $1.5 billion and $5 billion AUM in commodity pools (as of the last day of the fiscal quarter most recently completed prior to December 15) must ***file Form CPO-PQR*** for the quarter ended December 31 (60 days after December 31).*

February 29: NFA-member CPOs must ***file NFA Form PQR*** (or file CFTC Form CPO-PQR if a "large filer") for the quarter ended December 31. Mid-size CPOs that file CFTC Form CPO-PQR (Schedules A and B) by March 31 will satisfy this requirement. Small CPOs that file CFTC Form CPO-PQR (Schedule A plus Schedule of Investments) by March 31 will satisfy this requirement. Form PF filers that file CFTC Form CPO-PQR (Schedule A plus Schedule of Investments) by March 1 or March 30, depending on AUM, will satisfy this requirement.

February 29: A CPO that claims an exemption or exclusion under CFTC Regulation 4.5, 4.13(a)(1), 4.13(a)(2), 4.13(a)(3), or 4.13(a)(5) or a CTA that claims an exemption under 4.14(a)(8) must ***reaffirm*** the applicable notice of exemption through NFAs Electronic Exemption System (60 days after the end of the calendar year).

March 30: Calendar-year-filers' (including exempt reporting advisers') deadline to file an "annual updating amendment" to ***Form ADV*** which includes state notice filings and amendments to Form ADV, Part 2, if any (90 days after the end of the fiscal year).

March 30: All other CPOs must ***file Form CPO-PQR*** (90 days after December 31).*

March 30: CPOs must file with the NFA and distribute an ***Annual Report***, certified by an independent public accountant, to each participant in each pool it operates (90 days after the end of the pool's fiscal year). CPOs can submit a request for extension for a fund-of-funds.

**This deadline applies to advisers with a December 31 fiscal year-end.*

LEGAL & REGULATORY UPDATE

Firm Pays $367 Million to Settle SEC and CFTC Charges Over Conflicts of Interest

SEC Provides Conditional Waiver from Automatic Disqualifications

Two subsidiaries of a large financial services firm have admitted wrongdoing and agreed to pay $267 million in fines to the SEC and another $100 million to the CFTC after failing to sufficiently disclose conflicts of interest to clients, stemming primarily from preferences for the sale of proprietary investment products.

The SEC and CFTC found that the subsidiaries, which included a dually-registered investment adviser/broker-dealer and a nationally chartered bank, failed to disclose preferences to invest client funds in more expensive share classes of proprietary mutual funds and in proprietary hedge funds that paid "retrocessions" to an affiliate of the firm. The investments generated more revenue for the firm.

Andrew J. Ceresney, Director of the SEC's Division of Enforcement, stated, "Firms have an obligation to communicate all conflicts so all clients can fairly judge the investment advice they are receiving. These [firm] subsidiaries failed to disclose that they preferred to invest client money in firm-managed mutual funds and hedge funds, and clients were denied all the facts to determine why investment decisions were being made by their investment advisers."

Andrew Ceresney, Director, SEC Enforcement Division

As part of the settlement, the firm obtained a conditional waiver that allows it to continue to conduct business under Rule 506, which is a safe harbor for the private offering of securities. The firm's ability to rely on the waiver was conditioned upon a number of stringent requirements, including hiring an independent compliance consultant to conduct a comprehensive review of the firm's policies and procedures relating to Rule 506, test those policies and procedures, and produce an annual report on the firm's compliance with those policies and procedures. The consultant's annual report will be publicly available.

SEC Commissioner **Kara Stein** issued a statement in support of the decision to issue a conditional waiver. "During my tenure, I have been repeatedly concerned about the binary nature of granting or denying waivers. Today's action represents a different and more outcome-focused approach."

Kara Stein, SEC Commissioner

See J.P. Morgan to Pay $267 Million for Disclosure Failures, Release No. 2015-283 (Dec. 18, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-283.html.

See Order Under Rule 506(d) of the Securities Act of 1933 Granting a Waiver of the Rule 506(d)(1)(iii) Disqualification Provision, In Re JPMorgan Chase Bank, N.A., Sec. Act Rel. No. 33-9993 (Dec. 18, 2015), *available at* https://www.sec.gov/rules/other/2015/33-9993.pdf.

See Kara M. Stein, *Statement In The Matter Of JPMorgan Chase Bank, N.A., Regarding Order Under 506(d) Of The Securities Act Of 1933 Granting A Waiver Of The Rule 506(d)(1)(iii) Disqualification Provision* (Dec. 18, 2015), *available at* http://www.sec.gov/news/statement/statement-on-jpmorgan-chase-bank-12-18-2015.html.

SEC Settles Charges against Principals/CCO and Former CCO for Breaching Fiduciary Duty and Undisclosed Compensation

On December 14, the SEC settled charges against two individuals—an advisory firm's Chief Compliance Officer (CCO) and former CCO—and their now defunct firm. These individuals held other executive titles at the firm. The charges were originally brought on April 15, 2014 charging the firm and its chief executive officer, chief compliance officer, and another employee for misleading investors and breaching their fiduciary duties to clients by entering into undisclosed revenue sharing agreements with particular families of funds. More specifically, the firm and principals misrepresented the extent of the due diligence conducted on the investments recommended, failed to disclose conflicts of interest, and concealed revenue sharing payments from certain of the investments they recommended.

The respondents were also charged with violating Form ADV disclosure rules and the custody rule. The firm violated the custody rule because it used an auditor that was not independent and was not subject to regular PCAOB inspection, and thus not eligible to perform independent audits under the custody rule.

This matter is another SEC case that charges the CCO and former CCO for aiding and abetting the anti-fraud violations of the advisory firm and its founder, CEO, and owner. We note, however, that

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the CCOs wore multiple hats with respect to the alleged misconduct. The CCO and former CCO were barred from the securities industry with a right to reapply in five years and ordered to pay $107,395 and $132,405, respectively. The advisory firm's registration was revoked.

See In Re Total Wealth Management, Inc., Jacob Cooper, Nathan McNamee, and Douglas Shoemaker, order instituting administrative proceedings, SEC Rel. No. 3818, File No. 3-15842 (Apr. 15, 2014), *available at* http://www.sec.gov/litigation/admin/2014/33-9575.pdf. *See In Re Total Wealth Management, Inc., Jacob Cooper, Nathan McNamee, and Douglas Shoemaker*, order making findings and imposing remedial sanctions against McNamee and Shoemaker, SEC Rel. No. 31936, File No. 3-15842 (Dec. 14, 2015), *available at* http://www.sec.gov/litigation/admin/2014/33-9575.pdf. *See In Re Total Wealth Management, Inc., Jacob Cooper, Nathan McNamee, and Douglas Shoemaker*, order making findings and revoking the registration of the advisory firm, SEC Rel. No. 31935, File No. 3-15842 (Dec. 14, 2015) *available at* https://www.sec.gov/litigation/admin/2015/33-9989.pdf.

SEC Fines Private Equity Adviser for Disclosure-Based Fraud

Continuing its recent trend of bringing enforcement actions against advisers to private equity funds, the SEC has fined a private equity adviser $225,000 to settle fraud charges based on disclosure failures.

The SEC found that the adviser engaged in fraud by not disclosing such activities as making direct loans to the fund's portfolio companies, engaging in crossover investments, and concentrating capital beyond the concentration limits set out in the funds' Limited Partnership Agreements (LPAs). Among the SEC's findings:

- During the time period between 2006 and 2012, the adviser and some of its principals made almost $62 million worth of direct loans to the funds' portfolio companies without disclosing the loans to the funds' advisory boards. These loans created conflicts of interest by giving the adviser an interest in the portfolio company that was superior to that of the funds.

- During the time period between 2007 and 2012, the adviser caused multiple funds to invest in the same portfolio company at differing priority levels and/or valuations (so called "crossover" investments). Such an arrangement could potentially place one fund client in a more favorable position than another invested in the same portfolio company. The adviser did not adequately disclose to its fund clients such crossover investments or their potential to favor some clients over others.

- The funds' LPAs contained provisions that set out specific concentration limits regarding the funds' investments. However, the adviser repeatedly, and without the knowledge or consent of the funds' advisory boards, exceeded the concentration limits set out in the LPAs. Additionally, the adviser further exposed the funds to portfolio companies beyond the concentration limit by issuing numerous loans to the companies. Such loans were not adequately disclosed to the advisory boards.

The SEC alleged violations of Section 206(2) of the Advisers Act as well as Section 206(4) and Rule 206(4)-8 thereunder. The adviser was censured, agreed to cease and desist from any future violations of said provisions of the Advisers Act, and paid a civil money penalty of $225,000. In determining the penalties, the SEC took into consideration remedial action taken by the adviser.

See In the Matter of JH Partners, LLC, Investment Advisers Act of 1940 Rel. No. 4272 (Nov. 23, 2015), *available at* http://www.sec.gov/litigation/admin/2015/ia-4276.pdf.

Political Intelligence Firm Pays $375,000 for Compliance Failures Concerning Material Non-Public Information

A dually registered broker-dealer and investment adviser that provides research on likely outcomes of future government actions settled SEC charges on November 24 alleging failure to maintain written policies and procedures to prevent the misuse of material nonpublic information (MNPI) under section 15(g) of the Securities Exchange Act and section 204A of the Advisers Act. The SEC alleged both that the firm's policies and procedures were not sufficient, and that the firm did not follow the policies and procedures that it had adopted.

According to the order, the firm provided research to mutual funds, investment advisers, and hedge funds based on interactions between its analysts, who often had worked at government agencies, and government officials. The firm's policies and procedures prohibited employees from using or disclosing MNPI (including "the specific terms of any pending but not yet publicly proposed or approved action" by a government agency), and required that an employee with "any doubt" refrain from using or disclosing the MNPI and to consult with the compliance department. The order cited two specific instances in 2010 in which neither the employee nor the relevant supervisors took any steps to quarantine the information or consult with the Chief Compliance Officer, and concluded that the firm's policies and procedures were not reasonably enforced.

The order also states that the firm's policies and procedures did not address the substantial risk that its employees would receive MNPI in their discussions with government officials in relying on assessments by employees and supervisors, with limited involvement by the CCO. Citing previous orders in which employees' self-

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evaluations were determined to be insufficient for compliance with sections 15(g) and 204A, the order stated that the policies and procedures should have required that the CCO be provided sufficient information to assess the employees' use or disclosure of MNPI.

The settlement requires the firm to hire an independent compliance consultant for two years, adopt its recommendations (or propose alternatives) for changes or improvements in the enforcement of its policies and procedures, and pay $375,000 in civil penalties.

See In the Matter of Marwood Group Research, LLC, SEC Rel. No. 76512 (Nov. 24, 2015), *available at* http://www.sec.gov/litigation/admin/2015/34-76512.pdf.

NFA Reminds CPO and CTA Members to Comply with Annual Affirmation Requirements

The NFA issued a Notice to Members, I-15-26, on December 1 reminding firms to make their annual affirmation filings by February 29, 2016. The CFTC requires any person or entity claiming an exemption or exclusion from CPO registration under CFTC Regulation 4.5, 4.13(a)(1), 4.13(a)(2), 4.13(a)(3), 4.13(a)(5) or an exemption from CTA registration under 4.14(a)(8) to annually affirm the applicable notice of exemption or exclusion within 60 days of the calendar year end, which is February 29, 2016, for this affirmation cycle. Failure to affirm an active exemption or exclusion from CPO or CTA registration will result in the exemption or exclusion being withdrawn on March 1, 2016. See http://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4663.

If you have questions or comments about these or any other matters in the Legal & Regulatory Update column, contact the IAA Legal Team.

Smaller Advisers Compliance Forum—Get Involved!

First Meeting January 28

The IAA's new **Smaller Advisers Compliance Forum**—which will provide opportunities for firms with limited personnel and budgets to network and discuss compliance issues—will hold its first conference call on Thursday, January 28, 2016 at 2:00 pm ET. The meeting will provide an opportunity to discuss compliance challenges, share insights and to hear from **Mari-Anne Pisarri**, Partner, Pickard Djinis and Pisarri, the Forum's first presenter.

Mari-Anne Pisarri, Partner, Pickard Djinis and Pisarri, will be the Forum's first presenter.

This Forum will have a dedicated group in the Online Communities discussion board available in the Members Only portion of the IAA website. The Smaller Advisers Compliance Forum will hold quarterly conference calls and may occasionally meet regionally in person in connection with certain local IAA compliance workshops or other events.

Many member firms have expressed interest in this group. To join, please contact IAA Special Counsel Paul Glenn. Those who have already expressed interest in the Forum will be receiving electronic notifications.

For any questions, contact Paul Glenn at paul.glenn@investmentadviser.org or (202) 293-4222.

Compliance Corner—*continued from page 14*

Solutions LLC, a specialty compliance consulting firm dedicated to assisting investment advisory firms to implement, maintain and manage compliance with the Global Investment Performance Standards (GIPS®) as well as reviewing performance advertising materials for adherence with SEC requirements. She is a member of the United States Investment Performance Committee (USIPC), the CFA Institute's official local sponsoring organization for the GIPS standards in the United States. She holds the CFA Institute's Certificate in Investment Performance Measurement (CIPM).

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This article is intended to provide general information on the matters discussed herein and should not be relied upon for legal advice on any matter.

Amy Jones, CIPM Guardian Performance Solutions LLC

Richard Kerr, Partner K&L Gates LLP

ESMA Publishes Implementing Standards under MiFID II

The European Securities and Markets Authority (**ESMA**) has published a Final Report on additional draft implementing technical standards in relation to the new Markets in Financial Instruments Directive (**MiFID II**). This Report addresses many technical areas under MiFID II, including the standards on position reporting for commodity derivatives and the format and timing of weekly position reports. ESMA acknowledges that more work is needed in order to give market participants sufficient certainty to build their systems to comply with the position reporting obligations and intends to release additional guidance "as soon as possible" after publication of this technical standard to address these concerns. The Report now goes to the EU Commission for its consideration.

ESMA's Final Report is available at https://www.esma.europa.eu/sites/default/files/library/2015-1858_-_final_report_-_draft_implementing_technical_standards_under_mifid_ii.pdf.

EU Publishes Report on Prudential Regulation for Investment Firms

On December 14, the European Banking Authority (**EBA**) and the European Securities and Markets Authority (**ESMA**) published a report on the applicability of prudential regulations for investment firms, including how investment firms might fit within the scope of the Capital Requirements Regulation generally applicable to banks. The report is another that furthers the narrative—favored by global banking regulators and **opposed by the IAA**—that investment firms present potential risks to their "clients and counterparties, to the financial markets, and to financial stability" that are best addressed by bank-like prudential regulation.

The EBA and ESMA are recommending a new category of investment firms distinguishing between systemic and "bank-like" investment firms to which the full prudential requirements would apply; other investment firms (non-systemic) with a more limited set of prudential requirements; and very small firms with "non-interconnected" services. The agencies are also recommending that specific rules be developed for non-systemic investment firms with regard to "investment business risks, such as credit, market, operational and liquidity risks taking particular account of the holding of client money and securities." These recommendations appear inconsistent with the stated intentions of the **FSOC**, **FSB**, and **IOSCO**, all of which have moved away from trying to address risks in asset management through designation of particular firms as systemically important.

The report is available at https://www.esma.europa.eu/press-news/esma-news/report-investment-firms.

ESMA Publishes Guidelines for Giving Investment Advice

On December 17, the European Securities and Markets Authority (**ESMA**) published a Final Report on certain guidelines required by the new MiFID II in connection with giving investment advice. The guidelines are intended to enhance investor protection by increasing the knowledge and competence of individuals giving investment advice or providing information about financial instruments, investment services or ancillary services to clients on behalf of investment firms.

The guidelines will come into effect on January 3, 2017 and are available at https://www.esma.europa.eu/sites/default/files/library/2015-1886_-_final_report_on_guidelines_for_the_assessment_of_knowledge_and_competence.pdf.

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Basel Committee Scrutinizes Banks' Support of Asset Managers

On December 17, the Basel Committee on Banking Supervision released a consultative document proposing approaches to address risks to banks resulting from their relationships with so-called shadow banking entities, such as asset managers and funds. The report focuses on entities posing potential "step-in risk," which is the risk that a bank will "step in" to provide financial support to an entity in order to protect the bank from any adverse reputational risk stemming from its connection to the entity. In the case of asset managers, the report asserts that this might occur where the bank provides credit enhancement to a fund or where it is the only or the major liquidity provider.

Comments are due by March 17, 2016.

See the Bank for International Settlement's Consultative Document, *Identification and measurement of step-in risk* (Dec. 2015), *available at* https://www.bis.org/bcbs/publ/d349.pdf.

IOSCO Releases Survey on Liquidity Management Tools

On December 17, the International Organization of Securities Commissions (**IOSCO**) presented the findings of a survey on liquidity management tools used in 27 member jurisdictions. The most common tools are redemption fees; redemption gates; redemptions in kind; side pockets; and suspension of redemptions. Open-end funds are generally subject to additional regulations addressing leverage, asset and investor concentration, restrictions on illiquid asset investment and short-term borrowings.

According to the survey, regulatory definitions of "liquidity" vary but tend to be principles-based. Many jurisdictions provide guidance on when liquidity management tools may be used. The report notes that in the large majority of cases, these tools have been used without causing any broader effect beyond the funds involved.

See Liquidity Management Tools in Collective Investment Schemes: Results from an IOSCO Committee 5 survey to members, FR28/2015 (Dec. 2015), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD517.pdf.

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ESMA Seeks Input on Two AML Joint Consultation Papers

European regulators have published two consultation papers on anti-money laundering and terrorist financing regimes in Europe that include, among other things, guidance relating to investment advisers. The consultation papers, issued by the European Securities and Markets Authority (**ESMA**), the European Banking Authority (**EBA**), and the European Insurance and Occupational Pensions Authority (**EIOPA**), are open for comment until January 22, 2016. The papers are also interesting because they provide a fairly clear view of developing expectations for handling anti-money laundering and terrorist financing issues in Europe. They also may provide a preview of the final guidelines, which could be released as early as spring 2016.

The first consultation paper sets forth a cyclical process for conducting AML supervision on a risk-based basis: Step 1 is the identification of anti-money laundering and terrorist financing risk factors from available information sources in relevant markets; Step 2 is obtaining information in order to take a holistic view of those risks; Step 3 is the allocation of supervisory resources based on the risk assessment; and Step 4 is monitoring and review to ensure appropriate allocations are up to date and relevant—thereby leading back to Step 1 of risk identification.

See Joint Consultation Paper *The Risk-Based Supervision Guidelines,* JC 2015 060 (Oct. 21, 2015), *available at* https://eiopa.europa.eu/Publications/Consultations/JC%202015%20060%20(Joint%20Consultation%20on%20Guidelines%20on%20AML_CFT%20RBS_Art%2048(10)).pdf#search=aml.

The second consultation paper sets forth risk factors on simplified and enhanced customer due diligence and the types of things financial institutions should consider when assessing the money laundering and terrorist financing risk associated with individual business relationships and occasional transactions. Notably, this draft guidance includes sectoral guidelines for investment managers (Chapter 8).

See Joint Consultation Paper *The Risk Factors Guidelines,* JC 2015 061 (Oct. 21, 2015), *available at* https://eiopa.europa.eu/Publications/Consultations/JC%202015%20061%20(Joint%20Draft%20Guidelines%20on%20AML_CFT%20RFWG%20Art%2017%20and%2018).pdf.

Contact the IAA Legal Team or Special Counsel Paul Glenn with any questions (202) 293- 4222 or paul.glenn@investmentadviser.org.

ESMA Seeks Input on Automation in Financial Advice—"Robo" Investing

The Joint Committee of the European Supervisory Authorities, comprised of the European Securities and Markets Authority (ESMA), the European Banking Authority (EBA), and the European Insurance and Occupational Pensions Authority (EIOPA), has launched a Discussion Paper on **automation in financial advice**. The discussion paper aims to assess what, if any, action is required to harness the potential benefits of innovation and mitigate any risks in the use of automated financial advice.

The paper proceeds to explain the concept of automation in financial advice where financial institutions provide advice or recommendations to consumers with little or no human interaction, but rather rely on computer-based algorithms and other electronic decision making. The regulators want to monitor these new financial activities, take action where appropriate, and encourage an open dialogue between financial institutions and interacting consumers.

The European regulators identify several potential benefits of electronic advice: the potential for lower costs in operations and lower expenses for consumers; increased advice consistency; and the expanded number of consumers that can be served. They also clearly recognize the significant potential for expansion of the use of automated financial advice. The regulators acknowledge and discuss associated risks, including risks related to consumers having limited access to information and/or limited ability to process that information, risks related to flaws in the functioning of the tool, and risks related to a widespread use of automated financial advice tools (herding risk).

The discussion paper focuses on automated financial advice in the banking, insurance, pension, and securities contexts. The regulators seek input on their assessment of benefits, risks, and any needs for further guidance or oversight. Comments are due by March 4, 2016.

See Press release: ESAs seek stakeholder input on automation in financial advice, JC 2015 087 (Dec. 4, 2015), *available at* https://www.esma.europa.eu/sites/default/files/library/2015-087_jc_press_release_esas_issue_discussion_paper_on_automation_in_financial_advice_3.pdf.

See also Joint Committee Discussion Paper on Automation in Financial Advice, JC 2015 080 (Dec. 4, 2015), *available at* https://www.esma.europa.eu/sites/default/files/library/jc_2015_080_discussion_paper_on_automation_in_financial_advice.pdf.

Contact the IAA Legal Team or Special Counsel Paul Glenn with any questions at (202) 293- 4222 or paul.glenn@investmentadviser.org.

INSIDE THE BELTWAY

FY 2016 Omnibus Spending Bill: Modest Increase for SEC, Cybersecurity and No DOL Fiduciary Rider

Under the 2,200-page Omnibus spending bill approved by Congress on December 18, the SEC's budget would increase 6.7%, from $1.500 billion in FY 2015 to $1.605 billion for FY 2016. Although the $105 million increase is significant, it is $117 million less than the President's budget request.

SEC Chair **Mary Jo White** testified before the House Financial Services Committee on November 18 that the SEC is seeking $1.82 billion for FY 2017.

Of the $1.6 billion total, $68 million is designated for the SEC's Division of Economic and Risk Analysis (**DERA**) to improve use of economic analysis in the Commission's rulemaking process. The legislation also rescinds $25 million from the SEC's "reserve fund."

The **CFTC** did not fare as well as the SEC, with lawmakers keeping the agency's budget flat at $250 million. The CFTC had requested $322 million for fiscal 2016.

Notably, an oft-discussed policy rider that would have prevented the **Department of Labor** from proceeding with its rulemaking extending ERISA's fiduciary duty to anyone who provides retirement investing advice, did not make it into the Omnibus.

Because the rider was not included, lawmakers introduced bills immediately following passage of the Omnibus that would require congressional approval for a final fiduciary rule to take effect. Rep. **Peter Roskam** (R-Ill.) introduced the "Strengthening Access to Valuable Education and Retirement Support Act of 2015" (aka the "SAVERS Act"), a bill amending the Internal Revenue Code, and Rep. **Phil Roe** (R-Tenn.) introduced the "Affordable Retirement Advice Act" amending ERISA. Both bills provide a more flexible, alternative standard to the DOL proposal.

Rep. Peter Roskam (R-Ill.)

Rep. Phil Roe (R-Tenn.)

Separately, a provision was included in the Omnibus that bars the SEC from issuing or implementing a rule that would require publicly traded companies to disclose their political campaign contributions. After the Citizens United Supreme Court decision allowed for unlimited corporate campaign contributions, Democrats had asked the SEC to write a rule requiring companies to report this spending in financial disclosures.

The sweeping spending bill also includes the cybersecurity legislation supported by the IAA that would incentivize businesses to share data on cybersecurity threats with the government. House-Senate negotiators had been working on the cyber measure's final language since the Senate passed the Cybersecurity Information Sharing Act (CISA) in October. The House passed its two complementary bills in April.

House Panel Approves "Accredited Investor" Bill

The House Financial Services Committee approved a bill on December 9 that would broaden the definition of an "accredited investor" under federal securities law.

SEC rules currently permit private placement offerings to an unlimited number of "accredited investors" and, for offerings that do not involve general solicitation, to a limited number of sophisticated non-accredited investors.

Currently, financial thresholds based on income and net worth have to be met to qualify as an accredited investor. An individual person qualifies if he or she has at least $200,000 in annual income over the two most recent years or $1 million in net worth, without including a primary residence. Married couples have a $300,000 income threshold.

The bill, H.R. 2187, would write those thresholds into the 1933 Securities Act, indexed to inflation. It would also allow registered broker-dealers and investment advisers to qualify, and it would permit the SEC to write a rule expanding the definition to include people with sufficient "education or job experience" that gives them "professional knowledge" of a particular investment.

Rep. **David Schweikert** (R-Ariz.) sponsored the bill, which was narrowed in committee by an amendment. The measure was approved 54-2.

Rep. David Schweikert (R-Ariz.)

SEC Chair White testified before the House Financial Services Committee on November 18 that the agency plans to release a new accredited investor definition,

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pursuant to a Dodd-Frank Act mandate, within the next few months.

According to her, the agency is taking a "deep dive look" at the accredited investor criteria and the SEC staff is close to completing its work on a rule proposal. White told the committee that the agency is looking broadly "beyond net worth and income to experience and other qualifications." (will add cross-reference to SEC study story)

House Committee Approves Data Security Legislation

A House panel approved a bill supported by the banking industry that would establish a national data security and breach notification standard to protect consumers' financial data.


Rep. Randy Neugebauer (R-Texas)

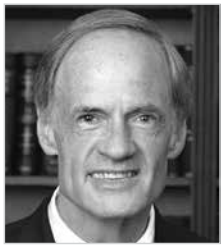
The House Financial Services Committee voted 46-9 for the Data Security Act of 2015 (H.R. 2205) during a markup. The measure, sponsored by Reps. **Randy Neugebauer** (R-Texas) and **John Carney** (D-Del.), is meant to strengthen protections for consumers against identity theft and fraud. It would direct any individual, corporation or nongovernmental entity that interacts with sensitive consumer financial or other nonpublic data to develop an information security plan to protect consumers' personal information.


Rep. John Carney (D-Del.)

Having been approved by the Financial Services Committee, the bill now goes to the House Energy and Commerce Committee, to which the legislation was jointly referred by the House parliamentarian.

Carney said during the December 9 markup that the current collection of state data breach laws isn't protecting consumers—and it's not supporting business. "Right now, data breach laws are a patchwork of these state approaches," Carney said. "Consumers and the companies that handle their personal financial data need to know the rules of the road when it comes to the standard for protecting data."

However, the **Consumer Federation of America** (CFA) and 16 other consumer organizations sent a letter dated December 7 to the committee opposing the bill, which they said would eliminate stronger existing state protections and prevent future state innovation.


Sen. Tom Carper (D-Del.)

A similar bill in the Senate (S. 961) would require individuals, corporations or other nongovernment entities that access, maintain, communicate or handle sensitive account information or nonpublic personal information to implement an information security program.

The Senate measure, sponsored by Sen. **Tom Carper** (D-Del.), also would require notification to consumers, federal law enforcement, appropriate administrative agencies, payment card networks and consumer reporting agencies of certain data breaches of unencrypted sensitive information likely to cause identity theft or fraudulent transactions on consumer financial accounts.

Contact IAA Vice President for Government Relations Neil Simon at neil.simon@investmentadviser.org or (202) 293-4222 to share your views or to obtain more information about these or other government relations matters.

Welcome New IAA Members!

The IAA is pleased to introduce the firms listed below that have recently joined the Association. Membership in the IAA currently stands at nearly 600 SEC-registered investment advisory firms that collectively manage $16 trillion for a wide variety of individual and institutional clients.

Join us in welcoming these 12 new members:

Brouwer & Janachowski, LLC — *Tiburon, CA*
Invest Financial Corporation — *Tampa, FL*
Investment Centers of America, Inc. — *Appleton, WI*
Jackson National Asset Management, LLC — *Lansing, MI*
LWI Financial Inc. — *San Jose, CA*
Macro Consulting Group — *Parsippany, NJ*
Monte Financial Group LLC — *Gulford, CT*
National Planning Corporation — *El Segundo, CA*
PPM America, Inc. — *Chicago, IL*
SII Investments, Inc. — *Appleton, WI*
The Tarbox Group, Inc. — *Newport Beach, CA*
Train, Babcock LLC — *New York, NY*

We also welcome these new associate members:

CFA Institute — *New York, NY*
Godfrey & Kahn, S.C. — *Milwaukee, WI*
Perkins Coie LLP — *Seattle, WA*
TD Knowles + Associates, PLLC — *Bellingham, WA*